



First in a Series of Updates Regarding the . . .

Bankruptcy Abuse Prevention and Consumer Protection Act of 2005

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "Act") was signed into law by President Bush on April 20, 2005. With some exceptions, the Act will take effect for bankruptcy cases filed after October 17, 2005. The Act contains sweeping changes to the Bankruptcy Code. These changes will affect many interests, including general unsecured trade creditors, secured creditors, landlords, utility companies, and parties to financial contracts. We will present some of the key issues affecting these constituencies in a series of newsletters. In this edition, we will provide you with an overview of the principal changes to the Bankruptcy Code affecting general unsecured trade creditors and landlords. Subsequent editions will cover issues affecting other business interests.

Reforms Benefiting Business Creditors Generally

Creditors will benefit from several provisions which allow them to recover more on their claims for goods sold to a debtor and to avoid litigation in often distant bankruptcy courts.

Expansion of Reclamation Claims.

The Act may give sellers of goods more than twice as long to make a reclamation demand to reclaim possession of goods sold to the debtor on credit. The amendment of § 546(c) preserves from avoidance a written reclamation demand so long as it is made (i) not later than 45 days after receipt of such goods by the debtor or (ii) not later than 20 days after the commencement of the case if the 45-day period expires after the commencement of the bankruptcy. The seller must be vigilant, however, to comply with the time limitations or an otherwise valid reclamation claim will be lost. It is also important to note that while § 546(c) currently defers to state law, the amendment contains no such reference. Therefore, the new § 546(c) contains a uniform rule that trumps state law.

Administrative Claim for Goods Sold Prepetition.

The Act gives sellers an administrative claim for goods sold to the debtor in the ordinary course of business within 20 days before commencement of the case. Although administrative claims sometimes were awarded in lieu of the return of goods pursuant to a timely reclamation demand, the new claim is not lost due to the failure to give notice before the deadlines described above or before the debtor has pledged or resold the goods. However, this new administrative claim is valueless if secured claims against the debtor exceed the value of its assets.

Broadened Preference Defenses.

The ordinary course of business defense to a preference suit will become easier to prove. Creditors who are owed money frequently are confronted with a suit to recover preferential payments made by an insolvent debtor within 90 days of bankruptcy on a pre-existing debt. The Act amends § 547(c) to require a preference defendant to prove only that the payments were made within the ordinary course of business between it and the debtor or that the payments were made according to ordinary business terms (*i.e.*, ordinary terms according to the industry standard). Preference defendants formerly had to meet both of these standards and frequently could not satisfy the industry standard. This burden will spare many payments that are made within stated terms or longer terms established by the course of dealing between the debtor and creditor.

In addition, the Act will end abuse by amending § 547(c) to preclude the filing of a preference action

that seeks to recover less than \$5,000. This is a positive step because preference claims below that amount were not economical to bring or defend. Because such small claims were seldom filed, a more meaningful reduction in litigation would have resulted from a higher threshold, however. It is important to note that this limitation does not prevent a debtor from sending a demand letter for less than \$5,000. Any party receiving such a demand should consult with counsel rather than simply issuing a check.

Serial Bankruptcies.

In a case under chapter 7, 11 or 13 filed within 1 year after dismissal of a previous case, the automatic stay terminates 30 days after the filing of the later case. The automatic stay may be extended on motion, however, but a case is presumptively filed in bad faith if there was a previous case and the debtor failed to (i) file documents as required by the court, (ii) provide adequate protection as ordered by the court, or (iii) perform under the terms of a confirmed plan.

Venue Requirements to Prevent Forum Shopping in Small Collection Cases.

The Act alters venue requirements by increasing jurisdictional limits and adding thresholds that did not previously exist. Section 1409(b) has been amended to add a \$10,000 threshold for cases brought against a non-insider to collect a non-consumer debt. Section 1409(b) also has been amended to require a trustee or debtor-in-possession to recover a claim against a consumer debtor of less than \$15,000 in the district court in which the defendant resides. That limit formerly was \$5,000. These changes will prevent forum shopping to require a defendant in a small case to litigate in a far-away district with the resulting increased expenses.

Benefits to Landlords

The Act solves some persistent issues that have plagued landlords since the 1994 Amendments to the Bankruptcy Code added some important safeguards. These changes include some drafting ambiguities that will cause litigation and may require further technical amendments to cure.

Reduced Extensions of Deadline to Assume or Reject.

