



## BUSINESS PROVISIONS - THE BANKRUPTCY ABUSE PREVENTION AND CONSUMER PROTECTION ACT OF 2005

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### Overview

On April 20, 2005, President Bush signed into law the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "Act") which makes broad and sweeping changes to the Bankruptcy Code (the "Code").<sup>1</sup> While much media attention has focused on the changes to the Code relating to consumer bankruptcy issues – which by all reports will make it more difficult for consumers to file Chapter 7 – the Act also changes many provisions of the Code that affect business bankruptcies from the perspective of both debtors and creditors. This paper addresses a number of these changes made to the Code by the Act.<sup>2</sup>

Several of the significant revisions to the Code from the Act are discussed below; however, important points to note are:

- The changes require debtors to do more advance planning prior to filing for bankruptcy. Time horizons have been shortened and courts have less discretion to extend them. There may be more pre-packaged bankruptcy filings known as "pre-packs" where a plan is negotiated with informal creditor groups and solicitation of creditor's approval of the plan is begun, if not completed, pre-petition.

- The Act places limits on payments a debtor may make to directors, officers and other insiders both before and after it files for bankruptcy.
- The Act gives creditors additional rights, particularly creditors who are either secured by real property or are lessors of real property.
- The Act now makes mandatory certain disclosure and reporting requirements for all "small business" debtors and provides them a streamlined Chapter 11 plan process.

### Classification of Debtors and Pre-petition Planning

The revised Code enhances the definitions of two specific types of business debtors – small business debtors and single asset real estate debtors. The provisions relating to small business debtors are extensive and are discussed below. The primary change for single asset real estate debtors is the elimination on the secured debt cap for a debtor to come under the relevant provisions of the Code. Previously, the Code limited the designation to entities with secured debts of less than \$4 million. Under the revised Code, all debtors who are owners of real property constituting a single property or project (other than family farmers and owners of residential property with fewer than 4 units) and who generate

<sup>1</sup>The Bankruptcy Code is designated as 11 U.S.C. §§ 101-1532.

<sup>2</sup>See *Highlights of Consumer Bankruptcy Changes Under The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005* by C. Scott Meyers, July 2005 for a summary of the changes made by the "Act" affecting consumer bankruptcies.

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substantially all of their gross income from owning and operating the real property and related activities are classified as single asset real estate debtors. § 101(51B). A single asset real estate debtor has only 90 days to either file a feasible plan or resume regular mortgage payments to avoid the court granting a secured lender relief from the automatic stay. § 362(d)(3). As a result, larger debtors having real estate as their primary asset will come under the heightened obligations to either generate adequate cash in bankruptcy to pay the secured lender or be able to quickly file a plan of reorganization. In addition, a secured lender may commence foreclosure against the real estate if, as part of a scheme to delay or hinder, the debtor transferred the real property without the consent of the lender or if the debtor has had multiple bankruptcy filings involving the same property. § 362(d)(4).

The revised Code makes it easier for a debtor to do a prepackaged reorganization. In a “pre-pack,” a potential debtor negotiates and solicits approvals from creditors for a plan before filing for bankruptcy so that it may then enter and exit the bankruptcy process quickly. Under prior rules, if the entity had to file for bankruptcy before completing the solicitation, a new disclosure statement would need to be filed before soliciting any creditors post-petition. The Code now permits pre-petition activity soliciting approval of a plan to continue uninterrupted post-petition and allows the court to dispense with a 341 meeting of creditors. § 1125(g) and § 341(e).

## ***Special Small Business Provisions***

The revised Code has new mandatory provisions for debtors meeting the definition of a small business. These provisions, which supplement other generally applicable provisions in the Code, put additional reporting burdens and time limits on a small business debtor, but also provide it with additional flexibility in filing and confirming a plan of reorganization. A small business debtor is defined as an entity whose primary business is not owning or operating real estate and whose

non-contingent and liquidated debts on the date the debtor files its petition (the “Petition Date”), excluding debts to insiders and affiliates, are less than \$2 million and where the court either has not appointed an unsecured creditors’ committee or determined that such committee is not active enough to provide effective oversight of the debtor. § 101(51D).

