

The Bankruptcy Reform Act of 2005

WHAT IT MEANS TO THE CREDIT & FINANCIAL PROFESSIONAL

Scott Blakeley, Esq.



**The
Credit
Research
Foundation**

**An Occasional Paper
July 2005**

Contents

<i>Topic</i>	<i>Page</i>
1. 2005 Act Effective Date	1
2. Rewriting The Preference Laws	1
3. Rewriting The Fraudulent Conveyance Laws	3
4. Rewriting The Involuntary Bankruptcy Petition Law	3
5. Rewriting The Reclamation Law	4
6. The Small Business Bankruptcy Law Provision	5
7. Reviewing An Individual Debtor's Ability to Pay: The "Means Test"	5
8. Expansion Of Bankruptcy Court's Power Over Creditors' Committees	6
9. Debtor Protecting Assets: Asset Protection Trusts, Homestead Exemptions And Retirement Funds	7
10. Earlier Filing Of Plan Of Reorganization	8
11. Early Assumption Of Real Estate Leases	8
12. Adequate Assurance To Utilities	9
13. Appointment Of Chapter 11 Trustee Or Conversion Or Dismissal of Case	9
14. Debtor's Lawyer's Responsibility To Creditors	10
15. Limitations On Key Employee Retention/Severance Programs	10
16. Impact on Bankruptcy Judges	10
17. Cross-Border Insolvencies	10

THE BANKRUPTCY REFORM ACT OF 2005: WHAT IT MEANS TO THE CREDIT AND FINANCIAL PROFESSIONAL

By: Scott Blakeley

After eight years of political wrangling, the U.S. Bankruptcy Code has finally been overhauled, through the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "2005 Act"). So how does the 2005 Act impact you as a commercial creditor? Do you have greater protections and rights as a result of these amendments? What strategies might you consider to maximize payment on a delinquent account where a customer may consider bankruptcy? This paper will address these issues and more.

1) 2005 Act Effective Date (Sections 1406 and 1501)

On April 20, 2005, the 2005 Act was enacted, and most provisions become effective for new cases filed 180 days after this date, which is October 17, 2005.

a) What It Means For Vendors

During the 180 days from enactment of the 2005 Act and the legislation taking effect, vendors may experience more sole proprietor customers and personal guarantors filing Chapter 7. Sole proprietors and guarantors may file Chapter 7 prior to the 2005 Act becoming effective so as to have their debts discharged, rather than risk having their Chapter 7 petition converted to Chapter 13 or dismissed. If converted to Chapter 13, the debtor will have to propose a plan to pay off a portion of their debt as a result of a creditor invoking the means test provision (discussed further in this paper) contained in the 2005 Act. If the bankruptcy case is dismissed, the debtor will have to deal with the creditor's collection efforts, unimpeded by the automatic stay.

2) Rewriting The Preference Laws

The 2005 Act reforms the preference laws in the following ways.

a) Background - What Is A Preference? (Section 547)

The Bankruptcy Code vests a bankruptcy trustee with far-reaching powers to avoid payments to vendors (and other creditors) within 90 days prior to the bankruptcy filing (one year for insiders). The Bankruptcy Code defines a preference expansively to include nearly every payment by an insolvent debtor 90 days prior to bankruptcy. The purposes of the preference laws are two-fold. First, unsecured creditors are discouraged from racing to the courthouse to dismember a debtor, thereby hastening its slide into bankruptcy. Second, a debtor is deterred from preferring certain unsecured creditors by the requirement that any unsecured creditor that receives a greater payment than similarly situated unsecured creditors disgorge the payment so that there may be an equal distribution of a debtor's assets.

b) Minimum Threshold To Sue For A Preference (Section 410)

A vendor sued for a preference for an amount less than \$5,000 poses special problems for the vendor. For the vendor to employ counsel and defend the preference lawsuit may not be cost effective, even if the vendor has valid defenses. Preference suits in this dollar range appear from the vendor's viewpoint as a "shake down" and the beneficiaries of these preference actions appear to be the trustee's professionals. The 2005 Act provides that \$500 is the minimum preference action that may be pursued.

