ROETZEL
FOCUSED ON WHAT MATTERS TO YOU

10 Things Every Practitioner Should Know About the New Bankruptcy Act

John "Jay" J. Rutter, Esq.

Roetzel & Andress LPA

Published in *Law & Fact*, a publication of the Cuyahoga County Bar Association (October 2006)

Introduction

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"), which President Bush signed into law April 20, 2005 and became effective October 17, 2005, brought major changes to bankruptcy law. While this new legislation was primarily enacted to stem the flow, real or perceived, of individual debtors who abused the old Code's widely available protections, BAPCPA brings with it substantial changes affecting nearly every field of law. The purpose of this article is to provide legal practitioners, particularly those with little or no bankruptcy expertise, with a snapshot of the new law's more significant changes and how BAPCPA affects businesses and individual clients alike.

Avoidance of Preferential and Fraudulent Transfers

BAPCPA's pro-creditor reputation derives in no small part from the limits it places upon a bankruptcy trustee's power to avoid certain debtor-creditor transactions. 11 U.S.C. § 546. For example, Section 546(c)(1) expands a seller's right to reclaim goods that it sold in the ordinary course of its business to a debtor pre-bankruptcy. The old law granted sellers paramount rights as to such goods that were sold to the debtor within ten (10) days of the filing of the bankruptcy case. The new statute, however, extends the reclamation period to include goods sold to the debtor forty-five (45) days before the filing. This expansion significantly enhances creditors' ability to recover goods that previously would have been forfeited to the bankruptcy estate. Under the new law, creditors have a much greater chance of making themselves whole (or close to it) instead of being left with a proof of claim typically worth a fraction of the goods' value.

Another important change is found in BAPCPA's surprising revision of Section 547(c)(2), commonly referred to as a creditor's "ordinary course of business defense" to a trustee's preference action. The pre-BAPCPA ordinary course defense required a creditor to show that a payment was: (1) made upon a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, (2) made in the ordinary course of business or financial affairs of the parties, *and* (3) made according to ordinary business terms. This three-prong test was understood to require a creditor to satisfy both a subjective inquiry into the parties' dealings (prongs 1 and 2) and an objective inquiry as to standards observed in the relevant industry (prong 3). BAPCPA lessens a creditor's burden substantially, as the new Section 547(c)(2) replaces the conjunctive "and" after the second element with "or." Based upon this new language, Section 547(c)(2) sets forth two separate and independent defenses: the well-used ordinary course defense and a new "ordinary business terms defense." *In re National Gas Distributors, LLC*, 2006 WL 2135557 (Bankr. E.D.N.C., 2006). Congress has thus provided creditors with an important new weapon for fending off preference actions.

Although trustees' powers to avoid certain transactions have been somewhat limited, Congress did beef up trustees' ability to avoid fraudulent transfers. For example, Section 548(a)(1)(B)(ii)(IV) adds so-called key employee retention plans, or KERPS, to the list of transfers that may be avoided, so long as the KERP payments at issue are not made in the ordinary course of business. Also, the look-back period during which a trustee may avoid fraudulent transfers has been increased from one year to two years prior to the commencement of a bankruptcy case, but only in cases that are filed on or after October 18, 2006.

Following is a review of several more prominent changes:

Consumers

Who may be a debtor?

Among the many provisions that BAPCPA critics fear discourage individuals from seeking bankruptcy protection is the newly-added Section 109(h)(1), which requires individuals to undergo credit counseling from an accredited and approved agency, at their expense, at least 180 days before filing a bankruptcy petition. Although this requirement may be waived in certain situations, such as when the would-be debtor cannot pay for counseling or counseling services are not available, courts have struggled to determine when "exigent circumstances" exist. *In re Piontek*, 2006 WL 1837905 (Bankr. W.D. Pa., 2006) (holding that joint-debtor wife's claimed inability to pay $50 for credit counseling was deemed insufficient to waive requirement based upon review of debtors' assets); *In re Westenberger*, 2006 WL 1105008 (Bankr. S.D. Fla., 2006) (waiving credit counseling requirement because debtor's frozen bank account constitutes exigent circumstance preventing payment of counseling fee); *In re Sosa*, Bankr. E.D. Texas, 2005 (dismissing case because joint debtor failed to obtain credit counseling before filing emergency petition to prevent foreclosure).

