



**GOLENBOCK  
EISEMAN  
ASSOR  
BELL &  
PESKOE LLP**

## The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005

The much publicized Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the “BAP/CPA”), amends various provisions of the United States Bankruptcy Code (the “Bankruptcy Code”). The primary focus of the BAP/CPA is on consumer bankruptcies. There are, however, numerous noteworthy amendments that pertain to business bankruptcy cases, including special provisions for small businesses and the creation of a new chapter of the Bankruptcy Code (chapter 15) that addresses cross-border insolvency cases. With limited exceptions, the provisions of the BAP/CPA will take effect on October 17, 2005, and will not apply to cases commenced prior to April 20, 2005. Highlighted below are some of the more significant amendments affecting business and consumer bankruptcy cases.

**Overall Comment:** Chapter 11 of the Bankruptcy Code contains a balance between state-created creditors’ rights and a congressional policy, generally referred to as the “Reorganization Policy,” that holds that the nation is better served if a debtor’s assets are used in a reorganized business rather than liquidated. Chapter 7 of the Bankruptcy Code balances creditors’ rights against a desire to provide over-burdened individuals with a fresh start. There is an on-going debate as to whether Congress has balanced these concerns appropriately and whether the bankruptcy courts apply the law as written. Not surprisingly the banking industry and other creditor constituencies have argued that the balance has improvidently favored debtors. With one notable exception, the creation of a new chapter 15 dealing with cross-border cases, the BAP/CPA is a hodge-podge of amendments to the Bankruptcy Code that reflect a consensus on the part of Congress that these criticisms are valid. The overall effect of the

BAP/CPA should be to speed up the progress of chapter 11 cases, to make reorganizations more difficult and to afford individuals with less of an opportunity to discharge their debts in bankruptcy and start anew.

### *Business Cases*

#### *Unexpired Leases of Nonresidential Real Property Assumptions and Rejections*

The BAP/CPA amends current Bankruptcy Code § 365(d)(4) to provide that unexpired leases of nonresidential real property in which the debtor is the lessee are deemed rejected (and possession of the property must be immediately surrendered to the lessor) by the earlier of 120 days after the commencement of the case, or the date of confirmation of a plan of reorganization. The court, for cause, may extend the 120-day period for an additional 90 days, but any additional extension can only be obtained upon the consent of the lessor.

#### *Administrative Claims*

The BAP/CPA also amends the current Bankruptcy Code § 503(b) to add subparagraph (7), which caps the amount of an administrative expense claim resulting from the rejection of a previously assumed lease of nonresidential real property at the monetary obligations due under the lease for a period of two years from the later of the rejection of the lease or the turnover of the premises. This amount is only reduced by amounts paid by an entity other than the debtor. Any other amounts due for the balance of the lease are treated as a general unsecured claim under Bankruptcy Code § 502(b)(6).

**Comment:** Debtors typically prefer to wait until just before obtaining court approval of a plan of reorganization before deciding whether to incur the expense of

assuming a lease. In larger cases, which (due to complexity) often last for several years, this amendment will force debtors to make decisions regarding lease assumptions a mere seven months after the commencement of a bankruptcy case. Because business plans have often not been finalized at this juncture, these decisions may be imprudent and costly to creditors. This amendment will make reorganizations more difficult, particularly in the case of a business such as a retail chain with numerous real estate leases.

#### *Debtor's Exclusive Period to File a Plan and Solicit Acceptances*

The BAP/CPA imposes a new deadline on the period during which a chapter 11 debtor has the exclusive right to file and obtain acceptances of a plan of reorganization. Under the BAP/CPA, the current 120-day "exclusivity period" for filing a plan of reorganization and the current 180-day exclusive period for obtaining acceptances of a plan may not be extended beyond 18 and 20 months, respectively, after the commencement of the case. Under existing Bankruptcy Code § 1121, it is within the court's discretion to extend or reduce the 120-day period upon a showing of "good cause" and there are no limits on the extent to which the court can extend or limit the period.