i) **What It Means For Vendors**

This change protects smaller vendors most prone to abusive litigation tactics, and the \$5,000 threshold amount does not undermine the policy supporting equality of treatment of like creditors.

c) **Venue Change:**

Suing The Vendor Where It Has Its Principal Place Of Business (Section 410)

For a vendor whose company is based, say, in California, and sells goods nationally, being sued, for \$5,000 by a bankruptcy trustee where the case is pending, say in Delaware, is inconvenient, and more costly to defend. The 2005 Act requires that a preference action seeking less than \$10,000 must be brought in the bankruptcy court where the vendor has its principal place of business.

i) **What It Means For Vendors**

This change protects vendors from a trustee taking advantage that it will cost the vendor more to litigate the preference given the inconvenient forum. This change of forcing the trustee to litigate in the vendor's home court for amounts between \$5,000 to \$10,000, should require the trustee to carefully consider a vendor's defenses, such as the new value and ordinary course of business before filing suit in a foreign court.

d) **Amending The Ordinary Course Of Business Exception (Section 409)**

The most commonly asserted defense to a preference action by vendors is the ordinary course of business defense. To qualify for the ordinary course of business defense, a vendor must establish both that the payment is ordinary as between the parties, and that the payment is ordinary in relation to prevailing business standards. The court determines a debtor's ordinariness of payments through comparison with prevailing business standards, which includes common terms used by other trade creditors in the same industry facing similar problems.

The policy supporting the ordinary course of business defense is two-fold: (1) protect customary transactions, and (2) encourage creditors to continue to extend credit to financially troubled debtors, possibly helping the debtor avoid bankruptcy.

The 2005 Act makes it easier for the vendor to prove up the ordinary course of business defense by allowing the vendor to establish either that the payment was ordinary between the debtor and the vendor, or that the payment was ordinary in comparison to the terms in the industry. The vendor is no longer required to prove both elements.

i) **What It Means For Vendors**

This provision strengthens the ordinary course of business defense. Provided the debt is incurred in the ordinary course of business, the vendor should prevail assuming that either the payment was in the ordinary course of business between the vendor and the debtor, or that the payment was made according to ordinary business terms.

e) **Extended Period For Creditors to Perfect Security Interest (Section 403)**

The 2005 Act provides a creditor up to 30 days to perfect their lien, thereby reducing the risk that a vendor's act of recording a security interest during the preference period may be challenged as a preference.

i) **What It Means For Vendors**

Vendors that take a security interest, consignment, or purchase money security interest in the goods they sell are subject to the preference laws, as such transactions are transfers under the preference laws. With the extended

period to perfect a security interest, vendors are given greater protection from a preference challenge.

3) **Rewriting The Fraudulent Conveyance Laws**

a) **What Is A Fraudulent Conveyance? (Section 548)**

A debtor, whether individual, corporation, LLC or partnership, may devise a scheme to channel assets from creditors. Under state and federal law, these types of transfers are referred to as intentional fraudulent transfers. Under Section 548 of the Bankruptcy Code, a trustee may attack a transfer made within a year of the bankruptcy filing.

b) **Reach Back Period Extended (Section 548)**

The 2005 Act permits assets that are fraudulently transferred within two years of the bankruptcy filing to be recaptured. The 2005 Act also permits recapture of fraudulent transfers to trusts within 10 years of the bankruptcy filing.

i) **What It Means For Vendors**

Creditors and trustees are given a greater opportunity to recapture assets that were fraudulently transferred, thereby increasing the distribution to vendors.

