

Bankruptcy and Creditors' Rights Update

Recent Bankruptcy Reform Legislation is Not Limited to Consumer Bankruptcies: A Summary of Significant Changes Affecting Business Interests

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On April 20, 2005, President Bush signed into law the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, which amended parts of the U.S. Bankruptcy Code. While much of the media attention on the new law has focused on its effect on consumer bankruptcies, the new law impacts almost every area of bankruptcy practice. This Bankruptcy Update highlights some of the significant provisions of the new law affecting business interests. These include amendments that:

- Expand the bankruptcy trustee's power to set aside fraudulent transfers;
- Restrict the trustee's ability to assert preference claims;
- Limit the scope and application of the automatic bankruptcy stay;
- Change the time limits for rejecting or assuming an unexpired lease of nonresidential real estate; and
- Create special procedures for debtors classified as a "small business."



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Generally, the new law will only apply to bankruptcy cases filed on or after October 17, 2005, but as noted below some provisions have different effective dates or will apply to all cases.

Changes Involving Fraudulent Transfers



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Section 548 of the Bankruptcy Code has been amended in several respects to give the trustee greater power to set aside "fraudulent transfers" for the benefit of creditors.

First, the look-back period for setting aside fraudulent transfers has been extended from one year to two years. The effect of this amendment is somewhat limited as a practical matter, because: (i) the trustee already has the power to avoid fraudulent transfers under state law pursuant to Section 544(b) of the Bankruptcy Code; and (ii) the look-back period under the law of many states is longer than the two-year period provided by the amendment. For example, the look-back period under Arizona law is four years.

Second, the amendment adds a new type of "constructive" fraudulent transfer that can be set aside. Specifically, a trustee can set aside a transfer: (i) for which the debtor received less than reasonably equivalent value; (ii) that was to or for the benefit of an insider under an employment contract; and

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A HISTORY TO LEVERAGE

(iii) that was not in the ordinary course of business. Although the amendment does not define “ordinary course of business,” the legislative history indicates that the amendment is intended “to enhance the recovery of . . . excessive prepetition compensation, *such as bonuses*, paid to insiders.” Bonuses to insiders, however, are not avoidable as fraudulent transfers per se. Rather, it is only those bonuses for which the debtor receives less than reasonably equivalent value that can be set aside.

Third, the amendment creates an entirely new type of fraudulent transfer. In this regard, a trustee can set aside any transfer made *within ten years before the bankruptcy was filed*, if: (i) the debtor made the transfer to a trust or similar device under which the debtor is both the settlor and the beneficiary; and (ii) the debtor made the transfer with the actual intent to hinder, delay or defraud creditors. The ten-year look-back period is substantially longer than the look-back period provided under the fraudulent transfer laws of many states.

The amendment provides that “transfer” for purposes of this subsection “includes a transfer made in anticipation of any money judgment, settlement, civil penalty, equitable order, or criminal fine incurred by, or which the debtor believed would be incurred” as a result of: (i) a violation of securities laws; or (ii) fraud, deceit, or manipulation in a fiduciary capacity or in connection with the purchase or sale of certain securities. The purpose and effect of this provision is unclear. Although some may argue that the provision narrows the scope of “transfer” for purposes of this new type of fraudulent transfer, such an argument is inconsistent with Section 102 of the Bankruptcy Code, which provides that “includes” is “not limiting.” Given the non-limiting construction of “includes” as well as the Bankruptcy Code’s broad definition of “transfer,” it appears that this new fraudulent transfer avoidance power applies to any type of transfer that fits the criteria set forth above.

Finally, the extension of the look-back period from one year to two years becomes effective with new bankruptcy cases filed on or after one year from the enactment date of the legislation – that is, April 20, 2006. All of the other amendments to this Section became effective immediately when President Bush signed the legislation on April 20, 2005.



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Changes Affecting Preference Litigation

A subtle, but significant, change favorable to defendants in preference litigation was made to Section 547(c)(2) of the Bankruptcy Code. This section contains what is known as the ordinary course defense. Under the former version of the Bankruptcy Code, in order to qualify for the ordinary course defense, the payment must have been made: (i) on a debt incurred by the debtor in the ordinary course of business; (ii) in the ordinary course of business or financial affairs of the debtor and the transferee; and (iii) according to ordinary business terms. In order to establish the defense, all three requirements had to be satisfied.

The second requirement of the defense has been referred to as the “subjective test” in that it examines the specific relationship between the debtor and the transferee. The third requirement of the defense is known as the “objective test,” because it focuses upon industry standards apart from the particulars of the dealings between the parties.

