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A Dozen Things That A Business Lawyer Should Know About The Bankruptcy Abuse Prevention And Consumer Protection Act Of 2005 – Part II

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"One of the prime purposes of the bankruptcy law has been…to protect creditors from one another."
— Mr. Justice Black in *Young v. Higbee Co.,* 324 U.S. 204 (1945).

Prior to the adoption of BAPCA, the bankruptcy court was empowered to deny an otherwise valid reclamation demand by ordering that the seller would instead receive a monetary claim, either with administrative expense priority or secured by a postpetition lien. This was the fate of many reclamation demands. The provisions creating those alternatives have now been deleted. However, new subparagraph (9) of §503(b) creates an administrative priority claim for the "value" of any goods sold to the debtor in the ordinary course of business and received by the debtor within 20 days before the commencement of the case. Section 503(b)(9) imposes no requirement of insolvency, or of compliance with §546(c); §546(c)(2) expressly provides that the administrative claim under §503(b)(9) is not affected by the seller's failure to demand reclamation in writing.

Again, these amendments are ambiguous and raise a number of questions.

- What happens if the reclamation claim is avoidable as a fraudulent transfer under §548, or is subject to attack by an actual creditor under state law and therefore could be avoided by the estate under §544(b)? Can it then be defeated? Was this result intended by Congress?[7]
- Is a showing that the goods were not received in the ordinary course of business the sole basis for attacking the administrative priority awarded by §503(b)(9)?
- When must the estate pay the §503(b)(9) administrative expense claim? Is the timing affected by §503(a), which permits a creditor to request payment of an administrative expense?
- What is the measure of "value" under §503(b)(9)? Is it the purchase price, the value of the goods to the debtor, or arm's-length market value?
- Does the seller have an administrative expense claim even if the goods have been paid for? Even if the seller has successfully reclaimed the goods? The statute does not answer these "obvious" questions.

Notwithstanding §362(a)(6) (which provides that the automatic stay generally bars creditor action to collect or recover on a prepetition claim), exceptions articulated in §§362(b)(3) and 546(b) permit a vendor to assert a §546(c) reclamation demand post-filing. Reclamation under that section is limited to goods in the debtor's possession as of the petition date.

- If the debtor resells the goods before the reclamation demand is propagated through the sales chain, what remedy does the creditor have?
- Since the reclamation procedures don't supplant the automatic stay altogether, does the stay preclude taking physical possession of the goods?

The amendments also expressly recognize what was implicit in prior law: The rights of a reclaiming creditor extend only to inventory value in excess of prior valid security interests. Further, §546(h) has long permitted the estate, with the creditor's consent, to return goods for credit at the purchase price. These returns are exempt from the estate's avoiding powers, including §549(a), and are intended to ease the burden of general trade claims as well as reclamation problems. The BAPCPA amendment to §546(h) clarifies that any such return of goods is subject to the prior rights of secured creditors.

- What rights does a reclaiming vendor have against a senior lien claimant who is clearly oversecured? Can the reclaiming vendor seek marshaling?[8]

In creating the Bankruptcy Reform Act of 1978, which established the framework of the present Bankruptcy Code, Congress expressed a crucial reservation about the reclamation rights of trade creditors. The legislative history stated that reclamation should be recognized in bankruptcy to the extent provided in §546(c), but should not be permitted to thwart a promising rehabilitation effort.[9]

- Does that legislative history have any real meaning now? In deleting the former priority and lien alternatives to physical reclamation under §546(c), while introducing a free-standing administrative priority under §503(b)(9), Congress appears to have lost sight of this concern.[10]

Preferential Transfers

BAPCPA's favorable treatment of vendors extends to a relaxed "ordinary course" sandard for the defense of prepetition transfers.

The rights BAPCPA bestows on trade creditors are not limited to reclamation of goods and administrative priority claims. Vendors also enjoy broader protection in preference litigation.

Section 547(b) of the Bankruptcy Code provides that the estate may recover any property that was transferred from the debtor to a creditor, on account of antecedent debt, within 90 days before the bankruptcy filing. The estate will pool such "preferential transfers" for pro rata distribution among all similarly situated creditors, but the Code also establishes several defenses for transfers that did not give the recipient a real advantage over other creditors.

- Under former §547(c)(2), the estate could not prevail if the disputed transfer was (i) made in payment of a debt incurred in the ordinary course of the debtor's dealings with the vendor, (ii) made in the ordinary course of the parties' business, and (iii) made according to ordinary business terms (*i.e.*, ordinary for the industry at issue).
- The amendments leave the first element unchanged, but the defendant now need only satisfy one or the other of the last two elements. Thus, a vendor will have no preference liability if it can demonstrate either that the transfer was made in the ordinary course of the parties' business *or* that the transfer was consistent with industry standards.