A small business debtor will have more prescribed interactions with the US Trustee or Bankruptcy Administrator than a large Chapter 11 debtor whose actions during bankruptcy are monitored by active creditors’ and/or equity holders’ committees<sup>3</sup>. The revisions acknowledge that most Chapter 11 filings are by small business debtors whose creditors do not have claims large enough to warrant their participation on a creditors’ committee. Therefore, a small business debtor has heightened reporting responsibilities and the Bankruptcy Administrator’s office is required to more actively monitor these debtors. A small business debtor must permit a representative from the Bankruptcy Administrator’s office to inspect its premises as well as its books and records. § 1116(7). In addition, the Bankruptcy Administrator must interview the debtor prior to the § 341 Meeting of Creditors to investigate the debtor’s viability, inquire about its business plan and to explain the debtor’s reporting obligations under the Code. 28 U.S.C. 586(a)(7).

A debtor who is classified as a small business has additional duties and obligations under the revised Code. A small business filing under Chapter 11 is required to make additional disclosures by supplementing the standard information required in a petition with a complete set of financial statements, including balance sheet and income statement, as well as a copy of its federal income tax returns. § 1116(1). The debtor must timely file all schedules and information within 30 days of its petition date and no extensions may be granted except for extraordinary or compelling circumstances. § 1116(3). In addition, the debtor is required to maintain insurance coverage customary for

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<sup>3</sup>North Carolina and Alabama have a Bankruptcy Administrator rather than a United States Trustee. In all significant respects their duties are the same.

its industry and timely file all tax returns and other governmental filings. § 1116(5) and (6).

Heightened reporting requirements during the pendency of its case mandate that a small business debtor must file periodic reports containing specified information and which must include a cash flow projection for each period, as well as a comparison of actual results versus projections made for the prior period. § 308(b). In addition, the debtor must report on whether or not it is meeting other requirements of the Code, orders of the court and if it is current in both filing and paying taxes. § 308(b)(4). Finally, a small business debtor who has filed a previous bankruptcy case may not be able take advantage of the automatic stay absent compelling circumstances and proof to the court of its ability to confirm a feasible plan of reorganization. § 362 (n).

Balancing the heightened reporting and monitoring requirements are simplified procedures for filing a disclosure statement and plan of reorganization and for approving the disclosure statement and confirming the plan. A small business debtor has more time in which it may exclusively file a plan than a regular Chapter 11 debtor – 180 versus 120 days after the Petition Date. § 1121(b) and (e)(1). In order to get an extension of time, the small business debtor must show that it will be able to confirm a plan and a new deadline must be imposed at the time an extension is granted. § 1121(e)(3).

Plan and disclosure statements are simplified for small businesses. In a small business case, the two may be combined into a single document and even if a separate plan and disclosure statement are filed, the hearing on them may be combined. § 1125(f). In addition, a small business debtor may be able to take advantage of a standard form disclosure statement and plan. § 1125(f).

Many debtors who meet the small business definition will not want to make the additional required disclosures such as the release of its tax returns. However, a plan (if any) must be filed within 300 days of the Petition

Date unless an extension is granted. By quickly encouraging the formation of an active creditors' committee, a Chapter 11 debtor may avoid being considered a small business and therefore avoid compliance with the specialized sections of the Code that would otherwise apply to it.

### ***Enhanced Creditor Rights***

A number of the new provisions enhance creditors' leverage by limiting the time a debtor has to make a decision or take action. First, unless the creditor agrees, a debtor has 120 days after filing its petition to decide to assume or reject a lease for non-residential real property. § 365(d)(4). The court may grant one 90 day extension for cause, but no additional extensions are permitted without the consent of the creditor. § 365(d)(4). If the debtor assumes such contract or lease and then later rejects it, the creditor has an administrative claim for up to 2 years worth of damages. § 503 (b)(7). While the shortened time to assume or reject a lease may be more beneficial for landlords, it may be more burdensome for general lenders who want the debtor to generate as much cash as possible. For example, the permitted time to assume a lease may not permit a retailer to go through a peak selling season before deciding which leases to assume or reject.

