

## ***Bankruptcy Reform Act Taking Effect Soon***

**AS OCTOBER 17 NEARS, WATCH FOR RED FLAGS THAT YOUR  
CUSTOMER MAY BE FIXING TO FILE BANKRUPTCY**

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On April 20, 2005, after eight years of political wrangling, the U.S. Bankruptcy Code was finally overhauled, with the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (Reform Act). Most provisions of the Reform Act become effective with bankruptcy cases filed after October 17, 2005.

### **A. Bankruptcy Filings Rise as Debtors Seek to Beat Restrictions of Reform Act**

The changes to the bankruptcy laws taking effect on October 17th will make the bankruptcy process more restrictive, burdensome and expensive for a vendor's customer, whether a corporation, LLC, partnership, sole proprietor as well as a personal guarantor whether the customer files a Chapter 11 reorganization or Chapter 7 liquidation. The Reform Act is intended to limit some of the abuses in bankruptcy, both by corporations and individuals. For example, sole proprietors and personal guarantors may be motivated to file Chapter 7 prior to the Reform Act takes effect to discharge their debts rather than

risk having their Chapter 7 petition challenged and converted to Chapter 13, where a repayment plan to creditors must be approved. Likewise, a corporation, LLC, and a partnership may be motivated to file Chapter 11 prior to the Reform Act takes effect so as to avoid new debtor-unfriendly deadlines, resulting in debtors having to reorganize more quickly, make additional financial disclosures and deal with creditor protections, including paying some creditor classes (such as vendors, landlords, utilities, and taxing authorities) after the bankruptcy filing.

The press is reporting a meaningful increase in bankruptcy filings due to the Reform Act's October 17th deadline. Indeed, *The Wall Street Journal* and *Washington Post* report that, for example, Delta Airlines and Northwestern Airlines may file bankruptcy and, if so, a factor for a pre-October 17th Chapter 11 filing is the Reform Act. Additionally, *USA Today* reported that bankruptcy filing surged 12 percent in April, May and June from that same period last year. Bankruptcy courts, recognizing the rise in the number of filings, are taking special measures, such as accepting bankruptcy filings on the weekend of October 15<sup>th</sup> in the Eastern District of California. The press warns that September and the first two weeks of October will be a busy time

in the bankruptcy courts across the nation.

What are some of the Reform Act provisions that may prompt customers' rush to file bankruptcy? What are the red flags that a vendor should look for that may identify a customer as a candidate to file bankruptcy prior to the Reform Act taking effect?

## **B. Provisions of Reform Act Prompting A Race to the Bankruptcy Court**

The provisions of the Reform Act that may prompt a customer to file bankruptcy prior to the Bankruptcy Reform Act taking effect depends on the form of business enterprise: whether sole proprietor, corporation, LLC or a personal guarantor.

### **1. Sole Proprietors and Personal Guarantors**

The Reform Act imposes restrictions on an individual's use of Chapter 7 of the Bankruptcy Code, which allows an individual to discharge debt, as well as restricts assets that may be exempt from creditors' claims.

#### **a. The "Means Test"**

The Reform Act makes it more difficult for individuals to file Chapter 7 liquidation by imposing a means test, which determines whether a debtor has the ability to repay a significant portion of their debts.

If, after computing a debtor's income and expenses, it is determined that a debtor is able to repay their debts, then the Chapter 7 case may be dismissed or converted to Chapter 13.

For a vendor holding a personal guarantee, the means test may force the guarantor to repay a portion of the guaranteed debt through a Chapter 13 plan, if the guarantor's income is too great. Likewise, for a vendor selling to a sole proprietor, the debtor may consider filing an individual Chapter 7. Should the sole proprietor's monthly income exceed the mean, the Chapter 7 case may be dismissed or converted to Chapter 13, thereby forcing repayment of creditors' claims. Given this, the sole proprietor and personal guarantor may be prompted to file Chapter 7 prior to the Reform Act's effective date.

#### **b. Homestead Exemption**

Florida, Iowa, Kansas, South Dakota and Texas have unlimited homestead exemptions that allow the wealthy to file for bankruptcy and keep their mansions away from creditors' claims.

The Reform Act restricts the homestead exemption to \$125,000, if the debtor bought their residence less than three years and four months before the bankruptcy filing. This provision also disallows the homestead exemption if the debtor purchased the property with the intent to defraud creditors.

Prior to the 2005 Act, debtors could shield their assets from creditors by moving, to, say, Texas or Florida and purchasing a house with all of their assets and filing for bankruptcy. This provision now protects creditors from this risk.

## **2. Corporations, LLC's and Partnerships**

The owners and professional managers of corporations, LLC's and partnerships may be prompted to file Chapter 11 prior to October 17th given the following changes to the Bankruptcy Code:

### **a. Exclusive Right to File Plan of Reorganization**

Prior to the 2005 Act, corporations had the exclusive right to file a plan of reorganization within the first 120 days of the bankruptcy filing, and an additional 60 days to solicit acceptance of the plan. A bankruptcy court could extend the exclusivity period indefinitely upon the debtor establishing "cause".

The Reform Act limits the debtor's exclusive right to propose a plan to 18 months. After that, there can be competing plans from creditors and creditor's committees.

### **b. Employee Retention Bonuses and Severance Programs**

Prior to the Reform Act, corporate debtors in the opening days of a chapter 11 would often request the bankruptcy court

approve a bonus scheme for management. Vendors would often view such requests by management as overreaching and an attempt by management to enrich themselves at the expense of creditors.

