Bankruptcy Reform Act of 1994

1996-09-01

Introduction

The changes embodied in the Bankruptcy Reform Act of 1994 (the "Amendments") are the most substantial revision of United States bankruptcy laws in sixteen years. The Amendments should expedite the administration of cases. Several controversial aspects of bills presented in earlier sessions of Congress are not found in the Amendments. Although the overruling of the *Deprizio* line of cases and the expansion of Chapter 13 jurisdictional limits are two areas where Congress has acted boldly, to a great extent the Amendments constitute only a codification of procedural devising employed by many courts. Congress has, for now, moved the ongoing discussion of a major overhaul of the bankruptcy laws to a commission, which is to recommend major substantive changes within the next two years.

This booklet is not intended as an exhaustive treatment or even a complete listing of the Amendments. It is prepared to direct the attention of creditors and their counsel to the more important aspects of the Amendments as they will likely affect commercial lending, with a very brief overview of how they will affect consumer cases.

This booklet has been prepared by the following independent law firms, whose larger offices are in the states indicated:

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The leaders of the bankruptcy practices in each of these firms are dedicated to assisting each of the other firms in serving its clients. Each firm is committed to assist in obtaining expeditious local representation for all of the clients of the other firms, and to provide counsel on the practice and procedure in the geographic region in which it regularly practices. The bankruptcy attorneys in each of these firms meet regularly to confer on issues of broad national application, exchange experiences, discuss cutting-edge techniques and engage in other cooperative efforts, such as the preparation of this booklet, to enhance each firm's abilities and resources.

Effectiveness of Amendments; Transition from Prior Law

The Amendments effect changes to title 11 of the U.S. Code (the "Bankruptcy Code"), as well as to title 28 of the U.S. Code (the "Judicial Code") which contains many of the procedural and jurisdictional rules governing bankruptcy cases. The Amendments take effect generally on the date of enactment. The Amendments were "enacted" on October 22, 1994, the date the bill was signed by the President.

Most of the Amendments shall not apply to cases commenced under the Bankruptcy Code before the date of enactment. Important and complex modifications to Sections 1110 and 1168 of the Bankruptcy Code, ending most distinctions in the treatment in Chapter 11 case among leasing, purchase-money financing and other types of secured financing of aircraft equipment, railroad rolling stock and vessels, shall apply only to equipment placed in service after the date of enactment. (There are also further phase-in aspects for these Amendments, including a provision for application of only the changes to Section 1110 to certain settlements in pending cases.) The Amendments clarifying creditors' rights to require that debtors in Chapters 11, 12 or 13 cure defaults determined according to the underlying agreements shall apply only to agreements entered into after enactment. Amendments pertaining to waivers of sovereign immunity and increased trustee compensation shall, however, apply to pending cases as well as new filings.

Overruling of *Deprizio*

Section 547(b) of the Bankruptcy Code allows a trustee (or a debtor in possession in a Chapter 11 case) to reverse the effects of a debtor's having made payments to relatives, friends and other "preferred" creditors on the eve of bankruptcy, while leaving other disfavored creditors with less than their fair share. This preference avoidance power generally permits the trustee to recover payments and other transfers that an insolvent debtor made to creditors within 90 days before the bankruptcy was filed, or within one year prior to bankruptcy if the creditor is an insider. (See Note 1.)

One of the larger concerns in the lending community concerning bankruptcy law is courts' tendency to apply a one-year reachback period, to reverse payments and grants of collateral on pre-existing debt to a lender who is not an insider, where the debt is guaranteed by an insider. In 1989, the lending community was stunned by a decision of the U.S. Court of Appeals for the Seventh Circuit, *Levit v. Ingersoll Rand Financial Corp. (In re V.N. Deprizio Construction Co.)*, usually referred to as the *Deprizio* case. This decision has, since 1989, been widely adopted by the courts.

The *Deprizio* case held that, when a debtor makes a payment to a lender more than 90 days but less than one year prior to bankruptcy, on a loan guaranteed by an insider of the debtor, the bankruptcy trustee could recover the payment from the lender, *even though the lender was not an insider* . A preference is recoverable if it is either to or for the benefit of a creditor. The court noted that, when the debtor pays the lender, it is simultaneously reducing both the debtor's and the guarantor's liability to the lender. Thus, it is "for the benefit of" the guarantor, as well as the lender. An insider who has signed a guaranty is also a creditor of the debtor by virtue of his or her right to be reimbursed by the debtor (and by subrogation to the lender's rights) against the debtor.

