RECENT CHANGES TO THE UNITED STATES BANKRUPTCY CODE – WHAT CONSTRUCTION LAWYERS SHOULD KNOW AND THE POTENTIAL IMPACT SUCH CHANGES MAY HAVE ON CONSTRUCTION PROJECTS

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On April 20, 2005 President Bush signed into law the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "Act"), changing substantial portions of the United States Bankruptcy Code, 11 U.S.C. § 101 et seq. (the "Code"). For the most part, the effective date of the Act was October 17, 2005 with respect to cases filed after that date. Although many of the changes to the Code focus on consumer debtors, the Act also makes numerous substantive revisions that are applicable in business bankruptcy cases. These revisions may significantly affect the rights of parties on construction projects or in construction cases.

The purpose of this article is to highlight some of the significant changes made to the Code by the Act and the impact that a bankruptcy case may have on various rights of parties in construction cases. The article will also focus on provisions primarily applicable to individual debtors that may affect commercial transactions in which such individual debtors are primary or secondary obligors.[1]

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[1] This summary does not attempt to summarize all the changes made by the Act to the Code or that might impact bankruptcy cases or construction cases. This summary should not be looked upon as expression of legal opinions by the author or his firm as the scope, applicability or affect of any provision of the Act to any specific facts.

I. <u>**The New Law - Administrative Claims.**</u>

The first significant change made by the Act is a change of the type of claim entitled to administrative priority in bankruptcy. Specifically, prior to the enactment of the Act, a creditor was entitled to administrative claims for the "actual, necessary cost and expense of preserving the estate." 11 U.S.C. § 503(b)(1)(A). A bankruptcy estate is created when a case is commenced. 11 U.S.C. § 541. As such, an administrative expense claim arises <u>after</u> the commencement of a bankruptcy case. 11 U.S.C. § 503(b)(1)(A).

However, Code Section 503(b) has been amended to grant sellers of goods an administrative expense claim for the value of any goods received by the debtor within twenty days **prior** to the debtor's bankruptcy filing, provided the goods were sold to the debtor in the ordinary course of the debtor's business. Specifically, Code Section 503(b)(9) provides:

> (b) After notice and hearing there shall be allowed administrative expenses, other than claims allowed under 502(f) of this title, including –
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> (9) the value of any goods received by the debtor within 20 days before the date of commencement of the case under this title in which the goods have been sold to the debtor in the ordinary course of such debtor's business.

The effect of the change brought about by the Act is that 20 days worth of the cost of goods sold to the debtor <u>before</u> the commencement of the bankruptcy case, and which would have normally constituted an unsecured claim in the debtor's bankruptcy case, have been granted administrative priority to be paid with other postpetition administrative claims including the debtor's attorneys, accountants and professionals fees.

This change in the Code may have a significant impact in construction cases, particularly for those entities that may provide goods as well as services to a construction project or contractor that goes into bankruptcy. Depending on the size of the project or the contractor and the timing of the goods, the administrative claim could be significant.

The administrative claim granted to a seller of goods within 20 days of the petition date exists independent of any evidence to the validity of a reclamation claim. Further, there is no requirement to demonstrate the debtor was insolvent when the goods were received. Such a change in the Code grants creditors an important new right which elevates what would have been an unsecured claim, a higher administrative priority status and payment. The administrative expense claim will receive payment after secured claims but before other prepetition unsecured claims.

As with any significant change in the law, a number of issues will arise which will be the basis of litigation including, but not limited to the following: (a) what constituted "good;" (b) how will "value" be determined; (c) what is the "ordinary course of the debtor's business" and how would such standard be determined; and (d) when will the creditor be entitled to be paid – at the outset of the case, at confirmation, or at some other time.

What the ultimate effect the Act may have on debtors in the construction industry is unknown. However, commentators have suggested that such a provision will make it harder for the debtor to reorganize successfully by moving a significant amount of unsecured prepetition debt to a priority administrative claim. <u>See</u> <u>e.g.</u> F. Knowles and R. Murphy, *2005 Bankruptcy Reform Legislative Changes of Interest to Trade Vendors*, Fredrickson & Byron, P.A., Minneapolis, MN.