Utilities get even more special treatment under the revised Code. A utility may cut off service to a debtor if, within 20 days after the Petition Date, the debtor does not furnish adequate assurance that future bills will be paid. § 366(b). For a debtor in Chapter 11, the time is extended to 30 days, but the new revisions define the term "adequate assurance" and they specifically indicate that many past common practices, such as granting any unpaid bills administrative expense priority, no longer provide a utility adequate assurance. § 366(c). Furthermore, without court approval, a utility may use any pre-petition security deposit to offset amounts owed to it. § 366(c)(4). For a debtor heavily dependent on communication services and other utility services, these changes may require extra cash to either pay a utility a

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significant deposit or to post a certificate of deposit or surety bond with the utility.

All creditors are entitled to more information under the revised Code. Any creditor who is not on a creditors' committee may obtain access to information from the committee which represents similar claims. § 1102(b)(3)(A). In addition, creditors' committees must solicit and receive comments from other creditors holding similar claims as those represented by the committee and who are not on the committee. § 1102(b)(3)(B) and (C). Finally, the revisions protect small creditors with an otherwise small claim but one that is large as compared to the size of the creditor. Although a creditors' committee is made up of the 7 largest creditors in each class, the court may expand the committee to include a creditor whose claim with the debtor is a significant portion of the creditor's annual gross revenues. § 1102(a)(4).

Under the Code, the trustee or debtor in possession may avoid or reverse certain transfers from the debtor, all for the benefit of the debtor's estate. The revisions to the Code give a pre-petition provider of goods and services to the debtor additional protections to escape loss. A seller of goods to a debtor may now reclaim goods received by the debtor within 45 days prior to the Petition Date, or, if the 45-day period expires after the Petition Date, a seller may reclaim such goods up to 20 days after the Petition Date without running afoul of the trustee's avoiding powers. § 546(c). Furthermore, and perhaps more important, a seller will have an administrative claim for any unpaid goods received by the debtor in the ordinary course of business within the 20 days prior to the Petition Date. § 503(b)(9).

## ***The Trustee's Avoiding Powers***

The Act makes it easier for creditors to defend preference actions brought by the trustee for transfers made by the debtor in the 90 day period prior to the Petition Date. These preference actions seem most unfair to creditors – not only do they generally have claims for goods shipped and for which they will get only pennies on the dollar, but they now are being sued in preference

actions for the return of money they were paid by the debtor for goods and services they sold to the debtor. In most large bankruptcy cases, it has become the practice to file hundreds of preference actions and force settlements, even when the creditor has a valid defense. With the revisions to the Code, a trustee may not bring a preference action for transfers to a creditor with a value of less than \$5,000. § 547(c)(9). Second, preference claims of less than \$10,000 must be brought in the court district where the defendant resides, not where the bankruptcy case was filed. 28 U.S.C. § 1409. Third, the ordinary course defense to a preference action is greatly simplified so that it will be a viable defense without the need for expert witnesses to testify as to what the ordinary course is in an industry and should reduce the number of settlements to “just get rid of the thing.” § 547(c)(2). In addition, a seller of goods now has 30 days after receipt of the goods by the debtor to perfect a security interest in them and hence to have an additional defense in a preference action. § 547(c)(3)(B) and § 547(e)(2).

On the other hand, to prevent abuse by creditors, the trustee is granted two provisions that make it easier for a trustee to avoid fraudulent pre-petition transfers. First, the reach back period for fraudulent transfers is lengthened to two years. § 548(a). Second, the trustee may avoid certain fraudulent transfers of the debtor to self-settled trusts made up to 10 years prior to the Petition Date. § 548(e).

## ***Payments to Insiders and Employees***

Additional revisions deal with payments to directors and officers and other insiders post-petition. Under the new Code, a debtor may no longer treat unlimited payments for retention bonuses or severance as administrative expenses. First, the revised Code places an absolute prohibition on the payment of retention bonuses to insiders unless the court finds that the services of the person are essential to the business, the insider has a bona fide job offer for at least his current salary and the amount is within prescribed guidelines. § 503(c)(1). There is also a prohibition on severance payments to insiders as well. No insider may receive a severance payment unless

the severance is offered to all full-time employees and the amount offered to the insider is within prescribed limits when compared to severance payments made to non-insiders. § 503(c)(2). A related provision permits the trustee to avoid payments made to insiders under an employment contract and not in the ordinary course of business within two years of the Petition Date. § 548(a)(1).

