

The Bankruptcy Reform Act of 2005

WHAT IT MEANS TO THE CREDIT & FINANCIAL PROFESSIONAL

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Executive Summary

- o The changes to the bankruptcy laws taking effect on October 17th will make the bankruptcy process more restrictive, burdensome and expensive for a vendor's customer, whether a corporation, LLC, partnership, sole proprietor as well as a personal guarantor whether the customer files a Chapter 11 reorganization or Chapter 7 liquidation.

- o The press is reporting a meaningful increase in bankruptcy filings due to the Reform Act's October 17th deadline

- o Given that customers are evaluating whether to file prior to the Reform Act's effective date, the credit professional not only needs to scrutinize red flags that a customer may be fixing to file bankruptcy, but review the credit documents that allow the credit professional to terminate the credit relationship.

- o Credit enhancements or alternative payment mechanisms can make the sale and reduce the risk prior to the Reform Act's effective date of October 17. The key to a credit enhancement is to structure the instrument so that you will realize the maximum recovery upon a customer's bankruptcy.

Bankruptcy Reform Act Taking Effect Soon
AS OCTOBER 17 NEARS, WATCH FOR RED FLAGS THAT YOUR
CUSTOMER MAY BE FIXING TO FILE BANKRUPTCY
Scott Blakeley

On April 20, 2005, after eight years of political wrangling, the U.S. Bankruptcy Code was finally overhauled, with the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (Reform Act). Most provisions of the Reform Act become effective with bankruptcy cases filed after October 17, 2005.

A. Bankruptcy Filings Rise as Debtors Seek to Beat Restrictions of Reform Act

The changes to the bankruptcy laws taking effect on October 17th will make the bankruptcy process more restrictive, burdensome and expensive for a vendor's customer, whether a corporation, LLC, partnership, sole proprietor as well as a personal guarantor whether the customer files a Chapter 11 reorganization or Chapter 7 liquidation. The Reform Act is intended to limit some of the abuses in bankruptcy, both by corporations and individuals. For example, sole proprietors and personal guarantors may be motivated to file Chapter 7 prior to the Reform Act taking effect to discharge their debts rather than risk having their Chapter 7 petition challenged and converted to Chapter 13, where a repayment plan to creditors must be approved. Likewise, a corporation, LLC, and a partnership may be motivated to file Chapter 11 prior to the Reform Act taking effect so as to avoid new debtor-unfriendly deadlines, resulting in debtors having to reorganize more quickly, making additional financial disclosures and dealing with creditor protections, including paying some creditor classes (such as vendors, landlords, utilities, and taxing authorities) after the bankruptcy filing.

The press is reporting a meaningful increase in bankruptcy filings due to the Reform Act's October 17th deadline. Indeed, The Wall Street Journal and Washington Post report that, for example, Delta Airlines and Northwestern Airlines may file bankruptcy and, if so, a factor for a pre-October 17th Chapter 11 filing is the Reform Act. Additionally, USA Today reported that bankruptcy filing surged 12 percent in April, May and June from that same period last year. Bankruptcy courts, recognizing the rise in the number of filings, are taking special measures, such as accepting bankruptcy filings on the weekend of October 15th in the Eastern District of California. The press warns that September and the first two weeks of October will be a busy time for bankruptcy courts across the nation.

What are some of the Reform Act provisions that may prompt customers' rush to file bankruptcy? What are the red flags that a vendor should look for that may identify a customer as a candidate to file bankruptcy prior to the Reform Act taking effect?

B. Provisions of Reform Act Prompting A Race to the Bankruptcy Court

The provisions of the Reform Act that may prompt a customer to file bankruptcy prior to the Bankruptcy Reform Act taking effect depending on the form of business enterprise: whether sole proprietor, corporation, LLC or a personal guarantor.

1. Sole Proprietors and Personal Guarantors

The Reform Act imposes restrictions on an individual's use of Chapter 7 of the Bankruptcy Code, which allows an individual to discharge debt, as well as restricts assets that may be exempt from creditors' claims.

a. The "Means Test"

The Reform Act makes it more difficult for individuals to file Chapter 7 liquidation by imposing a means test, which determines whether a debtor has the ability to repay a significant portion of their debts. If, after computing a debtor's income and expenses, 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.

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 plan, 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, thereby forcing repayment of creditors' claims. Given this, the sole proprietor and personal guarantor may be prompted to file Chapter 7 prior to the Reform Act's effective date.

b. Homestead Exemption

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

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.