II. <u>The New Law - The Right of Reclamation.</u>

Prior to the adoption of the Act, creditors who shipped goods to a debtor who subsequently filed bankruptcy could reclaim those goods "under applicable non-bankruptcy law" if the creditor gave written notice of reclamation within 10 days of receipt of the goods by the debtor (extending to 20 days if the 10 days had not run when the bankruptcy was filed). Under prior law, the bankruptcy court could deny the creditor the right to reclaim goods but only if it gave the creditor an administrative claim or a lien.

Further, bankruptcy courts looked at Uniform Commercial Code (the "UCC") provisions governing reclamation claims. Often, the right to reclaim was subject to the rights of "good faith purchasers". In most cases, a debtor's secured lender constitutes "a good faith purchaser" and their security interests primed any reclamation claim. Generally, the reclamation claims were cut off by the secured lender's liens, leaving the reclamation claim valueless. <u>See</u> R. Cieri and J. Ellman, *Understanding Reclamation Claims in Bankruptcy: Hidden Complexity in a Simple Statute*, 5 J. Bankr. L. & Prac 531 (excellent summary of reclamation rights in bankruptcy).

Under the Act, the Code increases the time to make a reclamation demand from 10 (or 20) days to 45 days before the bankruptcy filing (but not later than 20 days after the filing date if the 45 day period had not expired). The right of reclamation is found in 11 U.S.C. § 546(c), which now provides:

> (c)(1) except as provided in subsection (d) of this section and in section 507(c), <u>and subject to the prior rights of a holder of security interest in such goods or the proceeds thereof,</u> the rights and power of the trustee under section 544(a), 545, 547, and 549 are subject to the rights of a seller of goods that has sold goods to the debtor, in the ordinary course of such <u>seller's business,</u> to reclaim such goods if the debtor has received such goods while insolvent, within <u>45 days</u> before the date of commencement of the case under this title, but such seller may not reclaim such goods unless such seller demands in writing reclamation of such goods –
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> (A) not later than 45 days after the date of receipt of such goods by the debtor; or
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> (B) not later than 20 days after the commencement of the case, if 45 days expires after the commencement of the case.

Thus, under new provisions of Code Section 546(c), to reclaim goods sold to a bankruptcy debtor, a creditor must demonstrate that: (a) that goods were sold in the ordinary course of the "seller's business"; (b) the debtor received the goods while insolvent; (c) the debtor received goods within 45 days of the filing of the case; and (d) the creditor gave written demand to reclaim the goods (i) not later than 45 days after receipt, or (ii) not later than 20 days after the filing of the case, if the 45 days expired after the filing.

The benefit to creditors sending reclamation notices under revised Code Section 546(c) is that the reclamation applies for a significantly longer time frame than under its predecessor – 45 days as opposed to 10 days - and the notice period to reclaim goods is also expanded. Further, the new law now expressly recognized that a creditor's reclamation rights are "subject to the prior rights of holders of a security interest in such goods or the proceeds thereof." Finally, Code Section 546(c) is significant for what it eliminates. The new provision eliminates language which gave the bankruptcy court authority to grant creditor's administrative claim or trade lien. The new section also eliminates any reference to state or other laws such as the UCC.

While the mechanics of asserting a reclamation claim remain the same, the time to reclaim goods has been expanded. However, reclamation may become a less attractive alternative to creditors.

Again, several issues may arise which will be the basis of litigation, including, but not limited to, the following: (a) does the creditor have an absolute right to reclaim goods or only the right to request reclamation; (b) is the right to an administrative expense claim or lien eliminated; (c) does elimination of the reference to state law and UCC create "federal" right to reclaim and eliminate decades of case law interpreting reclamation rights, (d) are state law UCC defenses to reclamation such as consumption or commingling available; and (e) who has the burden of proof.