While payments to insiders are curtailed, certain revisions to the Code enhance payments to the remainder of the debtor's employees. The monetary cap on pre-petition wages and employee benefits entitled to priority payment is increased to \$10,000 and the reachback period now extends for 180 days. § 507(a)(4) and (5). An employer who terminates or modifies employee retirement plans on the eve of bankruptcy may have those plans reinstated by the court if it finds that the balance of the equities so requires. § 1114(l). Finally, there is an additional provision protecting back pay awards determined pursuant to a judicial or National Labor Relations Board proceeding. § 503(b)(1)(A)(ii).

### ***Operation of the Debtor and the Plan***

The trustee and the court are both given more specific guidelines to deal with a debtor who is not progressing toward filing a plan, is not meeting the requirements of the Code or is engaged in fraud. The revisions provide expanded grounds for dismissal or conversion of a case and for the appointment of a trustee. The new Code provides that a court must convert to Chapter 7 or dismiss a case for cause if it finds that doing so is in the best interest of the creditors and the estate. § 1112(b). The revisions expand the definition of cause to include a continuing diminution of the estate with little likelihood of rehabilitation, gross mismanagement of the estate, failure to maintain proper insurance coverage, unauthorized use of cash collateral, failure to comply with any filing or reporting requirements or other provisions of the Code, failure to timely pay taxes and failure to file a plan or disclosure statement within the time limits. § 1112(b)(4). Alternatively, if the court finds that grounds exist to convert or dismiss a case, rather than doing so, the court may order the appointment of a trustee or an

examiner if doing so would be in the best interests of the creditors and the estate. § 1104(a)(3).

Timing requirements on the debtor's exclusive ability to file a plan are tightened. A debtor has only 120 days from the Petition Date to exclusively file a plan and 180 days to get it accepted by creditors. § 1121(b) and (c). These deadlines may be extended to 18 months and 20 months, respectively. § 1121(d). To be confirmable, a plan must provide that all tax claims are paid in equal installments under the plan and at least as favorably as any other class of claims under the plan, other than a convenience class of small claims. § 1129(a)(9)(C). In addition, a disclosure statement is now required to include a discussion of potential material federal tax consequences for the debtor and equity holders under the plan. § 1125(a)(1). In determining the adequacy of a disclosure statement, the court shall consider the complexity of the case and the cost of providing additional information. § 1125(a)(1).

### ***Other Significant Changes to the Code***

The revisions address two contemporary concerns – personal privacy and quality of health care. Therefore, the new Code provides for the creation of privacy and patient care ombudsmen to protect those interests. Unless it finds one unnecessary, a Court must appoint a patient care ombudsman within 30 days of the Petition Date in the bankruptcy of a health care business to monitor the quality of patient care during the bankruptcy and to represent the interests of patients. § 333.

A consumer privacy ombudsman must be appointed by the court if a hearing is required relating to the sale or lease of property for which the debtor has a privacy policy in place as of the Petition Date “prohibiting the transfer of personally identifiable information about individuals to persons that are not affiliated with the debtor.” § 363(b)(1). The duties of the consumer privacy ombudsman include assisting the court to determine if the proposed sale complies with the debtor's privacy policy and the effect that such a sale or lease would have on the debtor's customers. § 332. Moreover, when a

proposed sale or lease affects personally identifiable information, the court must insure such action would not violate any applicable nonbankruptcy law. § 363(b).

A completely new Chapter of the Code is added to deal with cross border insolvencies. This Chapter, Chapter 15, is modeled after the Model Law on Cross Border Insolvency and provides mechanisms for dealing with insolvency courts in other nations. More particularly, new Chapter 15 applies to bankruptcy filings in other countries where the assistance of a U.S. court is required, as well as where a debtor files under the Code, but the cooperation of another country's courts are required for example, to protect and control assets of the estate.

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We would be happy to discuss any of the changes instituted by the 2005 Act with you. Please contact one of the following Brooks Pierce advisors if you would like to discuss these issues.

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