2. Corporations, LLC's and Partnerships

The owners and professional managers of corporations, LLC's and partnerships may be prompted to file Chapter 11 prior to October 17th given the following changes to the Bankruptcy Code:

a. Exclusive Right to File Plan of Reorganization

Prior to the 2005 Act, corporations had the exclusive right to file a plan of reorganization within the first 120 days of the bankruptcy filing, and an additional 60 days to solicit acceptance of the plan. A bankruptcy court could extend the exclusivity period indefinitely upon the debtor establishing "cause".

The Reform Act limits the debtor's exclusive right to propose a plan to 18 months. After that, there can be competing plans from creditors and creditor's committees.

b. Employee Retention Bonuses and Severance Programs

Prior to the Reform Act, corporate debtors in the opening days of a chapter 11 would often request 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 Reform Act, in order to obtain approval of a key employee retention plan, the debtor must establish that a retention or stay bonus is essential to induce management to continue employment. For the insider to be 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 debtor. 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, it cannot exceed 25 percent of the amount of bonuses transferred to the insider during the year prior to the retention bonus.

A debtor's management will view these restrictions negatively as they believe it leads to the departure of key personnel viewed as essential to the reorganization.

c. Real Estate Leases

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, or request an extension to decide to assume or reject the lease. A bankruptcy court would routinely extend this time during the course of bankruptcy proceeding.

The Reform Act requires a debtor to assume or reject its real estate lease within 210 days following the petition date.

d. Adequate Assurance to Utilities

Prior to the Reform Act, there was much litigation between a debtor and its utility as to what was deemed adequate assurance of payment to the utility.

The Reform Act resolves what constitutes adequate assurance of payment for a utility. A debtor offering a utility an administrative expense claim for its post-bankruptcy services no longer constitutes adequate

assurance of payment. 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.

As a result of the Reform Act, the debtor will be required to have more assets available to satisfy utilities adequate assurance requirements. Given these changes, the corporate debtor in financial difficulty, may file Chapter 11 prior to the Reform Act taking effect.

C. Red Flags That May Signal Your Customer May File Bankruptcy to Beat the Reform Act

A customer's slide into insolvency and financial distress often times is gradual and red flags indicating financial problems may take time to show themselves. As noted, the Reform Act's October 17th effective date is forcing customers, including personal guarantors, to evaluate their financial standing, including their debts to creditors, and whether to file bankruptcy prior to this date.

Beyond the obvious red flag of a customer failing to pay according to invoice, the following red flags may indicate that a customer may be fixing to file bankruptcy prior to October 17th:

1. Excess Cash Burn Rate

This is the amount by which a customer's expenses exceed its cash flow. To determine how long cash may last, and the prospects for payment of a credit sale, the credit professional may divide the company's burn-rate by the amount of cash it has. A high burn rate will result in the company being unable to finance operations.

2. Source of Financing Stalled

Many financial institutions, such as banks and other asset based lenders, are reluctant to provide additional rounds of financing when they see a customer is facing financial struggles. With the source of financing stalled, a customer will run out of cash.

3. Management and Key Employee Departures

With many customers, the value of the business may be the intellectual property that is in the hands of management or key employees. Their departure may have a significant impact on the corporations' continued operations, and thereby jeopardize repayment of a vendor's open account sale.

4. Stock Price Decline

When a publicly held company faces significant stock price decline, a number of detrimental consequences result. A customer will likely find that a drop in their stock prices may jeopardize their chances of getting additional financings as lenders are more selective on who they will continue to finance and they will often move their money into businesses that are less risky. Additionally, when options are a major employment incentive, management may flee when the stock price drops. As a result

the company may be unable to finance certain operations when they otherwise would due to their inability to rely on the market for additional financing.

5. Key Customer has Financial Difficulty

A number of large corporations have regular customers on who they depend as a source of revenue. If an incident should occur for a key customer in which, the customer stops purchasing from the corporation; it is likely that the corporation will also feel the effects of that key customer's financial struggles. The corporation's dependence on a large customer can have a domino effect in which if when one fails, the other will most likely fail too.

6. Sarbanes Oxley Disclosure of Financial Difficulty

The passage of Sarbanes-Oxley in 2002 forced companies to tighten their auditing and public financial disclosure processes. Section 409 of SOX requires early disclosure of a public company's financial difficulties, such as a loss of a major customer or resignation of an officer.

7. Using Tax Money to Pay Bills

Should a corporation lose its financing source, it may, out of desperation, use money earmarked to pay taxing authorities.

8. Ignoring Your E-mail and Calls

When a company begins its financial backslide, vendors will find that e-mails and phone calls requesting payments are not returned. Highlighting this risk is the recent trend of law and accounting firms asking for cash retainers instead of a portion of the equity of their corporate client.