**Comment:** This amendment may have a significant impact in very large cases because creditors will be tempted to wait-out the exclusive period to file their own plans of reorganization rather than negotiate with the debtor.

#### *Netting of Certain Financial Contracts*

Under the Bankruptcy Code, parties to certain contracts such as swaps and repurchase agreements generally thought of as derivatives can liquidate, offset or otherwise close out such contracts, without violating the automatic stay and without being subject to the avoidance provisions of the Bankruptcy Code. These provisions are designed to promote liquidity in the marketplace. The new law also expressly permits a party to multiple contracts with a debtor to "net" its liability to a debtor under one contract against obligations owed by a debtor under a different contract.

**Comment:** Under the current law, it is unclear whether the netting of such financial contracts is permissible. Entities that regularly participate in swaps, repurchase agreements and other similar contracts may wish to review their standard forms to make sure that they track the Bankruptcy Code to the maximum extent possible. Presumably industry standard forms will be adapted as well.

#### *Preference Actions*

The BAP/CPA amends Bankruptcy Code § 547(c) to provide that a transfer by a debtor in payment of an obligation incurred by the debtor may not be avoided if it is made (a) in the ordinary course of business or financial affairs of the debtor and the transferee *or* (b) made according to ordinary business terms. Under the current Bankruptcy Code, the transferee has to establish both of these elements to maintain this defense.

**Comment:** The amendment makes the ordinary course of business defense more available and will result in fewer transfers being subject to avoidance.

#### *Employee Benefit Limitations*

The BAP/CPA creates a new Bankruptcy Code § 503(c) which imposes limitations on the payment of retention bonuses and severance pay to key employees in order to retain their services in a chapter 11 case. Under the BAP/CPA, retention bonuses to insiders are permitted only where the employee has a *bona fide* job offer from another business at the same or greater rate of compensation, the individual's services are essential to the survival of the business and the transfer is of a limited amount. Severance payments to insiders are permitted only when paid as a part of a program that is generally applicable to all full-time employees, and in an amount not greater than 10 times the amount of mean severance pay given to non-management employees during that year. The BAP/CPA also limits payments made outside of the debtor's ordinary course of business and not justified under the facts and circumstances of the case, including to officers, managers or consultants hired after the commencement of the case.

**Comment:** This provision reflects concerns that the practice of debtors seeking and courts approving key employee retention programs has become abusive. However, the notion that an employee can obtain a job offer and make his or her prospective employer wait while the debtor seeks court approval of a retention bonus is not realistic. Some of the time, retention of key employees is critical to reorganization and Congress may have thrown the baby out with the bath water here.

#### *Fraudulent Transfers*

For cases commenced more than one year after April 20, 2005, the BAP/CPA extends the "look back" period from one to two years for the avoidance of fraudulent transfers. In addition, the BAP/CPA permits the avoidance, as a fraudulent transfer or obligation, of certain transfers made to insiders under

an employment contract, without regard to the debtor's solvency or financial condition at the time the transfer was made or the contract executed, if the transfer or obligation was not in the ordinary course of business and the debtor received less than reasonably equivalent value in exchange. Further, for cases commenced on or after April 20, 2005, the BAP/CPA provides that certain transfers fraudulently made to self-settled trusts within 10 years before the commencement of a debtor's case, including transfers made in anticipation of money judgments, settlements or penalties incurred as a result of violations of securities laws, may be avoided.

**Comment:** Among other things, this provision appears to be designed to permit courts to reexamine executive compensation. As a practical matter, it may make it more difficult for a troubled company to recruit top management at a time when such management is most needed. On the other hand, increasing the "look back" period from one to two years seems sensible.