4) **Rewriting The Involuntary Bankruptcy Petition Law**

a) **What Is An Involuntary Bankruptcy Petition? (Section 303)**

The purpose of involuntary bankruptcy is to provide vendors with a means of assuring equal distribution of the debtor's assets. In addition, an involuntary proceeding may benefit vendors (once an order for relief is entered) as a trustee can use the Bankruptcy Code's avoidance powers to recapture fraudulent conveyances, preferential transfers and unseat improperly perfected liens.

b) **Vendor's Debt Must Not Be Subject To A Bona fide Dispute (Section 1234)**

A creditor whose claim is subject to a bona fide dispute as to liability or amount may not be a petitioner in an involuntary bankruptcy case.

i) **What It Means For Vendors**

Under this provision, a creditor may be disqualified as a petitioning creditor where there is a legitimate basis for the debtor not paying the debt or disputing the amount. The policy for excluding claims subject to a bona fide dispute is to prevent creditors from using involuntary bankruptcy to coerce the debtor to pay debts which the debtor has legitimate defenses. If the court finds there is a bona fide dispute to a claim, the petitioning creditor does not qualify, and the petition must be dismissed, unless another qualified creditor is permitted to join the involuntary petition. To reduce the risk that it may be disqualified as a petitioning creditor, the vendor may consider including language in their credit application that forces the debtor to timely inspect the goods shipped:

"Applicant also agrees to examine immediately upon receipt, each of *[Creditor]*'s statements, and to advise *[Creditor]* of any disputed transactions or statements within 10 days of receipt, together with a written statement specifying the reasons for such dispute. Failure to notify *[Creditor]* of any dispute with respect to defective goods shall constitute a waiver of all such disputes."

5) **Rewriting The Reclamation Law (Sections 406 and 1227)**

The 2005 Act reforms the reclamation laws in the following ways.

a) **What Is Reclamation? (Section 546)**

Reclamation is the right of a seller to recover possession of goods delivered to an insolvent buyer. The remedy of reclamation is needed when an unsecured vendor is unable to retrieve goods or stop them in transit. A reclaiming vendor need not prove fraud, although the premise of reclamation is that the vendor was defrauded. Under the common law and the old Uniform Sales Act, the seller could only exercise its reclamation rights if it proved the buyer obtained delivery by misrepresenting its solvency. The Bankruptcy Code, section 546, adopts the UCC, but is modified. The Bankruptcy Code before the 2005 Act was signed into law required (1) that the seller's demand for reclamation be made in writing; and (2) in certain circumstances extends the notice period from ten to twenty days.

While the Bankruptcy Code still requires the vendor's demand for reclamation in writing, the notice period has been significantly lengthened. The Bankruptcy Code also provides the bankruptcy court with the ability to grant a seller a lien or priority claim in lieu of the goods. This allows the court to order that the goods remain with the debtor to help reorganize.

b) **Administrative Claim For Goods Shipped Within 20 Days (Section 1227)**

This provision gives vendors an administrative claim for goods shipped in the ordinary course of the debtor's business within 20 days prior to bankruptcy.

i) **What It Means for Vendors**

Vendors which ship goods within 20 days of the debtor filing bankruptcy no longer have to establish the validity of their reclamation claims. As the reclamation claim is given administrative priority, the vendor is entitled to payment in full on the reclamation claim under a Chapter 11.

c) **Extending The Reclamation Demand Period To 45 Days (Section 1227)**

If a vendor makes a reclamation demand within 45 days after the debtor receives goods, the debtor must pay for, or return the goods, and that the substitution of a lien or administrative expense claim in lieu of payment is no longer sufficient. In addition, if the 45 days extends beyond the petition date, then the deadline for the receipt of notice by the debtor is 20 days after the bankruptcy filing. If the vendor fails to give timely notice to the debtor, the vendor has an administrative expense claim so long as the goods were received by the debtor within 20 days prior to the petition date.

i) **What It Means For Vendors**

Prior to the 2005 Reform Act, the Bankruptcy Code provided the bankruptcy court with the ability to grant a vendor a lien or priority claim in lieu of the vendor reclaiming the goods. This provision allowed the court to require that the goods remain with the debtor to help it reorganize. The 2005 Act no longer permits the bankruptcy court to provide a priority claim or lien, when the court does not allow the vendor to reclaim the goods.

