

THE EFFECT OF THE 2005 BANKRUPTCY CODE AMENDMENTS ON PERSONAL PROPERTY SECURED TRANSACTIONS IN BUSINESS CASES

Gabriel R. Safar and Edwin E. Smith
Bingham McCutchen LLP

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The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "Act") was signed into law on April 20, 2005. Its provisions generally became effective on October 17, 2005. The Act makes significant changes to Title 11 of the United States Code (the "Bankruptcy Code") and some related statutes. The following is a brief summary of the effect of the Act on personal property secured transactions in business cases.

I. PROVISIONS OF THE ACT THAT DIRECTLY IMPACT SECURED TRANSACTIONS

Reclamation of Goods. Revised § 546(c) provides that, subject to the rights of secured parties, a seller of goods has a right to reclaim goods received by the debtor within 45 days before the commencement of the case. The seller must provide written notice of intent to reclaim the goods not later than 45 days after the date of the debtor's receipt of the goods, or not later than 20 days after the date of commencement of the case if the 45 day period expires after the commencement of the case. The revised section may create a federal right of reclamation in bankruptcy, but some commentators have suggested that it merely expands the time period for exercising state law reclamation rights under UCC § 2-702. Of course, if the reclamation notice is provided after the goods have been sold or processed, the seller will have no reclamation right. Moreover, even if the goods have not yet been sold or processed, the seller's reclamation right will be subject to the rights of a secured party having a security interest in the goods. Accordingly, the reclamation right will be meaningful only if the secured party is otherwise fully secured. Arguably, a reclaiming seller may seek a valuation of the secured party's other collateral in order to exercise its reclamation right. However, given that bankruptcy courts, debtors and other creditors are often reluctant to force valuations too early in a case, it is possible that a reclaiming seller may be offered an administrative claim or junior lien on other collateral contingent on it being later determined that the secured party was otherwise fully secured. See also the discussion of new § 503(b)(9) below.

Preference Actions. The Act contains significant amendments to § 547 that make it more difficult for trustees to avoid transfers to secured parties as preferences. Among those amendments are the following:

- *Transfers to Non-Insiders for the Benefit of Insiders.* Under revised § 547(i), if the debtor makes a transfer to a non-insider for the benefit of an insider during the period between ninety days and one year prior to the

commencement of the bankruptcy case, the trustee can avoid the transfer as a preference only with respect to the insider and not with respect to the non-insider transferee. The revision completes the task of statutorily reversing In re DePrizio, 874 F.2d 1186 (7th Cir. 1989)(debtor's payment to non-insider creditor outside of the 90-day preference period, but within the one-year insider preference period, that reduced the liability of an insider guarantor could be recovered from the non-insider creditor). See also § 550(c).

- *Extended Periods for Deferred Perfection.* Revised § 547(e)(2)(A) increases the safe harbor period from 10 to 30 days for a secured party to perfect its attached security interest, so that the transfer for preference purposes will occur on the date of attachment. In addition, revised § 547(c)(3) increases the “purchase-money defense” time period, in which a secured party must perfect a purchase-money security interest, from 20 to 30 days after the debtor receives the collateral. However, these revisions apply only to preferences. The secured party must still perfect its purchase-money security interest within the 20-day period required by UCC § 9-317(e) to prevail over an intervening lien creditor, including a bankruptcy trustee under § 544(a), and must timely take the perfection and other steps required by UCC § 9-324 to prevail over an earlier filed secured creditor with a security interest in after-acquired collateral encompassing the purchase-money collateral. Moreover, a non-purchase money secured party will still need timely to comply with the normal Article 9 perfection and priority rules in order to prevail over a lien creditor, including a bankruptcy trustee under § 544(a), and over a competing secured party.
- *Expanded Ordinary Course Defense.* Revised § 547(c)(2) reduces the number of elements needed to establish an “ordinary course of business” defense to the trustee’s action to avoid a payment as a preference. Under former § 547(c)(2), the transferee of the payment was required to establish that the debt was incurred in the ordinary course, the payment was made in the ordinary course, and that the payment was made according to ordinary business terms. Revised § 547(c)(2) provides that the transferee must now only show that the debt was incurred in the ordinary course, and *either* the payment was in the ordinary course *or* the payment was made according to ordinary business terms. The revised § 547(c)(2) will broaden the ordinary course of business defense for a secured party receiving payments of principal and interest on its secured loan. The broadened defense will be especially valuable to a secured party that is unable to demonstrate that the payment came from the secured party’s collateral and therefore had no preferential effect under § 547(b)(5).