The Means Test – a presumption of relief or abuse?

Perhaps the most vexing and complicated BAPCPA development lies in the new "Means Test," which is now used to determine whether an individual qualifies for a Chapter 7 proceeding. Briefly stated, the Means Test employs a complex set of calculations based upon IRS and Census Bureau standards to determine current monthly income and allowable expenses in order to arrive at a number that ultimately determines whether the debtor should be granted Chapter 7 relief or channeled into a Chapter 13 proceeding. The implementation of the Means Test reveals a stark philosophical shift, for the long-standing presumption in favor of granting Chapter 7 relief has been replaced with the presumption of abuse when the results of a debtor's Means Test reveals that sufficient monthly income exists to sustain a Chapter 13 plan. 11 U.S.C. § 707(b)(2)(A)(i).

Concerns about multiple filings

Section 362(c)(3) provides that, with limited exception, a debtor, who files a case under Chapters 7, 11, or 13 within one year of the dismissal of a previous case in which he or she was a debtor, must demonstrate why the automatic stay in the pending case should not terminate a mere thirty (30) days after its commencement. A debtor must show that the subsequent filing was done in good faith in order to maintain the automatic stay.

Section 362(c)(4) further provides that, because the third filing is presumed to have been made in bad faith, the automatic stay is eliminated altogether where a debtor has filed two or more cases within the preceding year that were dismissed. A stay, however, may be obtained upon request of a party in interest. It goes without saying that counsel must be aware of a client-debtor's history in order to protect the client from the serious consequences that may occur on account of previous filings.

Small Business Debtors

Generally speaking, a small business debtor is defined as a person engaged in commercial or business activities that has aggregate secured and unsecured debts, excluding debts owed to affiliates or insiders, of not more than $2,000,000.00 at the time of filing. BAPCPA has imposed new reporting requirements under which a small business debtor must demonstrate profitability, projected cash flow, comparisons of actual receipts and disbursements with those projections, and that it is in compliance with all post-petition requirements. 11 U.S.C. § 308. Compliance with all of these new reporting requirements is crucial, for unexcused failure to do so results in conversion and ultimate liquidation under Chapter 7 or dismissal of the case. 11 U.S.C. § 1112(b)(4)(F).

The exclusivity period, during which only the debtor may file a Chapter 11 plan, has also changed for small business cases. Section 1121 now provides a 180-day, as opposed to a 100-day, exclusivity period for small business debtors that may be extended to 300 days maximum before the debtor is required to show that, more likely than not, the court will confirm the plan.

Real Estate

Attorneys with residential real estate practices should note that further amendments to the automatic stay provisions of Section 362 grant lessors and secured parties with new protections against defensive bankruptcy filings. It used to be that a tenant facing eviction could avoid removal from his or her residence simply by filing a bankruptcy petition and invoking the automatic stay. In keeping with its policy of discouraging ill-motivated filings, however, Section 362(b)(22) provides that the automatic stay does not exist to prevent a lessor from executing upon a judgment for possession that was obtained pre-bankruptcy against a residential tenant under a lease or rental agreement. This change is especially powerful in Ohio, for Section 362(l) provides limited circumstances in which a debtor may revive the stay. Application of that section, however, hinges upon whether applicable non-bankruptcy law permits debtors to cure post-judgment defaults. Ohio's unlawful detainer statutes do not allow debtors to cure their defaults after judgment has been granted. Thus, Ohio judgment debtors cannot stave off their judgment-wielding lessors by simply filing a bankruptcy petition on the eve of eviction.

Secured creditors seeking foreclosure upon real property have also fared well under BAPCPA's new automatic stay provisions. For example, under Section 362(d)(4), courts may issue orders terminating or modifying the stay with respect to secured creditors and certain real property upon determining that a debtor's bankruptcy filing was made with intent to delay, hinder, and defraud creditors and that the case involves either a transfer of the debtor's interest in the real property or multiple bankruptcy filings affecting the property. Once duly recorded under state law, these orders are binding for a period of two years in any future bankruptcy case affecting the real property. Ambiguity exists, however, when these orders are compared with Section 1301, which extends the automatic stay to co-debtors in Chapter 13 cases. Section 1301 has not been changed, thus raising the question of whether Section 362(d)(4) orders are binding upon co-debtors in subsequent Chapter 13 cases. While it may be argued that Congress left Section 1301 untouched because it considered Section 362(d)(4) orders to be purely *in rem*, the courts have not dealt with the issue to date.