9. Retail Customers

Customers that are retailers may be especially susceptible to the greater restrictions imposed by the Reform Act. Post-October 17th, the retailer will have a limited time to decide whether to accept or reject the leases, of which the retailer may have scores of.

D. Review Your Credit Documents As Effective Date Nears

Given that customers are evaluating whether to file prior to the Reform Act's effective date, the credit professional not only needs to scrutinize red flags that a customer may be fixing to file bankruptcy, but review the credit documents that allow the credit professional to terminate the credit relationship. If the credit professional has identified a red flag that a customer may be fixing to file bankruptcy, the credit professional should have a condition in their credit application that gives the vendor the unilateral right to convert the credit sale to cash at the vendor's sole discretion. This condition permits the vendor to reduce the risk that a credit sale goes unpaid if the customer files bankruptcy to beat the Reform Act's effective date.

Part II

AS OCTOBER 17 NEARS, CONSIDER CREDIT ENHANCEMENT TO REDUCE BANKRUPTCY RISK

On April 20, 2005, the U.S. Bankruptcy Code was finally overhauled, with the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (Reform Act). As discussed in Part I, the changes to the U.S. bankruptcy laws taking effect on October 17th will make the bankruptcy process more restrictive, burdensome and expensive for a vendor's customer, whether a corporation, LLC, partnership, sole proprietor as well as a personal guarantor, whether the customer files a Chapter 11 reorganization or Chapter 7 liquidation.

The press is reporting a meaningful increase in bankruptcy filings due to the Reform Act's October 17th deadline. In light of this, vendors may consider looking

Creditors should take appropriate measures to reduce credit risk through October 17 for certain customers that may be determined as candidates to file bankruptcy prior to the effective date of the Reform Act. In dealing with the customer that may be showing red flags of financial strain, creditors should look for the credit enhancement tool that is most readily converted into cash, and is unlikely to be affected by a customer's bankruptcy. Some of those alternatives are discussed below.

1. Letter of Credit

A letter of credit (L/C) is a promise by an issuer, the bank, to pay the creditor, as beneficiary, when the customer has defaulted on the sale. The customer uses its assets as collateral for the L/C, so that the credit of the bank is substituted for the credit of the customer in favor of the creditor. The customer pays the issuing bank a fee to issue the L/C. If the creditor submits proper documents upon default, the bank will pay the L/C and the customer reimburses the bank. An L/C may be either revocable or irrevocable. An irrevocable L/C can be modified only with consent of the creditor. The bank without the consent of the creditor can modify a revocable L/C. The creditor can obtain a standby L/C, which assures payment after the customer's default. The creditor should insist on an irrevocable L/C with the customer sale.

L/C's are independent from the underlying contract between the customer and the creditor. The bank honoring the L/C is concerned only to see that the documents conform to the requirements in the L/C. If the documents conform, the bank will pay, and obtain reimbursement from the customer. The bank need not look past the documents to examine the underlying sale of goods.

Thus, a creditor is given protections that the issuing bank must honor its demand for payment (which complies with the terms of the L/C), regardless of whether the goods conform to the underlying sale contract. The amount of the L/C should equal the amount of the line of credit.

The L/C's independence of contracts allows a creditor to avoid the impact of a customer's bankruptcy, as a general rule. The creditor is paid by the bank and does not wait until the debtor confirms its plan. Bankruptcy courts recognize that the proceeds of a letter of credit are not property of the customer's bankruptcy estate, and that a bankruptcy court generally does not have authority to bar payment under a L/C, notwithstanding the effects of the automatic stay.

2. Certificate of Deposit

A CD may be issued by the customer's bank in the name of the creditor, or the creditor may hold a customer's deposit to reduce the risk of nonpayment with the credit sale. The CD is unconditionally payable to the creditor upon demand, and automatically renews for the length of the credit line. The principal amount accrues to the benefit of the creditor, and interest is paid to the customer. The creditor should have a written agreement with the customer that states this deposit arrangement.

The CD should be entrusted to the creditor and thus not part of the bankruptcy estate. A creditor would likely need to obtain relief from the automatic stay from the bankruptcy court to draw down on the CD upon a bankruptcy filing.

3. Credit Insurance

A creditor purchases credit insurance (CI) to avoid loss on a speculative customer, but retains the accounts receivable. CI may cover a variety of credit risk, such as a customer's bankruptcy, a default or dispute. An example of the terms of a credit insurance policy might stipulate that the CI generally covers up to 90% of the insured account. The risk premium for CI may be measured by the creditor's accounts receivable risk profile. The credit insurer may monitor the buyer's financial condition. The term of the policy may be one year.

