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MEDIA COLLECTION szabo PROFESSIONALS

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Dear Friends:

In 2006, the year after Congress passed the Bankruptcy Abuse Prevention and Consumer Protection Act, U.S. bankruptcies fell dramatically as the law's provisions made bankruptcy a less attractive option for potential filers. The following year, the number of bankruptcies took an upward swing that has continued, reflecting an economy burdened by a troubled housing market, tight credit, and flagging consumer confidence. In this issue's feature, we discuss the bankruptcy "chapters" that credit managers are most likely to encounter in the BAPCPA environment as well as the Act's implications regarding debt recovery and preference payment defenses.

Our busy fall and early winter calendar includes the Media Financial Managers (MFM) Regional Seminar, October 16, in New York, New York; the Advertising Media Credit Executives Association (AMCEA), October 18-22, in Columbus, Ohio; the National Media Credit Group, November 18, in New York, New York; and our annual Szabo Holiday Party, December 13, here in Atlanta.

Best wishes for a wonderful fall season,

Robin Szabo, President
Szabo Associates, Inc.

Bankruptcies on the Rise ... Cover Your Bases in the BAPCPA Environment

The number of business bankruptcies has continued to escalate, with commercial filings for the first half of 2008 up 45% from last year. According to data from Automated Access to Court Electronic Records (AACER), nearly 29,000 U.S. businesses filed during the first half of the year. While business bankruptcy filings have outpaced consumer filings, consumer bankruptcies have increased to the highest level in more than two years, according to data from the National Bankruptcy Research Center. As individual filings increase, so do business bankruptcies, particularly small- and medium-sized businesses that cannot endure contraction of their customer base. With interest rate resets on sub-prime mortgages, tight credit requirements for business borrowing, and approximately one dollar out of seven disposable income dollars being used to pay down debt, we can expect this trend to continue in the months ahead.

Doing business with customers who have filed for bankruptcy demands an understanding of the various types of bankruptcy and preference actions in light of requirements imposed by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA). Enacted after nearly eight years of debate in Congress and commonly referred to as the "New Bankruptcy Law," BAPCPA contains the most significant changes to federal bankruptcy law since the enactment of the Bankruptcy Code in 1978.

Of the six types of bankruptcy outlined in the Code, there are four that business creditors are most likely to encounter: Chapter 7, liquidation; Chapter 11, reorganization; Chapter 13, wage earner plan; and Chapter 15, ancillary and other international cases.

BAPCPA and Chapter 7.
Chapter 7 is the most common type of bankruptcy and is available to both individual and business debtors. A company in Chapter 7 stops all operations and goes out of business. An appointed or elected trustee collects the debtor's non-exempt property, sells it, and distributes the proceeds among creditors. Secured creditors are first in line to receive proceeds. Unsecured debtors are paid on a pro rata basis after administrative expenses and other priority claims such as wages, retirement, consumer deposits, and taxes are paid. Unless otherwise instructed by the court, creditors must file a claim with the court within 90 days after the first date set for the first meeting of creditors (341 meeting) to have a chance of getting paid.

For individual debtors seeking Chapter 7 relief, BAPCPA created the additional requirement that they seek credit counseling from a government-approved program within 180 days prior to filing and imposed additional restrictions and obstacles designed to make Chapter 7 filing more difficult. The law also created new responsibilities for those charged with administering consumer bankruptcy (filing

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attorneys, for example) and those who counsel debtors regarding bankruptcy relief.

Among the most controversial aspects of the Act is the requirement that debtors take a "means test" to force those debtors capable of paying some of their debts to do so rather than "wiping the slate clean." The test projects the debtor's current monthly income, less specified expenses, over a five-year period to determine if the filing constitutes an "abuse" of Chapter 7 provisions. BAPCPA provides that the trustee or any creditor can obtain dismissal of an individual's case or conversion (with the debtor's consent) to a Chapter 11 or 13 by showing that the filing constituted "abuse" of Chapter 7 provisions. The new law lowers the previous "substantial abuse" standard for dismissal or conversion to one of simple abuse.