In addition, the powerful discharge injunction, which eliminates a debtor's personal liability upon most pre-petition debts, has been modified to permit creditors holding residential mortgages to take certain post-discharge acts in lieu of foreclosure. For example, Section 524(j) allows creditors with security interests in a debtor's principal residence to seek periodic payments upon their liens instead of pursuing purely *in rem* relief, so long as this alternative falls within the creditors' ordinary course of business. This amendment provides such secured parties with an effective one-two punch that enables them to pursue less costly payment plans while retaining the ever-looming right to foreclose.

Family Law

With respect to family law, the automatic stay no longer applies to domestic support obligations, which include paternity, custody, domestic support obligation hearings, certain dissolution proceedings, and domestic violence proceedings. 11 U.S.C. § 362(b)(2)(A)(i) – (v).

BAPCPA's changes affect Ohio homesteads as well. Section 522(p)(1) provides that debtors "electing" to exempt property under state law may not exempt more than $125,000.00 of the value of a homestead that was acquired within 1,215 days of the bankruptcy filing. 11 U.S.C. § 522(p)(1). Whether this cap applies to debtors in all states is unclear. With the exception of Minnesota and Texas, all states are "opt out" states, meaning that their respective laws establish state exemptions and forbid debtors from utilizing the federal exemption scheme. Although the issue has not been decided in the Sixth Circuit, courts are split as to whether Section 522(p)(1) applies to non-opt out states or to all states. *See*, *In re McNabb*, 326 B.R. 785, 791 (Bankr. D. Ariz., 2005) (holding that § 522(p)(1) does not apply to opt out states because their laws require debtors to use state exemptions and therefore there is no "electing" state law); *In re Kaplan*, 331 B.R. 483, 487-88 (Bankr. S.D. Fla., 2005) (holding that Congress intended § 522(p)(1) to apply to all states, not just Minnesota and Texas).

Attorneys

BAPCPA imposes several new restrictions and liabilities upon bankruptcy practitioners who represent consumers. For example, the new Code has created the concept of the "debt relief agency," which must make numerous disclosures to "assisted persons." 11 U.S.C. § 527. The Code defines a debt relief agency as "any person who provides any bankruptcy assistance to an assisted person in return for the payment of money or other valuable consideration . . . ." 11 U.S.C. § 101(12A). While the plain meaning certainly appears to encompass debtors' counsel, the disclosure requirements and attendant liabilities foisted upon debt relief agencies have engendered heated debate. For example, Section 526(a)(4) prohibits a debt relief agency from advising "an assisted person . . . to incur more debt in contemplation of filing a case . . . or to pay an attorney or bankruptcy petition preparer fee or charge for services performed as part of . . . representing a debtor . . . ." Id.

Various disclosure requirements have been successfully attacked as unconstitutional, but the issue as to what exactly constitutes a debt relief agency remains uncertain. *See*, *Olsen v. Gonzalez*, Case No. 05-6365-HO (D. Ore., 2006) (holding that attorneys are debt relief agencies, but that restriction preventing attorney from advising client to incur debt is overbroad); *contra*, *In re Attorneys at Law and Debt Relief Agencies*, 332 B.R. 66 (Bankr. S.D. Ga., 2005) (ruling that attorneys are not debt relief agencies).

In addition, BAPCPA requires debtors' counsel to verify that they have made a "reasonable inquiry" into the truth of the information contained in a debtor's petition and schedules, a requirement that promises to slow the filing process and increase fees. 11 U.S.C. § 707(b)(4)(C)(i). What's more, the new Code provides for civil sanctions against a debtor's attorney if a case is dismissed and the court finds that the filings were not reasonably verified. 11 U.S.C. § 707(b)(4).

Conclusion

Given the substantial changes affecting creditors and consumers alike, every practitioner should familiarize him or herself with the BAPCPA so that well-informed and effective counsel is available to all of our valuable clients.

John "Jay" J. Rutter
330.849.6713 | jrutter@ralaw.com

Jay is an Associate in Roetzel's Akron office and represents banks and other financial institutions in business and commercial litigation matters.