For creditors who provide goods to a bankruptcy construction project or sale goods to a bankrupt contractor, it is important for lawyers and their clients to calculate the value of goods shipped to the debtor in the preceding 20 days to determine the administrative expense claim. Further, the decision of whether to reclaim goods must be made quickly and action must be taken in the bankruptcy court – at a minimum by a motion, but preferably through an adversary proceeding - to seek to enforce reclamation rights and to enjoin the debtor from consuming or commingling the goods sold.

III. **The New Law - Defending Preference Claims.**

Prior to the commencement of the Act, it was often typical that parties who received payment from a debtor within 90 days of the petition date would often be subject to an adversary proceeding seeking to recover such payments as a preferential transfer. 11 U.S.C. § 547. These adversary proceedings were commenced in the bankruptcy court by the bankrupt debtor or trustee in jurisdictions that were often far removed from the defendant's location. Such preferential transfer actions allowed debtors or trustees to "extort" settlements from the defendants over relatively small amounts because the cost of defending the preferential transfer action in the remote court was not worth the time or effort to defend.

A. Change in Venue and Amount. The Act made two changes to the Code to stop the perceived abuses by trustees. First, action to recover non-consumer debt against a non-insider of the debtor for less than $10,000 must be filed in the district in which the defendant is located. 28 U.S.C. § 1409(b). Second, in a non-consumer case, a preference for less than $5,000 is not recoverable. 11 U.S.C. § 547(c)(9) The change in the venue of where adversary proceedings may be commenced and the amount that can be recovered, should drastically reduce suits by trustees to recover relatively small preference amounts.

B. Ordinary Course of Business Defense. Further, the Act relaxed the standard for the ordinary course of business defense of a preferential transfer and appears to overrule the Eleventh Circuit case of Miller v. Florida Mining and Materials (In re. A.W. & Associates, Inc.), 136.F.3d 1439 (11th Cir. 1998) (preference defendant required to put on evidence of industry standards to prove transfer made according to "ordinary business terms").

Prior to the Act, defendants had to prove that alleged preferential payment received from the debtor were both ordinary between the debtor and the creditor and was ordinary in its industry. Proving that a payment was ordinary in the industry often required outside experts who could testify about the industry standard in general and often significantly increased the cost of defending a preferential transfer.

The Act now only requires a creditor show that the transfer was made in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and the transfer was made: (a) in the ordinary course of business and financial affairs of the debtor and the transferee**, or** (b) according to ordinary business terms. 11 U.S.C. § 547(c)(2). Disjoining the final two elements of the ordinary course of business should make it easier to protect transfers under the ordinary course of business defense.

C. Other Important Changes to Preference Recoveries. The Act also excepts from avoidance a transfer that was a payment pursuant to an alternative repayment schedule that was "created by an approved non-profit budget and credit counseling agency," 11 U.S.C. § 547(h), and "for a domestic support obligation." 11 U.S.C. § 547(c)(7).

IV. **<u>The New Law - Small Business Bankruptcies.</u>**

A. Change In Definition of Small Business Debtor. The Act provides for special expedited provisions for "small business" debtors. The Code now defines a small business debtor as a person engaged in commercial or business activities that has (a) the aggregate noncontingent liquidated secured and unsecured debts, as of the date of the petition, in an amount not more than $2,000,000.00 (excluding debts owed to one or more affiliates or insiders), and (b) no committee is appointed or the court determines that the committee is not sufficiently active to provide oversight of the debtor. 11 U.S.C. § 101(51D). Entities whose primary activity or business is owning or operating real property are excluded under the definition.

Under the old law, a business could opt-in for small business treatment. Under the new law, the classification is mandatory if the debt level and committee status is verified.

B. Reporting Requirements and Duties. Debtors in small businesses bankruptcies are required to provide more detailed reporting. Code Section 308 requires a small business to report "profitability" as receipts and cash disbursements in comparison with projections of prior reports and the statement that the debtor is in compliance with tax and governmental reporting requirements. Failure to comply with these rules may result in dismissal or conversion of the case.