- *De Minimus Standard.* Section 547(c)(9) has been added to the Bankruptcy Code to provide that the trustee may not avoid a transfer as a preference if the value of the transfer is less than \$5,000. The new section will enable a secured party to defend a preference action for a payment during the preference period on its secured loan of less than \$5,000 or on the attachment or perfection during the preference period of a security interest in collateral of less than \$5,000 in value. It is unclear whether the \$5,000 threshold refers to a single transfer or whether multiple transfers during the preference period must be aggregated.
- *Restricted Commercial Venue.* 28 USC § 1409(b) has been amended to provide that a trustee in a case under Title 11 must commence a proceeding to collect a debt of less than \$10,000 against a non-insider in the district court for the district in which the defendant resides. A proceeding to collect a debt includes an action by the trustee to avoid a payment to a secured party as a preference. Unless there are numerous alleged preferences from defendants residing in a single district, even the appointment of a local counsel to pursue small preferences may not be warranted.

Fraudulent Transfer. Revised § 548 expands the prepetition period in which the trustee may avoid a fraudulent transfer by extending the federal look-back period for avoidable fraudulent transfers from 1 year to 2 years before the commencement of the case. The amendment is effective on April 21, 2006.

Financial Contracts. The amendments expand the scope of the “safe harbor” financial contract provisions by which derivative and other financial contract transactions - securities contracts, swaps, forwards, commodity contracts and repurchase agreements - are not subject to the automatic stay, preference provisions or constructive fraudulent transfer provisions of the Bankruptcy Code. The definitions of the various contracts protected by the provisions are broadened, the market players who can benefit from the provisions are expanded, and cross-product netting is permitted. Coordinating amendments were made to the Federal Deposit Insurance Act (FDIA), the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) and the Securities Investor Protection Act of 1970 (SIPIC). The provisions affect financial contracts secured by security interests in deposit accounts, investment property and other collateral.

Cross-Boarder Insolvencies. The Act creates a new chapter of the Bankruptcy Code, Chapter 15, to deal with issues relating to cross-boarder insolvencies. Of particular importance for secured parties are §§ 1521(a)(5) and 1522(a). Section 1521(a)(5) provides that upon recognition of a foreign proceeding, a US court may permit a turnover of the debtor’s assets within the United States, including a secured party’s collateral, to the foreign representative. However, under § 1522(a), a US court may permit a turnover to the foreign

representative only if the creditors and other interested entities are “sufficiently protected.” The meaning of “sufficiently protected” for a secured party is likely to be given a meaning equivalent to “adequate protection” in the context of § 363(e).

Single Asset Real Estate Debtors. The definition of “single asset real estate” for purposes of stay relief under § 362(d)(3) is amended to eliminate the prior \$4,000,000 secured debt cap. The definition basically refers to a debtor that owns a single real estate project generating substantially all of the debtor’s gross income and as to which the business conducted is substantially limited to a real estate operation. Single asset real estate would include a commercial rental property but only a residential rental property with four or more residential units. The changes to § 362(d)(3) will require more qualifying debtors, in order to avoid the lifting of the automatic stay, to file a reorganization plan more quickly or to pay any real estate secured lender, as adequate protection, ongoing monthly interest on its loan at the applicable non-default contract rate. A real estate secured lender may include a personal property secured party with a security interest in fixtures.

II. PROVISIONS OF THE ACT THAT INDIRECTLY IMPACT SECURED TRANSACTIONS

Administrative Expenses and Priorities. Many of the Act’s revisions to the Bankruptcy Code’s administrative expense and priority sections increase the debtor’s cash obligations to confirm a plan in a Chapter 11 case. Increasing these cash obligations may deter a debtor from filing a Chapter 11 case or may result in more § 363 asset sales without a plan or in courts dismissing Chapter 11 cases or converting more Chapter 11 cases into Chapter 7 cases. They may also in some cases, as a practical matter, force secured parties that wish to use Chapter 11 as a means of liquidating their collateral to bear these larger expenses as a “tollgate tax” for using the Chapter 11 process. Among the revisions to the administrative expense and priority sections that increase the debtor’s cash obligations in order to confirm a plan are the following:

- *Goods Sold in the Ordinary Course and Non-Reclaimed Goods.* Revised § 503(b)(9) grants the seller of goods an administrative expenses claim for the value of any goods sold to the debtor in the ordinary course of the debtor’s business and that the debtor receives within 20 days before the commencement of the case. A seller of goods that fails to give a timely reclamation notice under revised § 546(c) may still assert its rights under revised § 503(b)(9).
- *Employee Wage and Benefit Priorities.* Revised § 507(a)(4) expands the wage priority for each qualifying individual up to \$10,000 (from \$4,925) earned within 180 (from 90) days before the petition date. Similarly, § 507(a)(5) enhances priority claims for contributions to employee benefit plans.