Provided the vendor can establish the elements of a reclamation claim, the extension of the reclamation period to 45 days may open the door to significantly more types of goods to be reclaimed, and lead to larger administrative claims asserted by vendors. However, larger administrative claims may pose a risk that a debtor may not be able to

pay these administrative claims, and thus jeopardize its exit from bankruptcy.

d) Rights Of Floating Lienholders

A vendor's reclamation rights are now specifically subject to the preexisting rights of a secured creditor that claims a security interest in the debtor's after-acquired inventory.

i) What It Means For Vendors

Where a vendor has delivered goods to the vendor during the reclamation period, the vendor's reclamation claim is lost should the debtor's pre-existing secured creditor be under secured.

e) Paying Off The Reclaiming Creditor in Chapter 11

Given the automatic administrative claim given to reclaiming creditors for those goods shipped within 20 days prior to bankruptcy, vendors may now push for early payment of their reclamation claim, as it has administrative priority.

6) Rewriting The Small Business Bankruptcy Law Provision (Sections 431 and 432)

The 2005 Act reforms the small business bankruptcy law provision in the following ways.

a) What Is A Small Business Bankruptcy? (Section 432)

Under the Bankruptcy Reform Act of 1994, Congress established a fast track for small business reorganizations for the purpose of making business reorganization less complex and expensive in Chapter 11. A debtor must first elect to be considered a small business debtor. A small business is defined as one whose non-contingent liquidated, secured and unsecured debts are less than \$2 million as of the bankruptcy filing.

b) Plan Confirmation Expedited (Section 437)

The hearing on the disclosure statement and confirmation of a plan can be combined. Only the debtor can file a plan within the first 90 days of the bankruptcy filing. The debtor has a maximum of 150 days from the petition date to have its plan confirmed. If a plan is not confirmed within this time, the case may be converted to Chapter 7, or dismissed. If no plan is proposed within 300 days, the case can be converted to Chapter 7 or dismissed.

c) New Reporting Requirements And Additional Duties of the Debtor (Section 434 and 436)

A debtor must file reports as to their profitability, projected cash receipts and disbursements, and comparisons with earlier reports. With a Chapter 11 filing, the debtor must file a recent balance sheet, statement of operations, cash-flow statement and federal income tax return. The debtor must attend all scheduled court and United States Trustee meetings. The debtor must timely file all schedules, statements, and reports unless granted an extension. The debtor must maintain insurance, and timely file all tax returns and other governmental filings.

i) What It Means For Vendors

A small-business Chapter 11 debtor is now required to provide more expansive and timely financial information as to its post-bankruptcy operations. This financial information may assist creditors in determining whether the debtor should continue to operate, whether management should be replaced and the timing for exiting Chapter 11. This financial reporting may also prompt some small debtors to stay clear of bankruptcy because of the financial reporting scrutiny.

7) Reviewing An Individual Debtor's Ability to Pay: The "Means Test" (Section 707)

The 2005 Act makes it more difficult for individuals to file for Chapter 7 by imposing a means test, which determines

whether a debtor has the ability to repay a significant portion of their debts.

The 2005 Act employs a “means test” to determine whether an individual qualifies to file a case under chapter 7, and to determine whether, once filed, a chapter 7 case may be dismissed or converted based upon abuse of the bankruptcy system. Means testing will be employed to determine whether an individual debtor’s average currently monthly income is more or less than the median income in the state where the debtor resides.

If, after computing currently monthly income, and deducting certain living expenses, and multiplying that amount by 60, the monthly income exceeds the lesser of (i) \$10,000; or (ii) the greater of 25% of the debtor’s unsecured non-priority claims or \$6,000, than the debtor is presumed to be abusing the bankruptcy process by filing a chapter 7 case. If it is determined that a debtor is able to repay their debts, then the Chapter 7 case may be dismissed or converted to Chapter 13.

i) **What It Means For Vendors**

For a vendor holding a personal guarantee the means test may force the guarantor to repay a portion of the guaranteed debt through a Chapter 13 bankruptcy filing if the guarantor’s income is too great. Likewise, for a vendor selling to a sole proprietor, the debtor may consider filing an individual Chapter 7. Should the sole proprietor’s monthly income exceed the mean, the Chapter 7 case may be dismissed or converted to Chapter 13.