BAPCPA and Chapter 11. Chapter 11 is designed to "reorganize" a business or an individual's finances through a court-approved plan. It is typically used to reorganize businesses, corporations, proprietorships, or partnerships and is often filed by individuals with assets and liabilities that exceed the monetary limits required for Chapter 13. Corporate Chapter 11 does not put the assets of the stockholders at risk. Sole proprietorship Chapter 11 includes both the business and personal assets of the owner/debtor. In some partnership Chapter 11 cases, the partners' personal assets are included or the partners themselves are forced to file. Although Chapter 11 does not require creditors to file a proof of claim if the creditor recognizes its claim (listed in an indisputable amount on the schedule of liabilities filed by the debtor), it is *always* a good idea to file a proof of claim.

Ordinarily, the management of a business in Chapter 11 continues to run the day-to-day business operations as the "debtor in possession," and operations are monitored by the U.S. trustee and the bankruptcy court. A "creditors' committee," generally appointed by the U.S. trustee, works with the company on a Plan of Reorganization, which must be accepted by the creditors and stockholders, and confirmed by the court. The court is empowered to override rejection of the plan by creditors and stockholders if it finds that the plan treats them fairly.

BAPCPA's modification of the law pertaining to creditors' committees empowers the court to direct the U.S. trustee to change the membership of a committee if the court determines that the "… change is necessary to ensure adequate representation of creditor or equity security holders." The court may order the trustee to increase the number of committee members to include a small business creditor, for example. The committee's responsibilities to the creditor body, and in particular small businesses, have also been changed to increase creditors' access to current and continuing information from the committee.

A Chapter 11 debtor has a 120-day exclusive period to file a plan and up to 180 days to obtain acceptance. Both of these periods can be extended or reduced for "cause" by the court. Prior to BAPCPA, the law did not impose a time limit for court-granted extensions. BAPCPA now sets the time limit for exclusive rights to a maximum of 18 months for filing the plan and 20 months for obtaining acceptance. As in Chapter 7, BAPCPA requires individuals who file Chapter 11 to receive credit counseling within 180 days prior to the filing.

An accelerated Chapter 11 for small business debtors, which allows the case to move more quickly by simplifying the disclosure statement and plan confirmation processes, was created by The Bankruptcy Reform Act of 1994. BAPCPA attempted to further address lingering concerns about the impracticality of Chapter 11 for the small business debtor. In order to be considered a "small business," a debtor must be engaged in commercial or business activities, other than primarily owning or operating real estate, with debt no greater than $2.19 million (excluding debt to insiders and affiliates). While this definition is not significantly different than in the previous law, BAPCPA added an additional criterion: The debtor's case must be one in which the U.S. trustee has not appointed a creditors' committee, or the court has determined the creditors' committee is insufficiently active and representative to provide oversight of the debtor.

Provided the parties can commit to the deadlines, this type of Chapter 11 filing can save the small business debtor money and time. BAPCPA provides a 180-day exclusive period for the small business debtor to file a plan. A plan and disclosure statement are required within 300 days after filing, and the plan confirmation deadline is 45 days after the plan is filed. The court may extend these deadlines, but only after showing that confirmation of a plan will occur before the end of the extension period.

BAPCPA and Chapter 13. Chapter 13, Wage Earner Plan, is designed for individuals with a regular source of income and allows debtors to retain ownership and possession of assets while requiring them to make payments to creditors over a three- to five-year period. BAPCPA requires Chapter 13 debtors to receive credit counseling within 180 days prior to filing and made several changes that effectively increased the amount that debtors must repay.

In Chapter 13 cases, unsecured creditors must file a proof of claim within 90 days after the first date set for the first meeting of creditors. Priority and secured claims are paid in full. Some secured claims, a home mortgage, for example, may be

subject to payment according to the original loan schedule provided arrears are made up during the plan period. Creditors with unsecured claims are not necessarily paid in full, but they must be paid at least as much as they would receive if the debtor's assets were liquidated under Chapter 7.

