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Amendments to the Bankruptcy Code

by Richard Macias

Recent amendments to the Bankruptcy Code that will take effect by the end of the year will result in a number of changes to the bankruptcy process. Most of the media attention has focused on the changes for individual or consumer bankruptcies. Other amendments, that have not received significant attention in the press, will change commercial cases as well, especially the newly created "small business" debtor rules.

All of these changes will have potential significance for small business owners. As creditors, small businesses often face even greater stress when significant receivables are jeopardized after an important customer files a bankruptcy. The changes attempt to relieve a portion of that stress. Most small business owners operate as proprietors, which mean they are individually liable for the debts of the business. Even for the small business that is incorporated, the individual owners/shareholders frequently must personally guaranty the debts of the corporation. These changes could sharply limit the utility of bankruptcy to such individuals.

The most important changes involving individual bankruptcies will include:

- "Means" testing
- Homestead exemption limitations
- More strict control over the amount of relief an individual debtor may receive.

On the business side, the most significant amendments provide for:

- An expedited procedure for "small" business debtors in Chapter 11
- Limitations on preference recovery actions against creditors
- Reform of the reclamation process for trade creditors.

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“Means Testing”

One of the most controversial amendments imposes limits on eligibility for discharge for individual debtors by requiring so called “means testing.” Under current law, individuals file under either Chapter 7, which allows for a discharge of virtually all debt but requires the debtor to forfeit most of their remaining assets, or Chapter 13, which allows debtors to keep most of their property in exchange for repaying a large portion of the debt in a plan over time.

Homestead Exemption

Current law allows debtors to exempt a certain amount of equity in their personal residence, a “homestead”, from the assets that can be reached by creditors. This has led to great controversy since there is wide variation among the states about the size of this exemption. Florida and Texas, for example, allow virtually a 100 percent exemption regardless of the value or outstanding debt on the home.

The amendments will cap the exemption available in bankruptcy to \$125,000. The Bankruptcy Court may deny the entire homestead exemption to a debtor that has changed address within 10 years prior to the bankruptcy if the court finds the move was for the purpose of hindering or defrauding creditors.

Individual Debtor Control

The current standard Chapter 13 individual debtor repayment plan is three years. The new law would require that debtors with income above their home state median increase the payment plan to five years. Debtors with income less than state median would still only have the three year obligation.

In order to be eligible for bankruptcy an individual must consult with an approved credit counseling agency within six months prior to filing. The court is allowed to reduce a creditor’s claim by up to 20 percent if that creditor refused to negotiate a reasonable alternative repayment schedule proposed by a credit counseling agency consulted by the debtor prior to the bankruptcy. Finally, the debtor must attend an approved financial education course as a condition of discharge.

Small Business Debtors

The new law establishes a special Chapter 11 bankruptcy category for “small businesses,” which the amendments define as a business with less than \$2 million of aggregate assets. The small business debtor will have a 180 day “exclusivity” cushion in which to file a plan of reorganization without competing plans from creditors. Businesses in this category will be allowed to expedite the bankruptcy process by using standard forms for disclosure statements and reorganization plans. The court hearing on the debtor’s disclosure statement and confirmation of the plan of reorganization can be combined. Generally, the small business debtor must have a court order plan confirmed within 300 day of the filing of face conversion to Chapter 7.

Preferences

Under current bankruptcy law, payments made to unsecured creditors in the 90 day period preceding the filing of a bankruptcy may be “preferential” and therefore recoverable by the bankruptcy estate. The theory behind the law is that it prevents a debtor from conferring a special benefit on preferred creditors and ensures a more equitable distribution to creditors from the debtor’s limited assets.

There was considerable Congressional debate suggesting that small business creditors were most susceptible to claims where the preference amount was less than \$10,000. As a result, under the new law, preference recovery actions against a creditor will be limited to claims exceeding \$5000. Also, if the claim is for less than \$10,000, the preference recovery lawsuit must be filed where the creditor has its principal place of business. Under current practice such suits are always filed in the state where the bankruptcy case is located, often putting the out-of-state small business creditor at a considerable disadvantage.

One of the most often used defenses to a preference claim has been modified and simplified as well. Under the new law, the preference claim can be defeated if the creditor can show the payments were either, paid consistent with the "ordinary course" of dealing that existed between the debtor and creditor or were consistent with business standards within the industry. Under current law, many bankruptcy courts have required that a creditor meet both of these test in order to establish the "payment in the ordinary course" defense to a preference claim.

Reclamation

Under current law a vendor creditor can seek to recover goods shipped to a debtor that is insolvent or files a bankruptcy. The old bankruptcy law allowed the vendor creditor to demand return for any goods that are received by the debtor with 20 days of the bankruptcy filing.

The amendments modify the reclamation process in a bankruptcy situation. The vendor creditor would now be allowed to seek a return of the goods received by the debtor within 45 days of the bankruptcy filing. Alternatively, should it the debtor be unable to return the goods (a frequent occurrence in manufacturing and distribution) the vendor creditor would be entitled to an administrative priority for goods shipped and received by the debtor in the 20 days proceeding the filing. The advantage to being an administrative creditor is that in a Chapter 11 the debtor's plan must include full payment for all administrative claims before the final plan can be approved whereas the distributions to unsecured creditors are usually minimal.

Conclusions

The changes for both individual and business bankruptcies are controversial. Most of the lobbying for the changes came from banks and credit card companies which argued these changes were necessary to stem bankruptcy abuse. Others have pointed out that the changes for individuals will severely limit the second chance offered by bankruptcy, a unique element of American entrepreneurship that allowed individual visionaries as diverse as Henry Ford and Ray Kroc to make a second try at business success.

From a practical standpoint, whether as creditor or debtor, the scope of the changes for both individual and business bankruptcies are significant. In all likelihood, these changes can be expected to have an impact on small businesses and the individual owners of these companies. ■

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