8) **Expansion Of Bankruptcy Court’s Power Over Creditors’ Committees**

a) **What Is A Creditors’ Committee? (Sections 1102 and 1103)**

Most operating companies in Chapter 11 have a creditors’ committee appointed. Perhaps the best way for a vendor to protect its interests in the Chapter 11 and obtain cost-effective legal representation is to serve on the creditors’ committee. The committee usually consists of five or seven members selected from the largest unsecured creditors of the debtor. Members are appointed by the United States Trustee, an arm of the Department of Justice, based upon requests to serve from creditors. The committee may hire legal counsel and financial consultants, and have the cost paid by the debtor.

The committee is responsible for protecting the interests of general unsecured creditors. This may include investigating the debtor’s past transactions, overseeing the debtor’s operations and monitoring its post-bankruptcy operations and progress towards a reorganization plan. The committee also has standing to negotiate the debtor’s plan of reorganization, to recommend to creditors whether to vote in favor or against the plan, and to even file its own plan of reorganization.

b) **Bankruptcy Court’s Power Over Creditors’ Committees (Section 405)**

Prior to the 2005 Act, the U.S. Trustee appointed the creditors’ committee, in addition to changing the membership of the committee. The 2005 Act provides the bankruptcy court with the authority to direct, after a request from a party in interest, the U.S. Trustee to change the membership of a committee, or increase the number of members of a committee to include a creditor that is a small business. This provision gives creditors the right to request the court to serve on the committee.

The responsibilities of creditors’ committee members is also expanded. A committee now has to provide bankruptcy case information, as well as solicit feedback from creditors with similar claims that are not appointed to the

committee.

i) **What It Means For Vendors**

The bankruptcy court's ability to change the composition of a creditors' committee, or appoint an additional creditors' committee, may make creditor involvement more effective. The provision that the committee must now share information from non-committee members may be difficult where the committee has signed a confidentiality agreement with debtor. Likewise, this provision does not set out the kind of information it must seek from non-committee members to comply. This provision allows small businesses to have a larger role in how a reorganization or liquidation of a debtor is handled.

9) **Debtor Protecting Assets:**

Asset Protection Trusts, Homestead Exemptions And Retirement Funds

Notwithstanding additional protections afforded creditors under the 2005 Act, a debtor still may be able to shelter assets from creditors and the bankruptcy trustee, including asset protection trusts, homestead exemptions and IRA's.

a) **Asset Protection Trusts**

The 2005 Act does not address debtors placing assets in asset protection trusts. Debtors can establish trusts in Alabama, Delaware, Nevada, Rhode Island and Utah by residents and nonresidents. A foreign asset protection trust exists via offshore legislation which allows the trusts to be formed and controlled by the person or entity which forms the trust. These trusts also include numerous provisions meant to prevent vendors from collecting outstanding balances by shortening the statute of limitations. The flight provisions allow the debtor to move the trust when the trust is being attacked in the jurisdiction the trust was established.

i) **What It Means For Vendors**

From a creditor's perspective, these trusts attempt to thwart attempts to pay a judgment, or bring assets into the estate of the debtor for distribution in a bankruptcy proceeding. The assets in these trusts may escape a creditor's reach. Whether a bankruptcy court determines the assets to be part of the debtor's estate or not, vendors will incur more legal fees and endure more litigation as a result of asset trusts. These trusts are another layer to prevent a vendor from receiving timely and full payment on a judgment.

b) **Homestead Exemptions (Section 322)**

Florida, Iowa, Kansas, South Dakota and Texas have unlimited homestead exemptions that allow the wealthy to file for bankruptcy and keep their mansions in those states sheltered from creditors. The 2005 Act restricts the homestead exemption in states to \$125,000 if the person in bankruptcy bought his or her residence less than three years and four months before filing. This provision also disallows the homestead exemption if the debtor purchased the property with the intent to defraud creditors.

i) **What It Means For Vendors**

Prior to the 2005 Act, debtors could shield their assets from creditors by moving, to, say, Texas or Florida and purchasing a house with all of their assets and filing for bankruptcy. This provision now protects creditors from this risk.

c) **Retirement Funds**

The 2005 Act increases a debtor's exemption of retirement funds from creditors to \$1 million.

i) **What It Means For Vendors**

A vendor should be mindful that when considering a guarantor's or sole proprietor's personal financial statements that a listing of an IRA does not mean that these assets can be used to pay a creditor's judgment.