Unless a transfer mirrored both a well-documented transaction history and readily available industry data, it was seldom easy to prove both of the elements that are now stated disjunctively. BAPCPA's relaxation of the ordinary-course defense thus substantially strengthens the vendor's position. The losers here will be the debtor's other unsecured creditors (and sometimes its senior lenders), which typically rely on preference settlements to bolster their own recoveries in the case.

A few other refinements to the preference statute are applicable to business cases.

- Under new §547(c)(9), business debtors can no longer seek to recover prepetition preferences if the value of the property transferred to a creditor is less than $5,000 in the aggregate.
- Also new §547(i) appears to accomplish what Congress did not quite manage in prior amendments, which is to override the controversial holding of the *Deprizio* case.[11]

Fraudulent Transfers

The fraudulent transfer recovery period has been extended, but the real news applies to employment contracts.

Section 548, captioned "Fraudulent Transfers and Obligations," principally addresses transactions in which the debtor transferred property or incurred an obligation to another party in exchange for less than reasonably equivalent value while insolvent (a "constructively fraudulent" transfer), or with actual intent to hinder, defraud, or delay creditors (an "actually fraudulent" transfer). This section was revised in several respects under BAPCPA.

- The most conspicuous change is that the look-back period under §548(a), formerly one year prior to the commencement of the case, has been expanded to two years.[12] This does not alter the estate's power under §544 to recover prepetition transfers pursuant to applicable state fraudulent conveyance laws, which often apply to even longer periods.
- Less remarked upon but potentially more important is new §548(a)(1)(B)(ii)(V): Transfers made or obligations incurred to or for the benefit of an insider of the debtor under an employment contract, for less than reasonably equivalent value and not in the ordinary course of business, are now voidable regardless of whether the debtor was insolvent at the time of the transfer.[13] As drafted, this is an invitation to challenge any significant employment arrangement.

A new subsection (e) also allows the estate to recover transfers to self-settled trusts under which the debtor is the beneficiary, if made within ten years of the petition date and made with actual intent to hinder, delay, or defraud any entity to which the debtor was or became indebted. For purposes of this provision, "transfers" include those made in anticipation of a money judgment, fine, or civil penalty related to a violation of securities laws, or to fraud, deceit, or manipulation in a fiduciary capacity or in connection with the purchase or sale of any registered security.

Executive Compensation

A last-minute addition to BAPCPA makes it more difficult to pay retention bonuses to key executives.

Management and employee incentive and retention plans are common in Chapter 11 cases. There is certainly the potential for abuse, as debtors' proposals may be overgenerous or unrelated to the success of the reorganization effort, or may constitute a disguised payment of prepetition severance obligations. But the objections of other parties in interest usually act as a check on any such depredations.

One of the questionable policy balancing effects of BAPCPA is that it imposes strict new limits on the amounts payable through key employee retention plans while at the same time increasing the risks of serving as a senior manager of an insolvent company. Fortunately, the main targets of the employee compensation amendments are executive retention and severance payments.

- Retention payments are generally no longer permitted unless the employee has a bona fide offer of employment elsewhere and is providing services essential to the debtor's survival. The payment amounts are now capped based on the debtor's other payments to similar employees during the prior calendar year.
- Severance payments are also capped and must be part of a program generally applicable to all employees of the debtor.
- However, incentive plans based on clear performance targets, such as company earnings, cost control, and the outcome of a Chapter 11 plan or sale process, should still be permissible despite the new restrictions.

A related amendment likely to spawn litigation is the expansion of §548 (the fraudulent transfer statute, described above) to address amounts paid and obligations incurred to an insider under an employment contract, without regard to the financial condition of the debtor at the time of the transfer.

- This amendment can be read to apply to any employment agreement under which the debtor arguably received less than reasonably equivalent value. As a result, financially troubled companies may find it harder to recruit and retain good executives.

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[7] *The new text does not address the rights of a good-faith purchaser who would have been protected under Article 2 of the UCC, but expressly protects the rights of a holder of a security interest.*

[8] *Prior law holds that a reclaiming vendor is not a prepetition secured creditor, and thus cannot invoke marshalling. See* Galey & Lord, Inc. v. Arley Corp. (In re Arico, Inc.), *239 B.R. 261(Bankr. S.D.N.Y. 1999).*

[9] *See House Report 95-595, pp371-372; Senate Report 95-989, pp. 86-87.*

[10] *See House Report 109-31, p.146.*

[11] Levit v. Ingersoll Rand Fin. Corp. (In re Deprizio), *874 F.2d 1186 (7th Cir. 1989), held that non-insider creditors could be subjected to the one-year insider preference look-back period in connection with an insider's guaranty of the debt. A 1994 amendment to §550 was not enough to extinguish all artifacts of this holding. New §547(i) took effect in all cases pending on April 20, 2005, or commenced thereafter.*

[12] *This amendment applies only in cases commenced more than one year after BAPCA's date of enactment,* i.e., *after April 20, 2006.*

[13] *This amendment took effect on BAPCPA's date of enactment, April 20, 2005, but does not apply to cases filed before that date.*

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