BAPCPA and "Chapter 20."
Prior to the new law, many debtors filed Chapter 7 to discharge unsecured debts, then followed with Chapter 13 to deal with secured debt. BAPCPA eliminates this practice, commonly referred to as "Chapter 20," and addresses other types of bad faith repeat filings. The new law expanded the time between subsequent Chapter 7 discharges from six to eight years. A debtor filing Chapter 13 cannot get a discharge if the debtor received a discharge in a Chapter 7, 11, or 12 case filed within four years of the filing of the new case. Additionally, a debtor filing Chapter 13 cannot receive a discharge if the case is filed within two years of the filing of a previous Chapter 13 case.

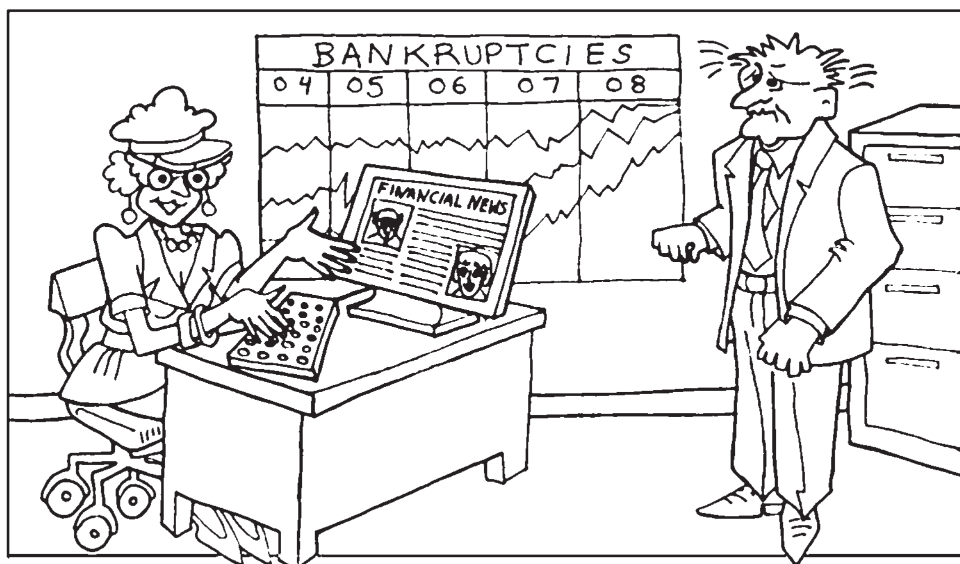
BAPCPA and Chapter 15.
BAPCPA added Chapter 15 to the Bankruptcy Code. Based on the Model Law on Cross-Border Insolvency drafted by the United Nations Commission on International Trade Law, it is much broader and detailed than Section 304 of the Code, which it replaced. Chapter 15 provides mechanisms for dealing with insolvency cases involving debtors, assets, claimants, and other parties of interest when more than one country are involved. Generally, a Chapter 15 case is ancillary to a primary proceeding in another country, usually the debtor's home country. Alternatively, the debtor or creditor may commence a full Chapter 7 or Chapter 11 case in the U.S. if the assets in this country are sufficiently complex to justify such a proceeding. If a full bankruptcy case is initiated in the U.S. by a foreign representative and there is a foreign main proceeding pending in another country, bankruptcy court jurisdiction is generally limited to the debtor's assets that are located in the United States.

BAPCPA and Preference Actions.
To trade creditors, one of the most welcome aspects of the new law is its expanded protections in the area of preferences. The initial burden of establishing that a payment is a preference belongs to the trustee. By law, the trustee cannot establish a preference unless all of five elements are met: (1) The payment was made on or within 90 days before the date of the Bankruptcy Petition (or between 90 days and one year before the filing of the petition if the creditor at the time of the transfer was an "insider"). (2) The payment was made to or for the benefit of the creditor. (3) The payment was for or on an account for an antecedent debt owed by the customer before the payment was made. (4) The payment was made while the customer was insolvent. (5) The payment must have enabled the creditor to receive more than it would receive under a Chapter 7 liquidation of the customer's bankruptcy estate. (For a more detailed explanation of these "essential elements," see *Collective Wisdom*, December 2004.)