Code Section 1116 establish new duties that small business debtors must satisfy. No later than seven days after the petition date, the debtor must provide its most recent balance sheet, statement of operation, cash flow statement, and federal income tax return. Further, a small business must attend "through its senior management personnel and counsel" a meeting scheduled by the U.S. trustee "including initial debtor interviews, scheduling conferences, and meetings of creditors convened under § 341 unless the court, after notice and hearing, waives that requirement upon the finding of extraordinary and compelling circumstances." Further, a small business debtor must file all post-petition financial and other reports required by the Federal Rules of Bankruptcy Procedure or by the local rules of the district court.

C. Inspections. Further, Code Section 1116(7) provides a small business must allow the United States Trustee or designated representative of the United States Trustee, to inspect the debtor's business premises, books, and records at a reasonable time, after reasonable prior written notice, unless notice is waived by the debtor.

D. Disclosures and Confirmation for Small Business Debtor. Code Section 1121(e)(2) provides that a small business debtor has 180 days of exclusivity and its plan and disclosure statement shall not be filed later than 300 days after the initial order for relief. 11 U.S.C. § 1121(e)(2). The plans must be confirmed no later than 45 days after the plan has been filed. 11 U.S.C. § 1121(e)(3) see also 11 U.S.C. § 1129(e).

E. Automatic Stay and Multiple Filers. The Act provides additional restrictions where the small business debtor has had a case dismissed or plan confirmed within two years of the second filing. Specifically, the automatic stay does not apply in the case in which the debtor is a small business and the case has been dismissed or plan confirmed within two years of the second filing. 11 U.S.C. § 362 (n). Further, the automatic stay will not apply if an entity that has acquired substantially all the assets or business of a small business debtor hat previously filed a bankruptcy case within two years of the second filing, unless such entity established by a preponderance of the evidence such entity "acquired substantially all of the assets or business of such small business debtor in good faith and not for the purpose of evading this paragraph." The restriction of the automatic stay may not apply if the debtor proves by preponderance of evidence that the filing of the petition resulted from circumstances beyond the control of the debtor, not foreseeable at the time the original case was then pending; and it is more likely than not that the court will confirm a feasible plan but not a liquidating plan, within a reasonable period of time.

Thus, the Act has placed more burdensome reporting requirements and conditions on the applicability of the automatic stay in certain small business cases. Knowing these requirements can assist creditors of bankrupt construction projects or contractors in obtaining more financial information and pressuring the debtor to quickly file a plan of reorganization or face conversion or dismissal of the case.

V. The New Law - Landlord Tenant.

Before the Act, when a debtor filed for bankruptcy, the time period in which to assume or reject the lease was often extended until the time of confirmation. Chapter 11 debtors often received multiple extensions of the time period in which they could exclusively file plans and disclosure statements. These extensions often left landlords in limbo for several years as to whether the debtor would assume or reject their lease. Under the Act, leases must be assumed or rejected from the earlier of (a) 120 days from commencement of the case, or (b) confirmation of the Plan. 11 U.S.C. § 365(d)(4). The debtor may be allowed one 90-day extension by the bankruptcy court for cause. However, after the extension, the landlord must consent to the extension of the time period whether to assume or reject the lease.

VI. The New Law – Shorten Time of Exclusivity.

Prior to the enactment of the Act, a chapter 11 debtor had the exclusive right to file a chapter 11 plan of reorganization for 120 days after the petition date and had 180 days to obtain acceptance of that plan. Further, under the old Code, the bankruptcy court may, upon a showing of cause, extend exclusivity. The right of a debtor under the old Code to extend exclusivity often provided the debtor significant leverage in negotiating the plan of reorganization.

Now, under the Act, courts no longer have the authority to grant extensions of exclusivity beyond 18 months to file a plan and 20 months to obtain confirmation of those plans. 11 U.S.C. § 1121(d)(2).

