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Highlights of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005

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On April 20, 2005, President George W. Bush signed into law Senate Bill 256, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. The reform legislation implements sweeping changes to the bankruptcy laws. The majority of the provisions of the reform legislation will become effective in October of this year.

While the popular press has highlighted the provisions of the reform legislation that will make it more difficult for individuals to seek bankruptcy relief, the legislation contains a wide variety of significant changes to bankruptcy practice. Some of the significant aspects are set forth below:

Consumer Provisions

Credit Counseling: Under the reform legislation, no individual may file for bankruptcy relief without having received credit counseling from an "approved non-profit, budget and credit counseling agency" within 180 days of the filing. (Section 109(h)).

Debtor Education: An individual will not be able to obtain a discharge under Chapter 7 or Chapter 13 unless the debtor has completed an education course in personal financial management approved by the United States Trustee. (Sections 727,1328)

The Means Test: Perhaps the most significant change enacted by the legislation is the requirement that an individual comply with a "means test" to be eligible for Chapter 7 relief. Under revised Section 707(b) of the Bankruptcy Code, a Chapter 7 case can be dismissed if the debtor's income is greater than the state median income. Abuse warranting dismissal of the Chapter 7 case or conversion to Chapter 13 is presumed if the debtor's monthly income, less expenses, falls above a threshold amount. This presumption of abuse may only be rebutted by the debtor showing “special circumstances that justify additional expenses or adjustments of current monthly income.”

Limitation on Discharge: A Chapter 7 debtor cannot receive a discharge if a prior discharge was received within eight years of the new filing (expanded from the current six-year period). (Section 727) A discharge will not be granted in Chapter 13 if the debtor obtained a discharge in Chapter 7, 11 or 12 within four years of the filing date, or a Chapter 13 discharge within two years of the filing date. (Section 1328)

Homestead Exemptions: In an attempt to combat the practice of debtors shielding assets by buying property in states with large homestead exemptions (such as Florida or Texas), revised Section 522(b)(3)(A) provides that the debtor may elect state exemptions only in the state in which they have lived for the 730 days prior to the bankruptcy. If the debtor moved during that 730-day period, the state exemptions are those where the debtor lived for the majority of the 180 days prior to the 730-day period. A $125,000 cap is imposed on the homestead exemption for property that was acquired within 1,215 days of the filing. Other limitations to the homestead exemption are imposed if the debtor has violated security laws, engaged in criminal conduct or fraudulently converted non-exempt assets to an exempt homestead (Sections 522(o), (p), (q)).

Limitations on the Automatic Stay: The reform legislation contains major limitations on the automatic stay contained in Section 362 of the Bankruptcy Code. Among the significant changes are the following:

- The stay will not prevent an eviction action from proceeding in certain circumstances;
- The stay is terminated where the debtor has engaged in serial bankruptcy filings;
- The stay terminates if the debtor does not timely file a statement of intention with regard to property subject to a security interest;
- The stay does not apply to a variety of domestic relations/domestic support obligations;
- The stay does not apply to the ability of a taxing authority to offset against refunds;
- The stay does not apply where the court finds that the filing was part of a scheme to hinder, delay or defraud a creditor holding a secured claim against the real estate.

Attorney Certifications: A new provision that will no doubt cause concern to bankruptcy practitioners is the amendment to Section 707(b)(4) requiring counsel for the debtor to make “reasonable inquiry to verify that the information contained” in pleadings, petitions, and motions is “well grounded in fact.” This section further provides that the signature of an attorney on the petition shall constitute a certification that the attorney has no knowledge after an inquiry that the information in the schedules filed with such petition is incorrect. Violation of these requirements could subject the debtor's counsel to Rule 9011 sanctions.

Business Bankruptcy Provisions

Leases of Non-Residential Real Property: Section 365(d) of the current Bankruptcy Code provides that leases are deemed rejected unless the debtor-in-possession or trustee assumes the lease within 60 days of the commencement of the bankruptcy case. The bankruptcy court can extend this 60-day period for cause. There is no limit on the number or length of extensions that the bankruptcy court may grant.

Amended, Section 365(d) grants the debtor or trustee 120 days to assume or reject. Without the consent of the land-lord, this period may only be extended for one additional 90-day period, upon a showing of cause. Section 365(b) has been amended to make clear that the requirement to cure defaults does not apply to non-monetary defaults that are incapable of being cured, with the exception of defaults relating to failure to operate in accordance with the lease.

Amended Section 503 provides that if a debtor assumes a non-residential real property lease and later rejects it, the landlord is entitled to an administrative priority claim for rejection damages. The amount of the administrative claim is capped by the rent due under the lease, without acceleration, for the greater of one year or 15 percent of the remaining term of such lease (not to exceed three years) plus the amount of unpaid rent due as of the date of the bankruptcy filing.

Exclusivity: Current Section 1121 of the Bankruptcy Code gives a Chapter 11 debtor the exclusive right to file a plan of reorganization during the first 120 days of the case. If a plan is filed within this exclusive period, the debtor is automatically granted an additional 60 days to solicit acceptance of the proposed plan. During this 180-day period, no other party may file a competing plan. The bankruptcy court may, for cause, enlarge (or reduce) the exclusivity period. No limit is placed on the number or length of such extensions.

New Section 1121 retains the 120 and 180 exclusivity periods but prohibits the bankruptcy court from extending these periods beyond 18 and 20 months, respectively.

Utility Services: Section 366(a) of the current Bankruptcy Code prevents a utility company from discontinuing service to a debtor solely on the basis of the debtor's failure to pay a pre-petition debt. In return, a utility company is entitled to receive adequate assurance of future payment within 20 days of the commencement of the case.

