

Introduction: Brief History of the Act

By Paul H. Deutch

On April 20, 2005, President Bush signed The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 into law (the "Act"). Although the Act has received much media attention in recent months for its potential impact upon consumers seeking protection under Chapter 7 of the Bankruptcy Code (the "Code"), it does contain a number of amendments to the Code that will affect, either directly or indirectly, the ways in which equipment lessors will relate to their liquidating or reorganizing lessees. This article provides a brief overview of some of the new amendments to the Code and explains how they will change the dynamics between lessors and lessees.



Editor's Note

You Spoke. We listened. *LJN's Equipment Leasing Newsletter* is providing this Special Issue to ensure that you have the most up-to-date information on The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 and how it affects your practice. Thank you to all of our subscribers who have given us feedback indicating that they would like to see more of our publication.

SPECIAL ISSUE

BANKRUPTCY

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005

Important Implications for the Equipment Leasing Industry

By Paul H. Deutch

CURE OF NONMONETARY DEFAULTS NOW REQUIRED

Perhaps one of the most significant changes to the Code involves a debtor's obligation to cure defaults arising under pre-petition executory contracts (essentially, contracts under which both parties still have material obligations) or unexpired personal or real property leases. Subject to certain exceptions, the pre-Act Code required that a debtor wishing to assume an unexpired lease or executory contract must first cure, or provide adequate assurance that it will promptly cure, defaults arising out of such lease or contract ("assumption" is required if the debtor wants to continue on as a party to an executory contract or unexpired lease *after* the debtor emerges from bankruptcy). Furthermore, because a debtor is not permitted to assign its rights and obligations arising under an unexpired lease or executory contract unless it is first assumed, the curing of existing defaults is also a precondition to assignment. In the last few years, however, a dispute has arisen among certain U.S. Circuit Courts of Appeals as to whether the Code required a debtor to cure nonmonetary as well as monetary defaults. Now, with the addition of a single word, Congress has made it clear that in order to assume and, where applicable, assign, an executory contract or unexpired lease, a debtor *must* cure nonmonetary as well as monetary defaults. As discussed below, this amendment may produce a harsh result for debtor-lessees because many, if not most, nonmonetary defaults could be deemed impossible to cure.

continued on page 2

In This Issue

**The Bankruptcy
Abuse Prevention and
Consumer Protection
Act of 20051**

Bankruptcy

continued from page 1

Section 365 of the Code is the statutory predicate for a debtor's assumption and assignment of unexpired leases and executory contracts. That section sets forth the limited parameters within which such assumption may occur including, for example, the requirement that the debtor cure default(s) arising under such agreement:

(b)(1) If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract or lease, the trustee —

(A) cures, or provides adequate assurance that the trustee will promptly cure, such default; 11 U.S.C. §365(b)(1)(A) (1994).

(It should be noted that in the Code, the word "trustee" is generally interchangeable with "debtor-in-possession.") As discussed in greater detail below, §365(b)(1)(A) has been amended by the Act to clarify, and under certain circumstances, relax its stringent cure requirements.

Under the pre-Act version of the Code, Congress also recognized the need for certain exceptions to the "cure" requirement of §365(b)(1). Section 365(b)(2) of the pre-Act Code stated that the cure requirement of §365(b)(1) is *inapplicable* if the default consisted of the breach of a provision relating to:

- (A) the insolvency or financial condition of the debtor at any time before the closing of the case;
- (B) the commencement of a case under this title;
- (C) the appointment of or taking possession by a trustee in a case

Paul H. Deutch (paul.deutch@troutmansanders.com) is an attorney in the New York office of Troutman Sanders LLP. He concentrates his practice in the areas of corporate restructuring and bankruptcy including the representation of Chapter 11 debtors, creditors' committees and various types of corporate and individual creditors.

under this title or a custodian before such commencement; or (D) the satisfaction of any penalty rate or provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease. 11 U.S.C. §365(b)(2) (1994).