Amendments to § 365(d)(4) provide that the debtor-in-possession or trustee may only obtain one 90-day extension of the statutory 120-day deadline to assume or reject a lease of nonresidential real property unless the landlord gives its prior written consent. While the Bankruptcy Code already set the 120-day deadline after the order for relief (*i.e.*, the date of the voluntary bankruptcy petition), bankruptcy courts often gave lengthy and multiple extensions of this deadline that could have lasted for years in some large retail cases. This change will give landlords more certainty about their ability to relet the property and, if the lease is assumed, a more prompt cure and certain stream of postpetition rent. Debtors will be placed in a dilemma of rejecting the lease (and giving up a leasehold) or assuming it (and incurring an administrative expense claim for rent) well before the sales results of the holiday season and, hence, the profitability of a location or their prospects of reorganization are known.

Cure Costs Explained — Sort of.

Amendments to §§ 365(b)(1) & (2) seem to indicate that in order to assume a lease or other executory contract, the debtor need not cure defaults which are "penalty provisions," pay "penalty rates," or defaults on other nonmonetary obligations which are impossible to cure at or after the date of assumption. On the other hand, the amendments require that the debtor compensate the landlord for pecuniary losses and, in the case of a default for failure to operate in accordance with the terms of a lease of non-residential real property, cure such defaults by performing in accordance with the lease terms after assumption. This section needs clarification. The convoluted syntax of this amendment is likely to generate litigation. Landlords also will be put to the proof of why late fees are truly compensatory and not punitive. They may need to litigate the issue of whether a replacement tenant may assume the lease if it cannot perform in accordance with all of the non-monetary terms of the lease (*i.e.*, due to a nonconforming use).

Rejection Damages for Assumed Lease.

The Act amends § 503(b)(7) in an attempt to deal with the likely result of the shortened deadline for assumption of a lease and the consequences of rejection of a lease that is improvidently assumed by the debtor and later must be rejected. The landlord will receive an administrative priority claim for "all monetary obligations" due for the 2-year period after the later of the lease rejection date or the surrender of possession (other than amounts arising from or relating to a "failure to operate" or a "penalty provision"). By using "all monetary obligations" rather than "rent," this provision probably picks up pass-through expenses (*i.e.*, taxes and CAM charges), compensatory interest and charges and deferred cure costs payable during the 2-year period. By limiting reductions in the administrative claim to "amounts actually received or to be received" from a third party, the language would seem to bar any reduction for a hypothetical (as opposed to actual) reletting as well as the application of a security deposit provided by the debtor. Landlords probably must litigate whether a draw under a letter of credit or payment under a lease guaranty or from a security deposit provided to a third party will reduce the administrative claim. It is unclear whether this provision limits the landlord's duty, if any, to mitigate its damages under state law.

The provision also clarifies a split of authority regarding the application of the statutory cap on future rent claims to leases that are rejected after assumption. The amendment makes it clear that any "other sums" due to the landlord for the balance of the lease term will be subject to the limitations of § 502(b) (6), which limits future rent claims to the greater of one year's rent or 15% of the remaining rent reserved under the lease (not to exceed three years' rent). Thus, there is no respite from the thorny issues under that section. While many issues remain, one outcome is reasonably certain — landlords will have significant clout in bankruptcy proceedings due to a large administrative claim arising from the rejection of their lease.

Conclusion

General unsecured creditors and landlords will benefit from the provisions of the Act summarized above. However, realizing those benefits will require vigilance and care in exercising the rights provided. If you have questions about how these or any other provisions of the Act may affect a transaction involving your company, please do not hesitate to contact any member of Schiff Hardin's Bankruptcy and Creditors' Rights Practice Group listed below.

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Schiff Hardin Bankruptcy, Workouts and Creditors' Rights Group

Schiff Hardin's Bankruptcy, Workouts and Creditors' Rights Group represents clients on all sides of corporate reorganizations, restructurings, workouts, liquidations, foreclosures, and bankruptcies. This includes debtors, secured and unsecured lenders, major trade creditors, lessors, and committees of unsecured creditors and equity holders.

Our trial lawyers have successfully litigated lender liability, fraud, fraudulent transfer, and preference cases in all levels of the federal and state judicial systems. We represent clients who initially hire us for bankruptcy matters, as well as regular firm clients who are landlords or institutional lenders, in secured and unsecured financing, real estate lending, floor plan financing, venture capital lending, and leveraged buyout financing.

We hope that you found the information in this alert helpful. This is the first in a series of alerts that we plan to issue about this important legislation and is the start of more regular communication from the group to our clients and friends of the firm.

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