- *Tax Claimants.* The Act amends § 1129(a)(9)(C) to provide that tax claims must be paid within 5 years after the date of entry of the order for relief, and the taxing authority must be paid in a manner not less favorable than other non-priority unsecured claims provided for by the plan. The Act also creates a new section of the Bankruptcy Code, § 511, to provide that the rate of interest on a tax claim, or the payment of interest to enable a creditor to receive the present value of the allowed amount of a tax claim, shall be the rate determined under applicable nonbankruptcy law. The provisions would affect secured, administrative and priority tax claims.
- *Patient Care and Consumer Privacy Ombudsmen.* Under newly created § 333, if the debtor is a health care business, the court is required to appoint an ombudsman to monitor the quality of patient care and to represent the interests of the patients. Under revised § 363(b), in certain circumstances, a court is required to order the appointment of a consumer privacy ombudsman to protect consumers' privacy in the context of § 363 sales. The expenses of a patient care or consumer privacy ombudsman will be administrative expenses and may put pressure on secured parties to increase their "carve outs" to provide for such expenses.

Standards for Conversion or Dismissal of a Chapter 11 Case. Amendments to § 1112(b) increase the probability that a Chapter 11 case will either be dismissed or converted into a Chapter 7 case, whether at the request or over the objection of a secured party. Among those revisions are the following:

- *Increased Grounds for Dismissal.* Revised § 1112(b) expands the grounds for conversion or dismissal of a Chapter 11 case by increasing the non-exhaustive list of "causes" for conversion or dismissal, including, for example, unauthorized use of a secured party's cash collateral after the order for relief.
- *Restricting the Court's Discretion.* Revised § 1112(b) requires a court to convert or dismiss a Chapter 11 case if a movant establishes cause, unless certain exemptions provided in the statute are met. Former § 1112(b) granted a court the discretion to either dismiss or convert the case, or do neither.
- *Expedited Process.* Revised § 1112(b) requires a court to hold a hearing within 30 days after the filing of a motion requesting conversion or dismissal, followed by a decision within 15 days after the hearing.

Debtor's Bargaining Power in a Chapter 11 Case. Various amendments throughout the Act reduce the debtor's bargaining power with its creditors in a Chapter 11 case:

- *Exclusive Period to File Plans.* Revised § 1121(d) limits the period of time during which the debtor can exclusively file a plan and solicit votes. Under revised § 1121(d) the 120 day exclusive period to file a plan may not be extended beyond a date 18 months after the order for relief and the 180 day exclusive period to solicit votes may not be extended beyond a date 20 months after the order for relief. By limiting the length of the debtor's exclusive periods, the changes may increase the opportunity for a secured party to file its own plan. The changes may also, of course, increase the opportunity for a creditors' committee or other interested person to file a plan in competition with a plan of the secured party or even the debtor, thus increasing the costs and duration of the Chapter 11 case.
- *Assumption and Rejection of Nonresidential Leases.* Revised § 365(d)(4) expands the amount of time in which a debtor must assume or reject a nonresidential real property lease from 60 to 120 days from the date of the order for relief. However, the provision limits the court's ability further to extend that period. Under revised § 365(d)(4), a court for cause may extend the period to assume or reject a nonresidential real property lease for only ninety days (from the initial 120 days) and any subsequent extension may be granted only with the prior written consent of the landlord in each instance. These changes may have a significant impact on debtors that might have off-balance sheet value in below-market nonresidential real estate leases, such as multi-store retailers, by causing premature assumptions or rejections of leases. They may also result in more negotiated bargains with landlords for debtors to obtain the landlords' consents to further extensions of time for the debtor to assume or reject. In addition, the changes may have a significant impact on the debtor's inventory financing since an inventory lender may require that the duration of its credit facility be shortened in the event that the time to assume or reject a lease of real property on which the inventory is located is not extended.
- *Utilities.* Subject to its receiving adequate assurances of payment within 20 days after the order for relief, a utility may not under § 366 alter, refuse or discontinue service to a debtor solely on the basis of the commencement of a bankruptcy case or the debtor's prepetition default in payment. Section 366(c) defines "adequate assurances". The Act's amendments to that section make clear that, among other things, the mere availability of an administrative expense priority is not sufficient. The changes should result in a debtor's greater need for cash deposits or letters of credit to secure utility obligations and could affect the debtor's borrowing needs. The changes in the law may be especially difficult for manufacturing debtors with high utility charges and for retail debtors with many locations.

Transfers by a Nonprofit Charitable Organization. Revised § 363(d) provides that sales of property by a debtor that is a non-profit charitable corporation or trust must be made in accordance with applicable nonbankruptcy law that governs transfers by such entities. This change may reduce the number of § 363 sale potential buyers of the assets of such a debtor in which a secured party has a security interest.