#### *Reclamation*

The BAP/CPA amends current Bankruptcy Code § 546(c) by increasing from 10 to 45 days the period of time immediately prior to the commencement of a case during which, if goods are sold to and received by a debtor while insolvent, a seller of goods may reclaim such goods after the debtor's bankruptcy filing notwithstanding the automatic stay. In addition, the BAP/CPA provides that even if a seller of goods does not provide timely notice of its reclamation claim, it may still assert an administrative expense claim for the value of any goods received by the debtor within 20 days prior to the commencement of the debtor's case.

**Comment:** This provision will substantially increase administrative claims in certain cases making it harder to confirm plans of reorganization and diluting the distributions for most creditors at the expense of other creditors.

#### *Debtors in Possession*

The BAP/CPA amends Bankruptcy Code § 1104(a) by expanding the grounds upon which a court may appoint a chapter 11 trustee. Bankruptcy Code § 1104(a) currently provides that the court may appoint a trustee upon a showing of cause or if the appointment is in the best interests of creditors, equity holders or the estate. Under the BAP/CPA, the court may also appoint a chapter 11 trustee if grounds exist to convert or dismiss a chapter 11 case, but the court determines that the appointment of a trustee or examiner is in the best inter-

ests of creditors and the estate. In addition, under the BAP/CPA, the United States trustee must move for the appointment of a trustee if there are reasonable grounds to suspect that a debtor's management or board participated in actual fraud, dishonesty, or criminal conduct in the management of the debtor or the debtor's public financial reporting. The BAP/CPA also amends Bankruptcy Code § 1112 by providing that absent unusual circumstances showing that dismissal or conversion of a chapter 11 case is not in the best interest of creditors and the estate, the court must convert or dismiss the case upon a showing of cause. The term "cause" is modified by the BAP/CPA and includes additional grounds not previously included in the existing Bankruptcy Code, such as, for example, (i) gross mismanagement of the estate; (ii) failure to maintain appropriate insurance that poses a risk to the estate or to the public and (iii) unauthorized use of cash collateral.

**Comment:** These amendments reflect a profound change in the policy that underlies chapter 11. Heretofore, existing management has been given great latitude to continue to manage and operate a debtor after a bankruptcy filing. In the new law, Congress has evinced a desire that the bankruptcy courts be less reticent in the appointment of fiduciaries and in ending the reorganization process. It remains to be seen whether bankruptcy judges will in fact modify current practice.

#### *Retention of Investment Bankers*

Under current Bankruptcy Code § 101(14), certain individuals do not qualify as "disinterested" due to their pre-bankruptcy work as an investment banker for a debtor. The BAP/CPA eliminates all references to investment bankers of a debtor from the definition of "disinterested." Thus, under the BAP/CPA, an investment banker may be employed by the debtor, irrespective of a prior relationship with the debtor, if the investment banker does not hold or represent a materially adverse interest to the debtor's estate or any class of creditors or equity security holders.

#### *Creditors' Committees*

Under the BAP/CPA, the court has the authority to order the United States trustee to change the membership of an official committee of unsecured creditors if the court determines that the change is necessary to ensure adequate representation, and may increase the number of members to include a small business debtor (as defined below) if it holds claims that are disproportionately large in relation to the small business debtor's annual gross revenues. In addition, the BAP/CPA requires that official committees provide access to cred-

itors who hold claims of the kind represented by the committee and who are not appointed to the committee, solicit and receive comments from the represented creditors and be subject to an order of the court that compels any additional report or disclosure to such represented creditors.

**Comment:** This provision may make debtors reluctant to share information with creditors' committees, knowing that the information may be widely disseminated. One of the things that permits creditors' committees to be effective is that the debtor can execute a confidentiality agreement with the creditors' committee and provide the committee with confidential proprietary information.