Section 550(a)(1) of the Bankruptcy Code specifies from whom the trustee may recover a preference, once the elements of a preference have been satisfied. This section allows the trustee to recover preferences from "the initial transferee of such transfer or the entity for whose benefit such transfer was made." Therefore, when a payment is deemed a preference by virtue of an insider guaranty, the trustee may recover the amount of that payment from either the initial transferee (the lender) or the person who received the benefit of the transfer (the insider guarantor). Since *Deprizio* has become well-established in the case law, trustees often pursue only the lender, who is more likely to have the financial ability to repay the preference.

Under the *Deprizio* doctrine, lenders who at all times dealt with a borrower and guarantor at full arms length have faced the prospect of disgorging all payments they received on guaranteed loans during the full year before a borrower's bankruptcy. Financial institutions noted that the *Deprizio* decision actually penalizes creditors for having the foresight to obtain a guaranty in support of a loan.

Many financial institutions have responded by revising their form of guaranty to include a waiver, by the guarantor, of all of its claims against the borrower, including the rights of subrogation and reimbursement if the guarantor pays on the guaranty. In this way, the guarantor may not be a creditor who benefits from the borrower's payment to the lender.

This device no longer should be necessary. The Amendments revise the Bankruptcy Code effectively to reverse *Deprizio* . The trustee still may recover as a preference any payment that the debtor made to a creditor or for the benefit of an insider guarantor between 90 days and one year before the debtor's bankruptcy; *however*, the trustee may not recover any such payment from anyone who is not an insider.

Limitations on Trustee's Avoidance Powers

In the case law, issue has arisen as to the statute of limitations for bringing avoidance actions under the Bankruptcy Code. Section 546(a)(1) has been amended to define the applicable statute of limitations as two years from the entry of an order for relief or one year after the first appointment of a trustee, if such appointment occurs before the expiration of the original two-year period. Therefore, the longest period a trustee would have to commence an avoidance action is three years after the entry of an order for relief (assuming the trustee were appointed one day before the expiration of two years from the date of entry or the order for relief commencing the bankruptcy case). The longest period a debtor-in-possession would have to commence such an action is two years from the date of the entry of the order for relief (generally, the commencement of the case). This Amendment does not affect the validity of any tolling agreements, nor does it bear on the equitable tolling doctrine that applies when it has been determined that fraud has occurred.

Perfection of Security Interests**Purchase Money**

Several sections of the Bankruptcy Code which relate to perfection of security interest have been amended. A purchase money security interest may be perfected under most states' laws if the perfection occurs within twenty days of the debtor's receiving possession of the property. The Bankruptcy Code has allowed a trustee to avoid perfection of such a security interest as a preference if the lender had not perfected within ten days of the debtor's receiving possession of the property. The Amendments revise Section 547(c)(2) of the Bankruptcy Code to conform the bankruptcy law to most states' laws and grant purchase money security lenders a twenty-day period to perfect their security interests, without risk that the trustee may avoid such perfection.

Continuation Statements

To clarify and confirm that a secured creditor may take the steps necessary to insure that its security interest in a debtor's property remains perfected during a bankruptcy case, Sections 362 and 546 of the Bankruptcy Code have been amended. Under the Amendments, it will not be a violation of the automatic stay or an act subject to "avoidance" for a creditor to file a financing statement or continuation statement after the commencement of a bankruptcy case. The actions by a secured creditor which are protected by the new law merely maintain the status quo of the secured creditor's lien and do not improve its position.

Post-petition Rents and Lodging Payments

As a general rule, a creditor's security interest acquired pre-petition does not extend to that same type of property acquired by the debtor post-petition, even if the documentation describes a "floating lien" all on existing or after-acquired property. An important exception is found in Section 552 of the Bankruptcy Code. If the security agreement extends to proceeds, products, offspring, rents or profits of the property in question, then post-petition proceeds are subject to the pre-petition lien.