Contractual provisions designating the circumstances enumerated in subsections (A), (B) and (C) of §365(b)(2) as events of default are commonly known as *ipso facto* clauses (*ie*, clauses that trigger a default based on the debtor's financial condition, bankruptcy filing or similar conditions usually present at the time when a bankruptcy case is filed) and are generally unenforceable under the Code. It is the last subsection of §365(b)(2), subsection (D), however, which has been a source of contention among certain Circuit Courts of Appeals as well as bankruptcy courts throughout the country with respect to its effect on a debtor's obligation to cure nonmonetary defaults.

Under the pre-Act version of the Code, a number of courts have construed §365(b)(2)(D) as relating only to penalties. Those courts construed the word "penalty" in subsection (D) as modifying both the words "rate" and "provision." Under such a reading, at least one court noted that the first clause of §365(b)(2)(D) addressed "penalty rates which are commonly imposed where a debtor's breach was monetary in nature," and that the second clause addressed "the payment of penalties under liquidated damage provisions where the debtor's breach was nonmonetary in nature." See *Worthington v. GMC (In re Claremont Acquisition Corp.)*, 113 F.3d 1029, 1034 (9th Cir. 1997). Other courts, however, have determined that the word "penalty" modifies "rate" (so that penalty rates of interest need not be paid to cure a default), but does not modify the phrase "provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations" (so that nonmonetary obligations of all kinds, whether

continued on page 3

Equipment Leasing Newsletter®

ALM

PUBLISHER Sofia Pables
EDITOR-IN-CHIEF Adam Schlagman
MANAGING EDITOR Julie Gromer
MARKETING PROMOTIONS
COORDINATOR Rob Formica
MARKETING ANALYSIS
COORDINATOR Traci Footes
GRAPHIC DESIGNER Louis F. Bartella

BOARD OF EDITORS

ANTHONY ALTAMURA Hahn & Hessen, LLP
New York
JAMES D. BACHMAN Doyle & Bachman
Washington, D.C.
WILLIAM J. BOSCO, JR. Leasing 101
Suffern, NY
RAYMOND W. DUSCH Schulte Roth & Zabel, LLP
New York
BETH STERN FLEMING Stevens & Lee, P.C.
Philadelphia
JAMES F. FOTENOS Greene Radovsky Maloney &
Share, LLP
San Francisco
BARBARA M. GOODSTEIN LeBoeuf, Lamb, Greene &
MacRae, LLP
New York
BARRY A. GRAYNOR Cooley Godward, LLP
San Francisco
EDWARD K. GROSS Ober, Kaler, Grimes & Shriver
Baltimore
MARC L. HAMROFF Moritt Hock Hamroff &
Horowitz, LLP
Garden City, NY
ANTHONY L. LAMM Lamm, Rubenstone, Totaro &
David, LLC
Bensalem, PA
RUTH L. LANSNER Holland & Knight, LLP
New York
MICHAEL A. LEICHTLING Troutman Sanders LLP
New York
CHARLES H. LICHTMAN Berger Singerman
Fort Lauderdale, FL
STEVEN N. LIPPMAN Tescher Lippman & Valinsky
Fort Lauderdale, FL
BARRY S. MARKS Baker, Donelson, Bearman,
Caldwell & Berkowitz, PC
Birmingham, AL
PAMELA J. MARTINSON Bingham McCutchen
San Francisco
DAVID G. MAYER Patton Boggs, LLP
Dallas
MICHAEL C. MULITZ Kaye Scholer, LLP
New York
MARK I. RABINOWITZ Blank Rome, LLP
Philadelphia
JEFFREY N. RICH Kirkpatrick & Lockhart, LLP
New York
A. MICHAEL SABINO Sabino & Sabino, P.C.
New York
IAN SHRANK Allen & Overy
New York
ROBERT THORNTON SMITH Linklaters & Paines
New York
JOHN E. STEWART Financial Reporting Advisors, LLC
Chicago
THATCHER A. STONE Alston & Bird, LLP
New York
ROBERT VITALE Cadwalader, Wickersham & Taft
New York
HOWARD K. WEBER New York

The Equipment Leasing Newsletter® (ISSN 9733-4304) is published by Law Journal Newsletters, a division of ALM. ©2005 ALM Properties, Inc. All rights reserved. No reproduction of any portion of this issue is allowed without written permission from the publisher. Telephone: (800) 999-1916
Editorial e-mail: jgromer@alm.com
Circulation e-mail: subspa@alm.com