### *Small Business Cases*

The BAP/CPA includes various amendments that establish time frames and enforcement mechanisms which apply to "small business debtors" in chapter 11 cases. Under the BAP/CPA a small business debtor for chapter 11 purposes is generally defined as a business with debts under \$2 million. The small business debtor's exclusive period to file a plan of reorganization is 180 days, and it must in any event be filed within 300 days of the commencement of the case. In addition, the BAP/CPA amends current Bankruptcy Code § 1116 by imposing upon a small business debtor duties in addition to those already required of a debtor in possession. Under the BAP/CPA, the small business debtor in possession must:

- Append to the petition or furnish within seven days of commencement of the case a copy of the most recent balance sheet, statement of operations, cash-flow statement, and tax return;
- Attend, through senior management and counsel, all meetings scheduled by the court and the United States trustee;
- Timely file all schedules and statements (may be extended not more than 30 days after a petition is filed absent extraordinary and compelling circumstances);
- File all post-petition financial and other required reports;
- Maintain insurance customary and appropriate for the industry;
- Timely file tax returns and pay taxes entitled to administrative expense priority; and
- Allow the United States trustee to inspect business premises, books and records.

### *New Chapter 15 - Cross-Border Insolvency Cases*

New chapter 15 of the Bankruptcy Code incorporates the United Nations Commission on International Trade Law ("UNICITRAL") model law on cross-border insolvency ("Model Law"), adopted by the United Nations General Assembly in December 1997, into U.S. law. Most significantly, new chapter 15 governs "outbound" as well as "inbound" insolvency proceedings. Prior law only governed inbound proceedings. In an outbound proceeding, a U.S. court is the primary tribunal and in an inbound proceeding, a foreign court is the primary tribunal.

The Model Law replaces current Bankruptcy Code § 304 governing "cases ancillary to foreign proceedings." Chapter 15 is divided into five subchapters, entitled "General Provisions," "Access of Foreign Representatives and Creditors to the Court," "Recognition of a Foreign Proceeding," "Cooperation with Foreign Courts and Foreign Representatives," and lastly, "Concurrent Proceedings."

Subchapter I contains new definitions. Subchapters II and III govern the rights and powers of foreign entities in our judicial system. Under subchapter II, "foreign representatives" and "foreign creditors" are recognized and given the ability to participate as parties in interest in insolvency cases pending in the United States. Upon obtaining an order granting recognition of a foreign proceeding in the U.S. court system, a series of other provisions of the Bankruptcy Code, including most notably the automatic stay of Bankruptcy Code § 362, apply to the foreign proceeding. Furthermore, the foreign representative is authorized to operate the U.S. debtor's business and exercise certain rights and powers of a trustee under the Bankruptcy Code. Chapter 15 does, however, contain provisions protecting the laws and policies of the United States.<sup>1</sup>

Subchapter IV incorporates a strong presumption favoring cooperation and communication with both foreign courts and foreign representatives. For example, new Bankruptcy Code § 1525 requires that the court cooperate to the "maximum extent possible," with foreign courts and foreign representatives. Finally, subchapter V tackles the thorny issue of coordinating concurrent proceedings.

<sup>1</sup> For instance, new Bankruptcy Code § 1506 contains the public policy exception which authorizes U.S. courts to refuse to take any action governed by chapter 15 if such is "manifesting [sic] contrary" to U.S. public policy.

**Comment:** Although only a handful of other countries have adopted the Model Law to date,<sup>2</sup> its enactment in the United States represents a giant leap forward for the Model Law, perhaps presaging greater global acceptance. As businesses become increasingly global in character, it is going to be increasingly important to have cross-border procedures for dealing with international insolvencies. The Model Law is largely, although not entirely, procedural. Difficult problems will arise when the substantive laws and policies of countries differ.

### *Consumer Cases*

#### *Time Between Discharges Expanded*

The BAP/CPA amends current Bankruptcy Code § 727(a)(8) to deny a discharge to a chapter 7 debtor if the debtor received a chapter 7 or chapter 11 discharge in a case filed within eight years of the filing of the pending case. Under the prior law, the amount of time between such discharges was six years. Furthermore, a chapter 13 debtor will now be denied a discharge if that debtor received a discharge in a case filed under chapters 7, 11, or 12 during the four years prior to the date of the order for relief in the pending case, or (2) in a case under chapter 13 during the two-year period preceding the date of such order. Under the prior law, no such limitations for obtaining a discharge under chapter 13 existed.