A critical issue for a financier of a hotel operation is whether a bankruptcy court will recognize and continue a pre-petition lien on hotel revenues generated post-petition. If the lien is extended by the court to cover post-petition revenues, then the debtor must give adequate protection to the lender and otherwise satisfy the Bankruptcy Code's conditions for use of cash collateral in order to use the revenues for post-petition operations. If the lien is not recognized, the post-petition hotel receipts are unencumbered and the debtor is free to use the revenues without providing any adequate protection to the pre-petition lender.

Many courts have refused to give a broad interpretation of real estate based security documents that encumber hotel revenues. Courts have held that the typical mortgage and deed of trust form which encumbers "rent, issues and profits" does not cover room receipts of a hotel. Courts have reasoned that "rents" refer to a landlord/tenant relationship; not an innkeeper/guest relationship. Consequently, collateral assignment of rent clauses in deeds of trust or mortgages have been held by some courts not to encumber a hotel's room receipts. Furthermore, where a lender perfected a pre-petition lien on the hotel operator's "accounts" or "general intangibles", courts nonetheless have denied the extension of a post-petition lien on the debtor's post-petition room receipts because "accounts" or "general intangibles" are not within the protected categories of later-acquired property listed in Section 552.

Amendments to Sections 552 and 363 of the Bankruptcy Code remove the uncertainty and provide that the fees, charges, accounts or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties which were subject to a pre-petition security interest will be subject to a continuing lien.

Furthermore, under the Amendments, secured creditors will be deemed to have pursued any steps that state law requires as a prerequisite to perfecting their interest in rents. Thus, even if a security interest is not perfected under applicable non-bankruptcy law, so long as the recorded security document includes an interest in pre-petition property and covers "amounts paid as rents or such property or the fees, charges, accounts, or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties," then the lender will have a continuing interest in post-petition "rents" which will be deemed perfected and be cash collateral.

These clarifications of the rights of hotel lenders are limited. The primary limiting provision is the "equities of the case" provision in Section 552(b)(2) which is designed, among other things, to give the courts broad discretion to balance the protection of secured creditors on the one hand against strong public policies generally favoring continuation of jobs, preservation of going concern values and rehabilitation of distressed debtors, generally. Furthermore, the debtor will be able to use pledged revenues if adequate protection is provided and, as always under the Bankruptcy Code, the lender's lien will be subject to scrutiny under the avoidance sections. These avoidance rights will not be waivable by the debtor either pre-petition or post-petition.

Executory Contracts

Unexpired Timeshare and Real Property Leases

If a debtor rejects a lease or timeshare agreement under which the debtor is the lessor/owner, the Bankruptcy Code has given a timeshare buyer or real property lessee the right to: (i) remain in possession and offset any damages against rent owed to the debtor; or (ii) treat the rejection as terminating the lease/timeshare interest and abandon the property. If the lessee remains in possession, the case law is inconsistent as to whether the timeshare buyer/lessee may enforce other rights in addition to the right to "possession," such as the right to enforce restrictive covenants or the right to assign the lease to a third party. For shopping center leases, the law also is unclear as to whether provisions in the lease dealing with use, exclusivity or tenant mix and balance are enforceable.

The Amendments clarify that if the lessee/timeshare buyer continues in possession after the rejection, it also will continue to enjoy all of the other rights appurtenant to possession of the property. These changes severely limit for debtor/lessors the advantages of rejecting leases. In shopping center cases, for example, the shopping center owner will not be able to change the tenant mix if doing so would violate the provisions of an existing pre-petition lease. This will give tenants greater bargaining strength when negotiating with debtor/lessors.

Personal Property Leases

The Amendments provide that a debtor must commence personal property lease payments within

60 days after the commencement of the bankruptcy case, even if the debtor has not decided whether to assume or reject the personal property lease. The Bankruptcy Code had required such payments only for real property leases.