10) **Earlier Filing Of Plan Of Reorganization**

a) **What Is A Plan Of Reorganization? (Sections 1112 through 1129)**

The plan of reorganization is an agreement between the debtor and its creditors that provide for rewriting the prepetition debts of the debtor and repayment of those debts. While creditors can agree to a plan that provides for virtually any kind of treatment, there are certain mandatory requirements for a plan to be confirmed: (1) it must be demonstrated that members of each class of impaired claims receive at least as much as they would in a chapter 7 liquidation; (2) it must be proposed in good faith; (3) it must comply with disclosure requirements; (4) it must be feasible; (5) it may not impermissibly classify claims; and (6) non-accepting classes of creditors are entitled to protection under the fair and equitable rule.

b) **Earlier Filing Of Plan Of Reorganization (Section 411)**

Prior to the 2005 Act, a debtor had the exclusive right to file a plan within the first 120 days, and an additional 60 days to solicit acceptances of the plan. A bankruptcy court could extend the exclusivity period indefinitely upon a showing of "cause". The 2005 Act limits the time a debtor has the exclusive right to propose a plan of reorganization to 18 months. After that, there can be competing plans from creditors and creditors' committees.

i) **What It Means For Vendors**

The 2005 Act's cutting off of a debtor's extensions of plan exclusivity may result in more creditor and committee plans being filed. Given that debtors can no longer have their exclusivity extended, creditors and committees may hang back from negotiating with a debtor to formulate a consensual plan. In large Chapter 11's, with many tiers of debt, the debtor may have limited time to confirm a plan in negotiating with these creditor groups.

11) **Early Assumption Of Real Estate Leases (Section 309)**

The 2005 Act requires a debtor to assume or reject its real estate lease within 120 days following the petition date. A court may extend the 120 day period to assume or reject for up to an additional 90 days. Further extensions require the lessor's consent.

i) **What It Means For Vendors**

The 2005 Act changes the way in which a debtor deals with assumption or rejection of its unexpired real estate lease. Prior to the Reform Act, a debtor had 60 days from the bankruptcy filing to decide whether to assume or reject its commercial real estate lease. A bankruptcy court routinely extended this time during the course of the bankruptcy case.

The consequences of forcing the debtor to decide to assume or reject a real estate lease by an earlier deadline, may drive up the administrative cost of a chapter 11 case and jeopardize its reorganization. A debtor may be forced to prematurely assume, and to continue to pay the rent, only to determine later that the early assumption was wrong. The 2005 Act attempts to limit the mistake of early assumption by limiting the administrative claim a landlord may

assert if the debtor later rejects a real estate lease it had assumed. This provision imposes a two year cap on the amount of the administrative claim a landlord may recover.

12) **Adequate Assurance To Utilities (Section 417)**

This provision attempts to resolve what constitutes adequate assurance of payment for a utility. A debtor offering a utility administrative expense claim no longer constitutes adequate assurance of payment. The time by which a debtor must provide adequate assurance to a utility is extended to 30 days, from 20 days, but what is adequate assurance is limited. This provision defines the term adequate assurance of payment as: a cash deposit; a letter of credit; a certificate of deposit; a surety bond; a prepayment of utility consumption; or another form of security that is mutually agreed on between the utility and the debtor or the trustee. Prior to the 2005 Act, there was much litigation between the debtors and their utilities, including telecom debtors and the telephone utilities, as to how to provide assurance of payment to the creditors.