#### *Exclusions from Estate Property*

Under the BAP/CPA, up to \$5,000 contributed by a debtor to an educational retirement account for a child or stepchild not later than 365 days before a bankruptcy filing is excluded from the debtor's bankruptcy estate. Also, new Bankruptcy Code § 541(b)(7) expressly excludes employee contributions to ERISA-qualified retirement plans, deferred compensation plans, tax-deferred annuities, and health insurance plans.

#### *Limitation on Homestead Exemption*

Under the BAP/CPA, any value in excess of \$125,000 that is added to a homestead during the 1215 days (about 3 years, 4 months) preceding the bankruptcy filing may not be included in a state homestead exemption unless it was rolled over from another homestead in the same state or the homestead is the residence of a farmer.

<sup>2</sup> To date, the Model Law has been adopted in Eritrea, Japan, Mexico, Poland, Romania, South Africa and Montenegro.

Furthermore, the BAP/CPA creates a \$125,000 homestead cap if either the debtor has been convicted of a felony which demonstrates that the filing of the case was an abuse of the provision of the Bankruptcy Code, or the debtor has debts from a violation of certain federal or state securities laws, crimes or intentional torts that caused serious bodily injury or death. The only exception to the cap is if the homestead is reasonably necessary for the support of the debtor and any dependent of the debtor.

#### *The Means Test for Chapter 7 Eligibility*

Under the BAP/CPA, a trustee or any creditor can move to dismiss a case for abuse if the debtor's income is greater than the median income for the state in which the debtor resides. Abuse is presumed if the debtor's current monthly income, as determined by a complex formula, is sufficient to pay at least 25% of the debtor's general unsecured debt over five years.

Debtors who meet this new standard will have their cases converted to cases under chapter 13 with a five year repayment plan. If a debtor's income is below the state median, the court may still find abuse, but creditors do not have standing to file the motion. The presumption of abuse may only be rebutted by demonstrating "special circumstances that justify additional expenses or adjustments of current monthly income."

**Comment:** This discussion only touches upon some of the profound changes to the bankruptcy laws as they impact individuals. Under prior law, it was relatively simple for individuals that were innocent victims of circumstance or even their own foolishness to get a fresh start. As a general rule, only individuals whose problems were the result of their own dishonesty were denied this opportunity. Under the new law, this is no longer the case. Unless demonstrably impecunious, individuals are now expected to repay a significant portion of their debts.

If you have any questions concerning this Special Bankruptcy Bulletin, or would like a copy of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, please contact Jonathan L. Flaxer at 212-907-7327, [jflaxer@golenbock.com](mailto:jflaxer@golenbock.com) or Douglas L. Furth at 212-907-7340, [dfurth@golenbock.com](mailto:dfurth@golenbock.com).

AUTHORS: Jonathan L. Flaxer, Douglas L. Furth, Andrea B. Schwartz and Moshie Solomon.

*Material in this Bulletin is intended for informational purposes only, and does not purport to be legal advice or opinion.*

© Golenbock Eiseman Assor Bell & Peskoe LLP

**JONATHAN L. FLAXER, PARTNER**

During his career, Mr. Flaxer has represented all types of constituencies in workouts and chapter 11 bankruptcy cases, including distressed investment funds, asset purchasers, indenture trustees, creditors' committees, landlords and tenants. He also has extensive experience in cross-border insolvency cases, and, in 1997, testified before a Senate subcommittee on the UNCITRAL Model Law on Cross-Border Insolvencies, which was recently enacted as part of the amendments to the Bankruptcy Code. Recently, Mr. Flaxer has represented the indenture trustee in the American Commercial Lines, Inc. and Exide Technologies cases, as well as the debtor in the Family Golf Centers, Inc. chapter 11 case. He is a member of the American Bankruptcy Institute, INSOL International, the Turnaround Managers Association, and the Panel of Mediators for the United States Bankruptcy Court, Southern District of New York