Reclamation Rights; Return of Goods

The Bankruptcy Code has honored a seller's state law reclamation rights with respect to goods the seller delivers to an insolvent debtor and for which goods the seller made written demand for reclamation within ten days after the debtor's receipt of the goods. The Amendments extend the period for making a reclamation demand to twenty days if the ten-day state law reclamation period expires after the commencement of the case. Since creditors often may not hear about a bankruptcy filing until after the expiration of the ten-day period, this provision may make it easier for unsecured creditors to satisfy the procedural requirements necessary to reclaim goods. However, since most courts also hold that a secured lender with a lien upon inventory has an interest in the goods superior to that of the reclaiming seller, the actual number of successful reclamation claims may not increase significantly.

The Amendments also give the debtor a right to return goods to a seller with the seller's consent and the court's approval. To return goods, the debtor must show that the return is in the best interests of the estate. If a return occurs, the creditor may offset the purchase price of the goods against any pre-petition claim. Although this provision appears to allow the debtor to prefer certain pre-petition suppliers, in reality if the goods can be turned into value for the estate it is highly unlikely, except in cases involving a 100 percent cash distribution, that the debtor will invoke this return provision. If the goods have little value or are specialized goods, the creditor still can protect itself against an unwanted return by refusing to consent.

Exclusivity

Section 1121 of the Bankruptcy Code grants a debtor the exclusive right to file a plan during the initial 120 days after the filing of a bankruptcy petition under Chapter 11. Under Section 1121(c), this "exclusivity" period expires either at the end of the 120-day period if the debtor has not filed a plan, or, if the debtor has filed a plan but the plan has not been accepted by creditors, 180 days after the filing of the petition. Under Section 1121(d), a bankruptcy court may extend or shorten the exclusivity period at the request of the debtor or any other party-in-interest upon a showing of cause. Extensions of exclusivity, over the objection of creditors, have been cited as a major cause of the inappropriate protraction of several major cases.

An order extending the exclusivity period is considered an interlocutory order. Section 158(a) of the Judicial Code provides that appeals from the interlocutory orders of a bankruptcy judge may be made only upon leave of the district court. The Amendments revise Section 158 to provide for an immediate appeal, as a matter of right, to the district court from a bankruptcy judge's order extending or reducing the exclusivity period.

The Amendments also effect changes in the exclusivity rules for small business Chapter 11 cases and single asset real estate cases. These changes are described in the chapters of this booklet generally describing those cases.

Expediting Single Asset Real Estate Cases

In the Amendments, Congress has attempted to combat a commonly noted abuse of the bankruptcy system. The Amendments allow secured lenders to obtain more easily relief from the automatic stay of foreclosure on single asset real estate debtors.

The Amendments define "single asset real estate" as real property constituting a single property or project which generates substantially all of the gross income of the debtor and on which the debtor conducts no substantial business other than operating the property itself. For the new provisions to apply, the "single asset" property may have no more than $4 million dollars of secured debt. The Amendments also do not apply to residential property with fewer than four units.

The abuse arises where a single asset debtor initiates a Chapter 11 case solely to delay a lender's efforts to foreclose on the property, and the debtor has no intention or realistic hope of presenting a feasible plan of reorganization. The Amendments allow secured creditors to obtain relief from the automatic stay and proceed with foreclosure proceedings unless the debtor complies with either of two requirements within the first 90 days of entering bankruptcy. Within that period, to avoid losing the protection of the automatic stay, the single asset debtor must either (1) file a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time, or (2) commence monthly payments to its secured creditors equal to interest at the current fair market rate on the value of each creditor's interest in the real property.

Many issues thus are telescoped into the early months of the case, requiring all parties to be prepared for expeditious advocacy.

Note that these provisions include, in essence, an "exclusivity" provision, in that they prevent secured creditors from obtaining stay relief to foreclose on the property for 90 days if the debtor files a feasible plan within that period.

Expediting Small Business Chapter 11 Cases

Several provisions in the Amendments are designed to afford small businesses a faster, more efficient and less expensive mechanism for reorganizing their businesses than Chapter 11 had provided, by eliminating the requirement for the appointment of a creditors' committee and simplifying the disclosure statement and plan confirmation process.

A "small business" is defined as a person engaged in commercial or business activities whose aggregate non-contingent liquidated secured and unsecured debts do not exceed $2,000,000. (A person whose primary activity is the business of owning or operating real property also does not qualify as a small business under the Amendments.) The Amendments provide that, in a case in which t