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A HISTORY TO LEVERAGE

Section 547(c)(2) was amended to make it easier for parties subject to preference claims to qualify for the ordinary course defense. Under the amended section, it is no longer necessary to satisfy both the “subjective” and “objective” tests. *Establishing one or the other now is sufficient.* In other words, one may qualify for the ordinary course defense if the payment was made on debt incurred by the debtor in the ordinary course of business and the payment was: (i) in the ordinary course of business or financial affairs of the debtor and the transferee; or (ii) according to ordinary business terms.

Additional changes have been made which make it more difficult for trustees and debtors to pursue smaller preference claims. Initially, Section 547(c)(9) of the Bankruptcy Code was added, which limits the ability to pursue preferences in non-consumer cases to claims of \$5,000 or more. In addition, 28 U.S.C. § 1409, which governs the venue for bankruptcy proceedings, was modified. A provision was added which requires that an action against a non-insider where the claim is less than \$10,000 be brought in the district where the defendant resides. The previous limitations, which remain in effect, require that actions to recover less than \$10,000 or consumer debts less than \$5,000 be brought in the district where the defendant resides, without regard to whether the defendant was an insider.



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Changes Relating to the Automatic Stay

When a petition under any chapter of the Bankruptcy Code has been filed by or against the debtor, virtually all creditor activity advancing the creditor’s interest at the expense of the debtor or the property of the debtor’s estate is automatically stayed. When a bankruptcy case is filed, the Bankruptcy Code automatically creates an injunction or restraining order which immediately stays all efforts, direct or indirect, to collect most types of debts. This injunction or restraining order is called the “automatic stay.” Once the automatic stay is in effect, all creditors are prohibited from: (i) contacting the debtor for the purpose of pursuing non-legal collection efforts such as demand letters, known as “dunning letters”; (ii) pursuing legal collection efforts such as lawsuits for eviction, breach of contract, and other claims against the debtor; (iii) collecting a judgment through garnishment or attachment; or (iv) continuing any actions against the debtor. Recent amendments have curtailed the import of the automatic stay.

Bad news for debtors that previously filed for bankruptcy relief within one year before the present case. The new law limits the application of the automatic stay or provides that it does not go into effect under certain circumstances. Generally, the automatic stay terminates thirty days after the commencement of a Chapter 7, 11 or 13 case if a previous dismissed case was pending within one year before the present case. The automatic stay, however, may remain in effect if the Bankruptcy Court finds that the present case is in good faith. A case is presumed to be in bad faith for this purpose if more than one case was pending under Chapter 7, 11 or 13, and at least one such case was dismissed under certain circumstances. In addition, if two or more previous cases were pending within one year before the present case, the automatic stay does not go into effect, but the automatic stay may be put into effect if the Bankruptcy Court finds that the present case is in good faith.

Good news for residential landlords. The amendments to the automatic stay provide that eviction proceedings are not subject to the automatic stay. This is limited to eviction proceedings only. In other words, the landlord may continue eviction proceedings in state court and ignore the automatic stay.

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A HISTORY TO LEVERAGE

The landlord, however, must still seek relief from the Bankruptcy Court for wage garnishments for back rent, or other efforts to collect money owed to the landlord.

Good news for secured creditors dealing with personal property. If debt is not reaffirmed, then the automatic stay terminates. The automatic stay which stops creditors' actions while the case is pending terminates as to personal property securing a claim if the debtor does not file and perform under a Statement of Intention. With regard to the lack of filing of the Statement of Intention, if the Statement of Intention is not filed within 45 days of commencement of a Chapter 7 or 13 case, the case will be automatically dismissed.

A bit of good news for employers. The withholding from the debtor's earnings of payments on the debtor's loans from pension, profit-sharing, stock bonus, 401(k), or similar plans is not stopped by the filing for bankruptcy relief.



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Changes Affecting Unexpired Leases of Nonresidential Real Estate

Section 365(d)(4) of the Bankruptcy Code was amended to increase the time period by an additional 60 days within which an unexpired lease of nonresidential real estate is deemed rejected. The new law provides that an unexpired lease of nonresidential real estate under which the debtor is the lessee is deemed rejected if not assumed or rejected by the earlier of 120 days after the petition is filed, or the date the plan is confirmed. Before the 120-day period expires, the Court may extend the period for "90 days on the motion of the trustee or lessor for cause."



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New Provisions Relating to "Small Business" Debtors

The new provisions also create a new category of Chapter 11 debtor, known as the "small business" debtor, and subject these small business debtors to a new streamlined set of procedures and plan requirements. Small businesses include persons engaged in commercial or business activities (other than owning or operating real estate) with no more than \$2 million in debt, unless an active creditors' committee has been appointed. These streamlined procedures are balanced against provisions for more active involvement by the U.S. Trustee in assessing the debtor's business plan and profitability, simplified but considerable financial reporting requirements, and expanded grounds for dismissal or conversion to Chapter 7 and appointment of a trustee.

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