The CI contract is not affected by a customer's bankruptcy. Bankruptcy courts recognize that the proceeds of a CI policy are not property of the customer's bankruptcy estate, and that a bankruptcy court does not have authority to interfere with payment under a CI policy.

A creditor does not have to obtain relief from the automatic stay from the bankruptcy court to receive payment on the CI policy after the bankruptcy filing.

4. Factoring

Factoring provides for the supplier to sell its customer account receivable at a discount to a third party, a factor, who is usually a financial institution. The sale is often non-recourse, which means that the factor is

responsible for the customer account in the event of default. The supplier usually invoices the customer, but the invoice is payable to the factor's address. The supplier sends the invoice to the factor, who pays the supplier a discounted amount of the invoice.

Factoring is an independent agreement between the supplier and the factor, and allows a supplier to avoid the effects of a customer's bankruptcy. Depending on whether the factoring agreement is recourse, it may be the factor that is the party in interest in the bankruptcy.

Bankruptcy courts recognize that the factor's payment of a supplier's claim is not property of the customer's bankruptcy estate, and that a bankruptcy court does not have authority to interfere with payment, notwithstanding the effects of the automatic stay.

5. Guarantee

A guarantee, whether corporate or personal, is not the preferred credit enhancement, as it requires the creditor to take legal action to get paid when the customer fails to pay. However, a guarantee may be used as leverage by the creditor to force the customer to pay by threatening to pursue the guarantor, who may be a principal of the customer. The basic legal principle is that the guarantor is not a party to the principal debt. The guarantor's undertaking is independent of the customer's promise to pay.

Merely because both contracts are on the same paper, for example, the credit application -- the customer's promise to pay for the creditor's goods or services, and the guarantor's promise to pay if the customer does not -- does not change the independence of the agreements.

The guarantee should be signed before a notary to reduce the risk that the guarantor may contend that the guarantee was forged. The guarantee's independence of contracts may allow a creditor to avoid the effects of a customer's bankruptcy.

6. Purchase Money Security Interest

The creditor may consider taking a security interest in the goods it sells to the customer, and the proceeds from the sale of those goods. Under amended Article 9 of the Uniform Commercial Code, for the creditor to obtain a valid purchase money security interest (PMSI) in the goods it sells to the customer, a multi-step process must be complied with. The customer first executes a security agreement describing the goods covered in favor of the creditor, which gives the creditor a security interest in those goods. The creditor perfects the security interest when it files a financing statement with the filing office (usually the Secretary of State), which adequately describes the goods.

The creditor's PMSI will prime the inventory secured creditor's lien only if: (1) the PMSI is already perfected at the time the customer receives possession of the goods; and (2) the creditor gives written notice to any other preexisting inventory secured creditor. If the creditor fails to perfect the PMSI,

including giving notice, the creditor's priority is governed by the "first to file" rule. This means that an inventory secured creditor will prime the creditor's PMSI.

The creditor holding a PMSI should be entitled to adequate protection with the customer filing bankruptcy. Adequate protection provides that the creditor's property interest is entitled to protection from depreciation and is insured against risk of loss.

7. Consignment

Article 9 of the UCC's perfection requirements provides the means whereby a supplier can establish a valid security interest in its own inventory, even when that inventory has been delivered to the customer. The supplier's compliance with the perfection requirements of the UCC protects ownership of inventory. In the event of a dispute over the goods, the supplier will prevail over a competing supplier.

An agreement is executed describing the relationship of the parties involved (i.e., the supplier owner is consignor and the customer seller is consignee); a description of the inventory; and agreement that title to the merchandise only passes to third-party buyers. Then the supplier completes a UCC-1 financing statement, which again describes the inventory and makes clear that the inventory is delivered on consignment. The supplier then files the statement with the filing office (usually the Secretary of State).

A supplier must give notice to any creditor asserting a security interest in the customer's inventory in order to avoid any appearance that inventory coming to the customer is free from ownership claims. To have priority in the accounts receivable generated by the sale of consigned goods, the supplier must also comply with the UCC notice-filing requirements as to accounts receivable.

With the bankruptcy filing, the creditor that is a party to a consignment agreement with the debtor may find the agreement challenged by a debtor or other party if the creditor fails to adhere with Article 9. The creditor may also have to trace the proceeds the sale of its product that is subject to the purchase money security interest.