BAPCPA changed the venue statute for preference actions. Generally, preference actions of less than $10,000 may now take place only in the district court for the district where the trade creditor resides. This modification helps protect trade creditors from settlement pressure in cases where the cost of defending the payment might exceed the amount of the debt.

The Act also established a minimum amount subject to avoidance of less than $5,000 (an aggregate amount of transfers during the 90-day reach back period). The effect of these two modifications is that amounts between $5,000 and $10,000 must be litigated where the trade creditor is located, and amounts less than $5,000 are precluded from being litigated as preferential transfers at all.

BAPCPA also addressed instances in which payments are made by the debtor to a "non-insider" creditor for the *benefit* of an "insider" creditor. The new language states that if such a transfer is made between 90 days and one year before the date of the filing, the transfer can be



"Five days prior to filing bankruptcy, Mr. Z dispatched Mr. C with $1,780,000 in company funds to pay off a bookie in Reno, a vacation house contractor in Palm Beach, and a manicurist in Poughkeepsie. After hearing about her husband's intended defense of the payments the now ex-Mrs. Z was quoted as saying, 'Yeah, sounds to me like the "ordinary course of business" for that two-timing no-good creep.' "

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avoided ***only with respect to the insider***. If the insider is the guarantor of the debt, and the debtor makes payment to the creditor, the guarantor benefits. Courts in the past have applied the "DePrizio" rule, which held that a payment to a creditor which also benefited an insider (in this example, the guarantor) would be regarded the same as that of an insider, within that longer reach back period of one year. The new Act clarifies the situation, placing trade creditors in a more favorable position and allaying their fears of preference actions because they hold the personal guaranty of an insider.

One of the more frustrating aspects of the previous law has been the two-prong test required of creditors for the "ordinary course of business" defense. Prior to the new Act, creditors wishing to successfully defend a payment with this defense had to show: (1) that the transfer was *made* in the ordinary course of business or financial affairs of the debtor and the transferee for a debt *incurred* by the debtor in the ordinary course of business; *and* (2) made *according to* ordinary business terms. The requirement imposed an enormous challenge to creditors who had a limited history of transactions with the debtor or to whom the preference payment was for the first transaction between the creditor and debtor.

Under the new Act, the exception will be satisfied when the transfer is a payment made in the ordinary course of business of both the debtor and transferee *or* when it is a payment made according to ordinary business terms. (The transfer still must be one for a debt incurred in the ordinary course of business for both the debtor and the transferee.) The change enables creditors to choose the best defense available to them. The "subjective test" required by the first alternative demands that the specific relationship between the creditor and debtor be thoroughly examined. If, before and during the preference period, payment was consistently between 45 and 50 days and there were no changes in the collection efforts, the subjective test has been passed. If the creditor chooses to show that the payment was made according to ordinary business terms in accordance with industry norms, the "objective test" prescribed by the Code requires the creditor to provide evidence of the range of terms considered normal in the industry.

Support and Criticism.
Prior to the passage of BAPCPA, proponents and opponents faced off on a number of issues, central to which was disagreement about the extent of abuse and fraud in the bankruptcy system. Supporters emphasized the need to restore personal responsibility and integrity to a system that too often allowed fraud and abuse to prevail, while critics argued that claims of abuse and fraud were overblown. Among the most contentious issues under debate were the means test, additional reporting requirements, mandated credit counseling, and additional attorney liability, all of which, critics argued, would result in higher costs to debtors seeking relief. Trade creditors, however, have welcomed many provisions of the new law, which can facilitate debt recovery and reduce the burden of successfully defending preference payments. ♦

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