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What Is New In The Bankruptcy Abuse Prevention And Consumer Protection Act Of 2005

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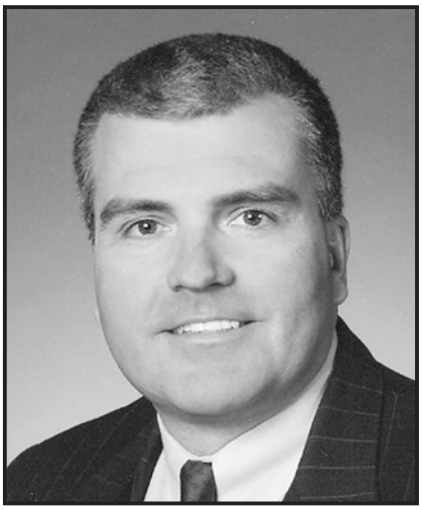
Introduction

On April 20, 2005, President Bush signed the *Bankruptcy Abuse Prevention and Consumer Protection Act of 2005* (the "Amendments") making sweeping changes to a variety of the provisions of the United States Bankruptcy Code (the "Code" or the "Bankruptcy Code"). While the general effective date of the Amendments was October 17, 2005, certain of the Amendments were effective immediately upon enactment and, as noted below, one provision is not effective until April 20, 2006.

While most of the news coverage of the Amendments has focused upon the ability of individual consumer debtors to seek refuge in the Bankruptcy Court from credit card debt and medical bills, the Amendments also make significant changes impacting commercial or business debtors and their creditors. In this article, we analyze three areas that we have found are of particular significance to creditors when their customers file bankruptcy: Preference exposure, Fraudulent Transfer claims and Reclamation issues.

Enhanced Preference Defenses

Perhaps no commercial law remedy is more irksome to businesses than the Bankruptcy Code's preference action provided by section 547. Once an account debtor goes into bankruptcy, leaving the creditor with an unpaid receivable that will likely see, at best, a token recovery, insult is added to injury when a trustee or creditors' committee sues for recovery of all payments received in the 90 days prior to bankruptcy. However, the Bankruptcy Code has been amended in several ways that will benefit creditors who find themselves on the defensive side of a preference complaint. While the changes do not eliminate the burden of this unpopular statutory cause of action, they do slightly shift the playing field in the creditor's favor.



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First, the "ordinary course of business defense" set forth in section 547(c)(2) has been liberalized to require that a defendant show only that the alleged preferential transfer was made in payment of a debt incurred by the debtor in the ordinary course and *either* (1) was made in the ordinary course of business between the debtor and the creditor, *or* (2) was "made according to ordinary business terms," meaning the ordinary business terms prevailing in the debtor's industry. The pre-Amendment formulation of the ordinary course defense required a showing of both of the latter elements. Thus, the amended provision permits the defendant to establish the defense by a showing that the payment terms in issue were consistent with the debtor's payment history. This is often more straightforward than proving the "industry standard" prong, which may require extensive discovery, expert testimony and attendant expense.

Second, the Amendments add a new pro-

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vision which makes transfers to one creditor aggregating *less than $5,000* during the 90-day preference period *immune* from attack as preferences in a business case and thus unavoidable. This section eliminates what has become a routine practice of many estate counsel of pursuing even minimal transfers as preferences. However, some trustee and committee counsel will likely attempt to aggregate groups of sub-$5,000 transfers to affiliated defendant creditors in an effort to avoid the limitation. The Courts' reception of such efforts remains to be seen.

Third, the Amendments expressly overrule the holding in *In re Deprizio*, 874 F.2d 1186 (7th Cir. 1989), which expanded the "reach back" period for a noninsider's preference liability from 90 days to one year pre-petition, on evidence that the transfer benefited an insider guarantor. *Deprizio* had been the subject of the 1994 amendments to the Code, but the 1994 change left open an ambiguity regarding the potential liability of a noninsider transferee of a preference. The Amendments clarify that, during the expanded one-year period, the estate can recover the value of the preferential transfer only from the insider for whose benefit the transfer was made, and not from the noninsider. Note that this amendment was made *effective immediately upon the enactment of the Amendments*, and thus applies to any case that was *pending or commenced on or after April 20, 2005*.

Fourth, the preference defense that protects a debtor's grant of a security interest to secure new value given by a secured creditor has been enhanced by increasing from 20 to 30 days the period during which the new security interest must be perfected to protect the security interest from preference attack. The date of the transfer of the security interest is the date that the grant is made, and not the later date when perfection occurs. Similarly, the Amendments increase the time in which a secured creditor has to perfect a security interest after the grant thereof from 10 to 30 days. If the creditor timely perfects, the transfer for purposes of the statute is the initial date of the grant of the security interest.