8. Security Interest in Assets

Where the creditor has a delinquent account, the creditor may be able to obtain collateral from the customer to secure its delinquent account in the form of a Security Agreement. The Security Agreement between the creditor and customer generally covers all property of the customer concerning the creditor's pre-existing debt. The creditor's priority to the customer's assets is generally chronological to preexisting secured creditors (first to file), and does not require notification to prior secured creditors, as the creditor's interest is junior to theirs.

The creditor's lien on all the debtor's assets is perfected at the time of filing the UCC-1. The debtor's assets include all things that are movable, but do not include money or general intangibles. The debtor must sign the security agreement and the security agreement must describe the collateral. The

requirements for the creditor that must be met in the creation of a security interest are that: value must have been given by the creditor in exchange for the security interest; the debtor must have rights in the collateral it offers; and the debtor must have signed a security agreement which contains a description of the collateral. A creditor perfects the security interest when it files a financing statement with the filing office (usually the Secretary of State) that adequately describes the collateral.

The main purpose in filing a financing statement is to guarantee that any third parties will have been notified of existing security interests in the collateral. The filing creditor thus takes priority over other non-secured creditors and has the right to take possession of and sell the collateral if the debtor defaults. The creditor holding a secured claim in the debtor's assets should be entitled to adequate protection with the customer filing bankruptcy.

9. Setoff

The right of setoff allows entities that owe each other money to apply their mutual debts against each other, thereby avoiding the situation of making A pay B when B owes A. The right of setoff arises under state law and, if such right exists, is preserved in bankruptcy cases. For a company to offset, three steps must be taken: (1) an authorized officer must make the decision to effectuate the setoff, (2) some action must be taken accomplishing the setoff and (3) the setoff must be recorded.

Offsets allow entities that owe each other money to setoff the debts against one another. The filing of bankruptcy by a debtor dramatically changes the economics of an open account relationship involving the setoff of mutual debts. It is vitally important to preserve the right to setoff debts in the context of bankruptcy.

If the creditor cannot obtain a credit enhancement from the customer, the creditor may consider an alternative means of payment to reduce credit risk.

10. Credit Card

Having a customer pay by credit card is appealing to the seller as it allows for payment prior to goods being released to the customer. However, a seller may be at risk with the customer charging a purchase. The creditor may be responsible for unauthorized purchases and fraud. A seller may accept a personal credit card for a commercial sale; however, it may be an indication that the company the person is purchasing for is in financial trouble. (More likely, it means that the person wants the frequent flyer miles).

Credit card transactions conducted by telephone, fax or the Internet, also known as card-not-present transactions, have a higher risk of fraud. A credit card payment is an independent agreement, and allows a creditor to avoid the effects of a customer's bankruptcy.

11. E-Checks and Checks by Fax

An e-check is an electronic version of a paper check. The e-check may provide for multiple payers, endorser signatures and is governed by the UCC covering checks. The creditor may choose to have a third party accept the payments in an e-lockbox or have the receipt directed to the accounts receivable department for handling. E-checks use digital signatures where federal legislation recently recognized their use.

Checks by Fax are similar to conventional checks with the difference being that you print your customer's check on your in-house printer or fax machine and prepare it for deposit. Your customer makes out a check payable to you, signs it, just as if it was to be mailed, and faxes it to you. You then make a bank draft "duplicate" of the check and submit it for deposit, and keep their original check as a record of this transaction. Previously technology was an issue for some smaller local banks, but those issues for the most part have been resolved. Provided that the customer's e-check or fax check has cleared its account, there should be no bankruptcy risk with a customer paying by that method.

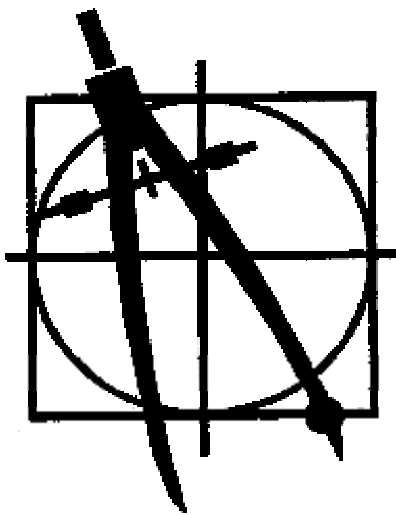
Conclusion

Credit enhancements or alternative payment mechanisms can make the sale and reduce the risk prior to the Reform Act's effective date of October 17. The key to a credit enhancement is to structure the instrument so that you will realize the maximum recovery upon a customer's bankruptcy.

About The Author

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.



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