Under the Reform Act, in order to obtain approval of a key employee retention plan, the debtor must establish that a retention or stay bonus is essential to induce management to continue employment. For the insider to be entitled to such a bonus, he or she must have a job offer from another business. In addition, the insider's services must be essential to the debtor. The retention bonus and severance package cannot exceed ten times the amount paid to non-management persons within the year in which the transfer is made or, in the absence of such non-management bonuses, cannot exceed 25 percent of the amount of bonuses transferred to the insider during the year prior to the retention bonus.

A debtor's management will view these restrictions negatively as they believe it leads to the departure of key personnel viewed as essential to the reorganization.

### **c. Real Estate Leases**

Prior to the Reform Act, a debtor had 60 days from the bankruptcy filing to decide whether to assume or reject its commercial real estate lease, or request an extension to decide

to assume or reject the lease. A bankruptcy court would routinely extend this time during the course of bankruptcy proceeding.

The Reform Act requires a debtor to assume or reject its real estate lease within 210 days following the petition date.

#### **d. Adequate Assurance to Utilities**

Prior to the Reform Act, there was much litigation between a debtor and its utility as to what was deemed adequate assurance of payment to the utility.

The Reform Act resolves what constitutes adequate assurance of payment for a utility. A debtor offering a utility an administrative expense claim for its post-bankruptcy services no longer constitutes adequate assurance of payment. This provision defines the term adequate assurance of payment as: a cash deposit; a letter of credit; a certificate of deposit; a surety bond; a prepayment of utility consumption; or another form of security that is mutually agreed on between the utility and the debtor or the trustee.

As a result of the Reform Act, the debtor will be required to have more assets available to satisfy utilities adequate assurance requirements. Given these changes, the corporate

debtor in financial difficulty, may file Chapter 11 prior to the Reform Act taking effect.

### **C. Red Flags That May Signal Your Customer May File Bankruptcy to Beat the Reform Act**

A customer's slide into insolvency and financial distress often times is gradual and red flags indicating financial problems may take time to show themselves. As noted, the Reform Act's October 17<sup>th</sup> effective date is forcing customers, including personal guarantors, to evaluate their financial standing, including their debts to creditors, and whether to file bankruptcy prior to this date.

Beyond the obvious red flag of a customer failing to pay according to invoice, the following red flags may indicate that a customer may be fixing to file bankruptcy prior to October 17<sup>th</sup>:

#### **1. Excess Cash Burn Rate**

This is the amount by which a customer's expenses exceed its cash flow. To determine how long cash may last, and the prospects for payment of a credit sale, the credit professional may divide the company's burn-rate by the amount of cash it has.

A high burn rate will result in the company unable to finance operations.



## **2. Source of Financing Stalled**

Many financial institutions, such as banks and other asset based lenders, are reluctant to provide additional rounds of financing when they see a customer is facing financial struggles. With the source of financing stalled, a customer will run out of cash.

## **3. Management and Key Employee Departures**

With many customers, the value of the business may be the intellectual property that is in the hands of management or key employees. Their departure may have a significant impact on the corporations' continued operations, and thereby jeopardize repayment of a vendor's open account sale.

## **4. Stock Price Decline**

When a publicly held company faces significant stock price decline, a number of detrimental consequences result. A customer will likely find that a drop in their stock prices may jeopardize their chances of getting additional financings as lenders are more selective on who they will continue to finance and they will often move their money into businesses that are less risky. Additionally, when options are a major employment incentive, management may flee when the stock price drops. As a result the company may be unable to finance certain operation

when they otherwise would due to their inability to relay on the market for additional financing.

#### **5. Key Customer has Financial Difficulty**

A number of large corporations have regular customers on who they depend on as a source of revenue. If an incident should occur for a key customer in which, the customer stops purchasing from the corporation; it is likely that the corporation will also feel the effects of that key customer's financial struggles. The corporation's dependence on a large customer can have a domino effect in which when one fails, the other will most likely fail too.

#### **6. Sarbanes Oxley Disclosure of Financial Difficulty**

The passage of Sarbanes-Oxley in 2002 forced companies to tighten their auditing and public financial disclosure processes. Section 409 of SOX requires early disclosure of a public company's financial difficulties, such as a loss of a major customer or resignation of an officer.

#### **7. Using Tax Money to Pay Bills**

Should a corporation lose its financing source, it may, out of desperation, use money earmarked to pay taxing authorities.

#### **8. Ignoring Your E-mail and Calls**

When a company begins its financial backslide, vendors will

find that e-mails and phone calls requesting payments are not returned. Highlighting this risk is the recent trend of law and accounting firms asking for cash retainers instead of a portion of the equity of their corporate client.

#### **9. Retail Customers**

Customers that are retailers may be especially susceptible to the greater restrictions imposed by the Reform Act. Post-October 17<sup>th</sup>, the retailer will have a limited time to decide whether to accept or reject the leases, of which the retailer may have scores of.

#### **D. Review Your Credit Documents As Effective Date Nears**

Given that customers are evaluating whether to file prior to the Reform Act's effective date, the credit professional not only needs to scrutinize red flags that a customer may be fixing to file bankruptcy, but review the credit documents that allow the credit professional to terminate the credit relationship. If the credit professional has identified a red flag that a customer may be fixing to file bankruptcy, the credit professional should have a condition in their credit application that gives the vendor the unilateral right to convert the credit sale to cash at the vendor's sole discretion. This condition permits the vendor to reduce the risk that a credit sale goes

unpaid if the customer files bankruptcy to beat the Reform Act's effective date.

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