VII. <u>The New Law - Other Important Changes in the Code.</u>

A. <u>Employee Wages and Priority</u>. Under the old law, employee wage and benefit priority was capped at $4,925 per employee for wages and benefits incurred within 90 days before the petition date. Under the Act, the employee wage and benefit priority has been increased to $10,000 per employee and the time period expanded to 180 days before the petition date. 11 U.S.C. § 507(a)(4).

B. <u>The Importance of Certification</u>. In determining the amount of reasonable compensation to be awarded to a debtor's professionals employed pursuant to Code Sections 327 and 1103, bankruptcy courts can take into account all relevant factors including "with respect to a professional person, whether the person is board certified or otherwise has demonstrated skill or experience in the bankruptcy field." 11 U.S.C. § 330(a)(3)(E).

Becoming board certified – whether in construction bankruptcy, civil trial, or another area of law- may be a factor in determining compensation of professionals retained by the debtor. If you or your firm will be representing Chapter 11 debtors with construction issues, becoming board certified in construction law will bolster the likelihood of your fees being allowed in full or possibly enhanced.

VIII. **The New Law - Homestead Exemption.**

As stated earlier, the Act adapted many changes to the Code that focus on consumer debtors. The Act was adopted to eliminate perceived abuses by debtors in states with high or unlimited homestead exemption, like Texas and Florida, from obtaining a discharge or shielding assets, in the form of expensive homes, from creditor's claims. Code Section 522(p) was enacted to stop such perceived abuses by limiting the homestead exemption to $125,000.00.

This provision has already created litigation and court opinions interpreting Code Section 522(p) have reached diametrically opposite results. The dispute relates to the distinction between states that have adopted the federal exemption scheme and those states that have "opted out" of the federal exemption scheme in favor of allowing debtors to only exempt those assets permitted by the state's laws. The dispute centers around whether Code Section 522(p) applies only to debtors in non-opt-out states or to debtors in all states. The focus of the controversy is the phrase "as a result of electing under subsection (b)(3)(A) to exempt property under state or local law . . . ."

One Court, in interpreting the "plain meaning" of Section 522(p)(1) concluded that this section can only apply to debtors who live in states that allow debtors to choose between state and federal exemptions because only such debtors are allowed to "elect" exemptions under different exemption schemes. Based on this reasoning, the Court in In re McNabb, 326 B.R. 785, 791 (Bankr. D. Ariz 2005) , held the $125,000 homestead exemption cap did not apply to debtors residing in Arizona and Florida because, as these states are "opt-out states", and these states do not permit a debtor to choose between State and Federal exemptions.

However, faced with this same issue, Judge Robert Mark, Chief Bankruptcy Judge for the Southern District of Florida, held exactly the opposite in the case of In re Kaplan, 331 B.R. 483, 488 (Bankr. S.D. Fla. 2005); see also In re Wayrynen, 332 B.R. 479, 486 (Bankr. S.D. Fla. 2005) (J. Friedman) (Section 522(p) would not be read to limit homestead exemption to only "non opt-out states". However, the "safe harbour" provision of Section 522(p)(2)(B) allows debtor to exempt the equity in homes previously owned in the State of Florida that have appreciated in value.)

This split in the bankruptcy courts over the applicability of Section 522(p) will generate significant litigation in the State of Florida over the homestead exemption cap. The ultimate outcome may significantly impact individual guarantor's debt obligation.

IX. Conclusion.

By increasing reporting requirements for small business bankruptcies, reducing debtor's historical exclusive right to file and confirm plans of reorganization, limiting the time period to assume or reject real property leases, placing restriction on recovery of preferential transfers and expanding the rights of creditors, creditors have gained a perceived advantage in future bankruptcy cases. Knowing the recent changes to the Code should assist lawyers in protecting the claims of their construction clients and in negotiations regarding treatment of claims under a plan of reorganization.