Finally, the statute which governs venue of avoidance actions has been amended to provide that actions to recover amounts *less than $10,000* from a noninsider can be filed "only in the district court for the district in which the defendant resides." This means that, unlike the prior venue provision, whereby all preference actions could be brought in the Bankruptcy Court where the debtor's case was pending, preference actions against noninsiders for less than $10,000 related to cases filed on or after October 17, 2005 must be commenced in the defendant's home district. This change is obviously intended to discourage preference actions at this level unless there is effectively a lack of any valid defense.

Expanded Grounds To Attack Fraudulent Transfers

One significant change to the Bankruptcy Code's fraudulent transfer statute is the increase of the "reach back" period from one to two years, permitting the estate to seek recovery under federal law of fraudulent transfers made up to two years prior to bankruptcy. This change, which is effective only in cases filed *on or after April 20, 2006*, brings the federal statute more in line with analogous state statutes, many of which provide a "reach back" period of four years. While estates have always been able to seek recovery of fraudulent transfers under the longer state law reach back periods, state statutes vary considerably from the Bankruptcy Code provision. Thus, depending upon applicable state law, the amendment may significantly expand a bankruptcy estate's avoidance powers.

The Amendments also add a provision that permits bankruptcy estates to avoid transfers made to insiders under employment contracts that were entered into outside the ordinary course of business and for less than fair consideration. This change gives bankruptcy estates the power to unwind "golden parachute" and similar executive compensation packages entered into to the detriment of a debtor and its creditors. This amendmentwas made *effective immediately*, and applies to any case filed on or after April 20, 2005.

Finally, a provision has been added to the Code to permit a bankruptcy estate to seek recovery of a transfer by a debtor during the ten years prior to the bankruptcy filing to a "self-settled trust or similar device" of which the debtor is a beneficiary, and made with the intent to hinder, delay or defraud creditors. The targeted transfers include those intended to avoid liability for securities fraud claims and penalties. As such, the Amendments evidence Congressional intent to unwind trusts set up by affluent debtors in an effort to avoid paying criminal and civil penalties and judgments arising from securities law violations.

Expanded Rights Of Reclaiming Sellers

Before the October 17, 2005 effective date of the Amendments, the Bankruptcy Code allowed sellers to reclaim goods delivered to an insolvent debtor before the filing of the bankruptcy petition by service of a written reclamation notice within 10 days after the debtor's receipt of the goods. That 10 day period was previously extended to 20 days if the initial 10 day period has not expired on the petition date.

The Amendments include a number of changes that enhance a reclaiming seller's rights by expanding the reclamation period as well as the corresponding notice period to 45 days, so that the reclaiming seller may make written demand for reclamation of goods received by an insolvent debtor up to 45 days after the debtor's receipt of the goods. The Amendments further provide that, where the 45-day period expires after the commencement of the bankruptcy case, a reclaiming seller has until 20 days after the petition date to make a reclamation demand. This provision does *not* provide that a reclaiming seller can demand return of its goods by the *later* of either (i) 45 days after receipt or (ii) within 20 days after the commencement of the case. Instead, the 20th day after the petition date is an absolute deadline, and is not extended if, for instance, the initial 45 day period had 35 days to run as of the petition date. Thus, all reclamation demands must be (i) in writing, and (ii) made not later than 20 days after the commencement of the case

In another important change, sellers who do not send timely reclamation demands will nonetheless be entitled to an administrative expense claim for the value of goods received by the debtor within 20 days before the commencement of the case, provided that the sale was in the ordinary course of the debtor's business.

Prior to the enactment of the Amendments, the Bankruptcy Code specifically provided that if the Court denied the seller the right to physically reclaim the goods, the reclaiming seller was to be granted either a lien or an administrative priority. The Amendments have deleted this statutory recitation of remedies, leaving unspoken the remedy for a reclaiming seller who supplied goods to the debtor between 20 and 45 days prior to the filing date, where the goods are not available for return to the seller.

Finally, a reclaiming seller's rights are now expressly subject to the rights of a holder of a security interest in the goods or their proceeds.

Conclusion

The foregoing summarizes just a few of the Amendments' changes to the Bankruptcy Code that are of interest to commercial creditors. As the changes have just become effective, the Bankruptcy Courts are just beginning to interpret the Amendments as they apply to cases before them. Accordingly, the Amendments' impact upon the business community merits further scrutiny.