The utility may alter or refuse 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 for service that is satisfactory. The utility may also setoff against a security deposit provided to the utility by the debtor prior to the bankruptcy.

i) **What It Means For Vendors**

This provision requires debtors to provide utilities with cash deposits or credit enhancements during the early stage of the Chapter 11. The debtor will be required to have more assets available to satisfy a utility's adequate assurance requirements. The debtor is still protected from the immediate termination of services.

13) **Appointment Of Chapter 11 Trustee Or Conversion Or Dismissal of Case (Section 442)**

a) **Management Continues To Operate Chapter 11 Debtor (Section 1104)**

Under Chapter 11, it is presumed that the debtor will remain in possession and current management will continue to manage its affairs. The filing of bankruptcy, insolvency and poor business decisions are insufficient to oust management. The debtor's officers need not be employed by the bankruptcy court.

b) **Additional Grounds To Convert Or Dismiss A Case (Section 442)**

Prior to the 2005 Act, the bankruptcy court may convert a Chapter 11 to Chapter 7 liquidation or dismiss the case upon a showing of cause.

This provision requires the bankruptcy court to convert or dismiss a case if a party seeking conversion or dismissal establishes "cause". Several new grounds for showing "cause" are set forth, including gross mismanagement and unauthorized use of cash collateral.

c) **Appointment Of Trustee Where Fraud Suspected (Section 1405)**

In cases of suspected fraud, the U.S. Trustee must seek the appointment of a trustee to replace management.

i) **What It Means For Vendors**

This provision is prompted by the Enron line of bankruptcies and the concern of corporate fraud. Given that the U.S. Trustee is directed to seek appointment of a trustee on mere suspicion of fraud, creditors may see more requests of the court to appoint a trustee. This will lead to more litigation and expense, as management opposes the request to stay in control.

14) **Debtor's Lawyer's Responsibility To Creditors**

a) **Burden To Confirm Debtors' Financial Condition (Section 319)**

The 2005 Act may leave attorneys for individual debtors subject to court sanctions if they can't prove the effort they made to check the debtor's bankruptcy schedules and statement of financial affairs.

Fact checking may entail everything from hiring a private investigator, to verifying a client's debts, to hiring an appraiser to confirm the value of a debtor's home.

The 2005 Act requires attorneys for individual debtors to certify their clients' financial statements to the court and will be held financially responsible if the statements are false. The 2005 Act may hold attorneys for individual debtors liable for mistakes such as a debtor reporting fewer assets than they have. Attorneys may also be subject to sanctions if inaccuracies in a debtor's schedules results in the dismissal of the debtor's Chapter 7 petition or in its conversion to a Chapter 13 petition.

15) **Limitations On Key Employee Retention/Severance Programs (Section 503)**

Prior to the 2005 Reform Act, corporate debtors in the opening days of the Chapter 11 filing would often request that the bankruptcy court approve a bonus scheme for management. Vendors would often view such requests by management as overreaching and an attempt by management to enrich themselves at the expense of creditors. Under the 2005 Act, in order to obtain approval of a key employee retention plan, the debtor must establish that a retention of stay bonus is essential to induce the insider to continue their employment. For the insider to become entitled to such a bonus, he or she must have a job offer from another business. In addition, the insider's services must be essential to the business. Under this section, the range of acceptable retention bonuses and severance pay for such insiders is linked to the bonuses and severance packages that are available to non-management employees. Thus, even if it is proven that the key person is essential to the success of the debtor, and that this person has another equal or better opportunity awaiting him or her, the retention bonus and severance package cannot exceed ten times the amount paid to non-management persons within the year in which the transfer is made or, in the absence of such non-management bonuses, cannot exceed 25 percent of the amount of bonuses transferred to the insider himself during the year prior to the retention bonus.

i) **What It Means For Vendors**

Vendors, on the one hand, may view the restrictions as a sensible balance to force debtor's management to be more accountable to creditor interests. Management, on the other hand, view these restrictions negatively and lead to the departure of management that may be essential to a debtor reorganizing. In particular, requiring that management comparable job offers to be eligible for retention bonuses may induce management, it may be argued, to search for a new job at a time when they should be focused on the debtor's reorganization.