Mr. Flaxer is the author of "Supreme Court Says Market Test is Key to 'New Value' Contribution," 2000, Bankruptcy Yearbook Almanac; "United States Senate Subcommittee Holds Hearings on UNCITRAL Cross-Border Insolvency Proposal," INSOL International World, March 1998; "Bankruptcy Court Power to Adjudicate Contract Disputes," American Bankruptcy Institute Law Review, Vol. 2, No. 2, Winter 1994; "Bankruptcy in China," American Bankruptcy Institute Journal, Vol. XIII, No. 5, June 1994.

Mr. Flaxer is a graduate of Brooklyn Law School (1979) and New York University (1976). He joined Golenbock Eiseman Assor Bell & Peskoe LLP in December 1999. Prior to joining GEAB&P, Mr. Flaxer was an associate and, beginning in 1987, a partner of Winick & Rich, P.C. where he specialized in chapter 11 bankruptcies and corporate restructurings. Prior to joining Winick & Rich, P.C., Mr. Flaxer served a two-year clerkship with the Honorable Manuel J. Price (Ret.), United States Bankruptcy Judge, Eastern District of New York.

**DOUGLAS L. FURTH, PARTNER**

During his career, Mr. Furth has represented institutional lenders, including indenture trustees, in the workout, bankruptcy or restructuring of billions of dollars of secured debt across a wide spectrum of industries including, real estate, hotels, health care, retail, automobiles, manufacturing, toys, distribution and fast food. He was a pioneer in the negotiation and implementation of prepackaged chapter 11 cases having been primarily responsible for over ten successful prepackaged cases. Recently, he has represented the indenture trustee in the Dan River Inc. and General Media chapter 11 cases and he is currently representing the Debtor in the chapter 11 case for Whitehead Mann Inc. Notable bankruptcies in which he has played an important role include Farmland Industries (financial advisor to debtor), Marvel Entertainment (successful plan proponent), Olympia & York (bondholder's committee), Alert Holdings (equity committee), Ames Department Stores (special litigation counsel to creditor's committee), Coleco (senior secured creditor) and Texaco (debtor). In addition, Mr. Furth has represented chapter 11 debtors including a prominent destination resort hotel, a 107-unit retail chain and one of the largest New York City cooperative corporations to successfully emerge from chapter 11. He has also represented acquirers of a variety of significant assets from chapter 11 debtors including the successful purchasers of a major New York City office tower, a well-known hotel franchise, airplane equipment and many retail locations. He also has extensive experience representing landlords and tenants in bankruptcy cases.

Mr. Furth is the author of The Economics of Distressed Investing Buyside Magazine (Summer 2004), What Institutional Lenders Can Expect From The Business Aspects of the Pending Bankruptcy Legislation, 118 Banking L.J. 520 (2001), and Secured Creditors Playing to Win in a Single Asset Chapter 11 Case, 4 Journal of Bankruptcy Law and Practice 177 (1995).

Mr. Furth, a graduate of The Georgetown University Law Center (1982) and Dartmouth College (1979), joined Golenbock Eiseman Assor Bell & Peskoe LLP in December 2003. Prior to joining GEAB&P, Mr. Furth was a Managing Director and General Counsel of Trinity Capital, LLC. From 1988 through 2000, Mr. Furth was an associate and, beginning in 1991, a partner of Battle Fowler LLP where he specialized in chapter 11 bankruptcies and corporate restructurings. Prior to joining Battle Fowler, Mr. Furth was associated with Weil, Gotshal & Manges.



**GOLENBOCK EISEMAN ASSOR BELL & PESKOE LLP**

437 Madison Avenue • New York, NY 10022

[www.golenbock.com](http://www.golenbock.com)