New Section 366 requires that adequate assurance of payment be in the form of cash deposits, a letter of credit, a certificate of deposit, a surety bond, a prepayment of utility consumption or some other form of security mutually agreed upon between the utility and the debtor. New Section 366 also makes clear that a utility may alter, refuse, or discontinue utility service if, during the 30-day period beginning on the date of the filing of the petition, the utility does not receive from the debtor adequate assurance of payment for utility service that is satisfactory to the utility. The debtor may request that the bankruptcy court modify the amount of an assurance of payment. New Section 366 also allows a utility to set off against 11 security deposit made by the debtor before the commencement of the bankruptcy case with-out notice or order of the court.

Employee Retention Issues: In recent years, key employee .retention plans (KERPs) have become a frequent tool in large Chapter 11 cases. The purpose of such programs is ostensibly to minimize turnover, attract competent new employees and motivate key employees to work diligently and productively to maximize enterprise value and achieve a successful reorganization.

New Section S03(c) provides that no such payments shall be made, absent a finding by the bankruptcy court that the employee has a bona fide job offer from another business at the same or greater rate of compensation and that the employee's services are essential to the business. The amount of compensation is also limited by a formula pegged to bonuses paid to non-management employees or bonuses paid to management personnel in the year prior to payment of KERP compensation. In addition, severance payments may be made to insiders only as part of a program applicable to all full-time employees, and in an amount not greater than 10 times the amount of mean severance given to non-management employees during the calendar year in which the payment is made.

Reclamation Rights and Administrative Expenses: Under current Bankruptcy Code Section S46(c), a creditor who sells goods to an insolvent debtor may demand reclamation of such goods within 10 days after the debtor receives the goods, or within 20 days after the debtor's receipt if the 10-day period expires after the debtor's bankruptcy filing.

Amended Section 546(c) significantly expands a seller's reclamation rights by providing that if an insolvent debtor receives goods within 45 days before it files for bankruptcy, the seller has 45 days from the date of receipt to demand reclamation. If the 45-day period expires after the debtor's bankruptcy filing, the seller may assert a reclamation claim within 20 days after the filing date. In another significant change from current law, the amendment also provides that even if a seller does not assert a reclamation claim, it may assert an administrative expense claim (which has priority over most other claims) for the value of any goods received by the debtor within 20 days before the bankruptcy filing.

Amended Section 503 grants administrative priority treatment for the actual and necessary costs and expenses of closing a healthcare business (including disposition of patient records and transfer of patients to another facility) incurred by a trustee, federal or state agency, or a political subdivision.

Preferences and Fraudulent Transfers: Section 547(c) (2) of the Bankruptcy Code provides an ordinary course of business exception to a creditor's liability for preferential transfers. Currently, in order to qualify under the ordinary course of business exception, a transfer must have been made (i) in the ordinary course of business of the debtor and the creditor and (ii) according to the ordinary business terms prevailing in the relevant industry.

The amendment to Section 547(c)(a) changes the and to or, thus making the ordinary course of business exception applicable if the transfer was made either (i) in the ordinary course of business of the debtor and the creditor or (ii) according to the ordinary business terms prevailing in the relevant industry. Amended Section 547 also adds a provision that exempts from preference liability payments by a business entity to a creditor that aggregate less than $5,000. Amended Section 547 also extends the time period during which a purchase money security interest may be perfected without being deemed a preference from 20 days to 30 days after the debtor receives possession of the property covered by the security interest.

Under current law, Bankruptcy Code Section 548 allows a debtor to avoid fraudulent transfers made within one year before the bankruptcy filing.

Amended Section 548 expands the look-back period to transfers made within two years before the bankruptcy filing for cases filed more than one year after the enactment of the new legislation. Amended Section 548 specifically includes among avoidable transfers any transfer made to or for the benefit of an insider under an employment contract and not in the ordinary course of business, regardless of whether the debtor was insolvent at the time of such transfer. For all cases filed on or after the date of the enactment, amended Section 548 also adds a provision that allows the avoidance of transfers of a debtor's property to a self-settled trust or similar device of which the debtor is a beneficiary, if the debtor made the transfer with the intent to defraud its creditors, including transfers made in anticipation of a judgment or penalty for a violation of securities laws.

Grounds for Dismissal or Conversion and Appointment of Trustee: Under current Bankruptcy Code Section 1112, the bankruptcy court has discretion to convert a Chapter 11 case to a case under Chapter 7, or dismiss a case, for cause. The statute identifies several non-exclusive factors that may constitute such cause.

Amended Section 1112 provides that, unless unusual circumstances demonstrate that conversion or dismissal is not in the best interests of the estate, the court must convert or dismiss the case if cause is demonstrated. The definition of cause has been expanded to include grounds not previously specified.

Current Section 1104(a) of the Bankruptcy Code provides that the court may appoint a trustee if cause is shown, or if it is in the best interests of creditors and parties in interest.

Amended Section 1104 expands the grounds for the appointment of a trustee by giving the court the discretion to appoint a trustee if grounds exist to convert or dismiss the case, but the court determines that the appointment of a trustee is in the best interests of creditors. The amendment also provides that, for cases filed on or after the enactment of the new legislation, the United States trustee must move for the appointment of a trustee if there are reasonable grounds to suspect fraud by the debtor's management or board of directors.

These sweeping changes to existing bankruptcy law will certainly change bankruptcy practice significantly. It has been 25 years since the enactment of the Bankruptcy Code in 1979. The courts have continued to find new interpretations and applications to that 25-year-old legislation. There is no question that the full impact of the bankruptcy reform legislation will not be known until the courts begin to apply and interpret the statute.

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