16) **Impact on Bankruptcy Judges**

a) **More Bankruptcy Judges**

The 2005 Act provides some relief for bankruptcy courts by funding 28 new judgeships. Delaware will continue and likely expand as the favored venue of large corporate Chapter 11 filings, with the addition of four new judges.

17) **Cross-Border Insolvencies**

The 2005 Act adds a new Chapter 15 to the Bankruptcy Code, which enacts the Model Law on Cross-Border

Insolvencies developed by the United Nations Commission on International Trade Law (UNCITRAL). The purpose of chapter 15 is to (i) govern the access the foreign representatives and creditors will have to the courts, (ii) address the recognition that the bankruptcy court may give to foreign proceedings and the relief that the court may grant with respect to such proceedings, (iii) establish a protocol for cooperation and communication between U.S. and foreign courts and representatives and (iv) implement a scheme for managing concurrent foreign and domestic proceedings and ensuring that the relief afforded in different jurisdictions is consistent.

Circumstances in which Chapter 15 can be applied is when assistance is sought in the United States by a foreign court or foreign representative in connection with a foreign proceeding, when assistance is sought in a foreign country in connection with a case under the Bankruptcy Code, when a foreign proceeding and a case under the Bankruptcy Code with respect to the same debtor are pending concurrently, or when creditors or other interested parties in a foreign country wish to commence or participate in case or proceeding under the Bankruptcy Code.

As a procedure, a court must recognize foreign proceedings as either a “foreign main proceeding” or a “foreign nonmain proceeding”. If the debtor’s assets or place of business is in the U.S., then the proceeding is considered “foreign main proceeding” as apposed to a “foreign nonmain proceeding” where the debtor’s assets are held in the country where the foreign recognition proceeding is held. This distinction is relevant because if the court recognizes the proceeding as a foreign main proceeding, then certain provisions of the Bankruptcy Code apply with respect to the debtor’s property within the territorial jurisdiction of the United States. These provisions include: the adequate protection, the automatic stay, and the sale, use or lease provisions of the Bankruptcy Code. Additionally, in a foreign main proceeding, the foreign representative has standing under Chapter 15 to institute preference actions, fraudulent transfer actions, and other action alike and as such has a direct right to intervene in any proceedings in a U.S. court in which the debtor is a party. On the other hand, if the procedure is recognized by the court to be a foreign nonmain proceeding, the Court under Section 1521 of the Bankruptcy Code may only enter a broad relief, such as staying execution, preventing the debtor’s transfer of assets, or they can entrust the realization of administration of the assets to a trustee or examiner.

Scott E. Blakeley, Esq. is a graduate of Pepperdine University, and holds an M.B.A. From Loyola University and a Law Degree from Southwestern University. He has served as law clerk to Bankruptcy Judge John J. Wilson. Scott advises companies around the country regarding creditors’ rights, commercial, e-commerce and bankruptcy law. Credit Today selected him as one of the 50 most influential people in commercial credit.

Mr. Blakeley is a prolific writer and has produced a series of publications for the Credit Research Foundation specifically related to bankruptcy issues as well as other legal matters. Scott is contributing editor of NACM’s *Credit Manual of Commercial Law*; and has published dozens of articles and manuals in the area of creditors’ rights, commercial law and bankruptcy in such publications as *Business Credit*, *Managing Credit*, *Receivables & Collections*, *Norton’s Bankruptcy Review* and the *Practicing Law Institute*, and speaks frequently to credit industry groups regarding these topics throughout the country. He is a member on the board of editors for the California Bankruptcy Journal and is an editorial advisor for Credit Today.

© Copyright 2005 by the Credit Research Foundation

All rights in this paper are reserved. No part of the paper may be reproduced in any manner whatsoever without written permission. Printed in the United States of America Credit Research Foundation
8840 Columbia 100 Parkway
Columbia MD 21045