LJN's Equipment Leasing Newsletter P0000-235
Periodicals Postage Pending at Philadelphia, PA
POSTMASTER: Send address changes to:
ALM
1617 JFK Blvd., Suite 1750, Philadelphia, PA 19103
Annual Subscription: \$429

Published Monthly by:
Law Journal Newsletters
1617 JFK Boulevard, Suite 1750, Philadelphia, Pa 19103
www.ljnonline.com

Bankruptcy

continued from page 2

penal or otherwise, need not be cured). See, e.g., *Eagle Insurance Co. v. Bankvest Capital Corp.* (In re *Bankvest Capital Corp.*), 360 F.3d 291 (1st Cir. 2004), cert denied, 124 S.Ct. 2874 (2004); *In re Mirant Corp.*, No. 03-46590, 2004 Bankr. LEXIS 1377 (Bankr. N.D. Tex. Sept. 15, 2004).

Unlike the last time that §365(b) was amended (pursuant to the Bankruptcy Reform Act of 1994), Congress has now made its intentions clear that, except as expressly excluded, a debtor must cure both monetary and nonmonetary defaults. As revised by the Act, §365(b)(2)(D) now reads as follows (new language in italics):

(D) the satisfaction of any penalty rate or *penalty* provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease. 11 U.S.C. §365(b)(2)(D) (2005).

By making this one word change, Congress has answered the basic question of whether nonmonetary defaults must be cured. However, Congress has left ample room for disputes to arise over the need to cure and the manner in which a cure can be affected in specific situations. These remaining areas of uncertainty may best be understood by reviewing some of the cases that precipitated the amendment.

In *Worthington v. GMC* (In re *Claremont Acquisition Corp.*), 113 F.3d 1029, 1034 (9th Cir. 1997), the Ninth Circuit Court of Appeals heard the appeal of General Motors Corporation ("GMC"), seeking to reverse a lower court decision authorizing a debtor/dealership/franchisee to assume its franchise agreement with GMC and assign it to a third party not of GMC's choosing. GMC argued that the franchise agreement could not be assumed and, therefore, assigned, because there existed an incurable nonmonetary default, to wit, a breach of a "lights out" provision, which stated that the franchise agreement could be terminated if the dealership closed its operations for more than 7 consecutive days. In the *Claremont* case, the

debtor had, in fact, failed to open its doors for the 12 days immediately preceding its Chapter 11 filing. The Ninth Circuit noted that such a nonmonetary default "is a 'historical fact' and, by definition, cannot be cured." 113 F.3d at 1033. The only question then was whether such default was excused from being cured under §365(b)(2)(D).

The debtor in *Claremont* argued that §365(b)(2)(D) was unambiguous and that, as described above, such section was actually comprised of two distinct clauses affecting separate types of defaults: the first, applying to the satisfaction of penalty provisions in an executory contract or unexpired lease, and the second, to all nonmonetary defaults. Under the debtor's reading in *Claremont*, therefore, nonmonetary defaults are not required to be cured as a prerequisite to assumption under §365(b)(1).

GMC, on the other hand, read §365(b)(2)(D) so that the word "penalty" modified the word "rate" in the first clause of (b)(2)(D) and also the word "provision" in the second clause. By reading 365(b)(2)(D) in this fashion, nonmonetary defaults remained subject to the cure requirements of 365(b)(1) except to the extent they were deemed to be penalties.

The Ninth Circuit agreed with GMC, holding that the proper reading of 365(b)(2)(D) "provides an exception from cure for satisfaction of 'penalty rates' and 'penalty provisions,'" and that the construction demanded by the debtor would be grammatically incorrect. *Id.* at 1034. The court further noted that a reading of subsection (D) in a manner which provided a "catch-all" for all nonmonetary defaults would render subsections (A), (B) and (C) superfluous because they would each be included in (D). *Id.* The court also stated that the legislative history of §365(b)(2)(D), albeit limited, suggested that Congress intended to limit such section to penalties. *Id.*

Since its publication, the Ninth Circuit's decision has received much criticism, perhaps nowhere more significantly than in March 2004, when the U.S. Court of Appeals for the First Circuit examined the apparent ambi-

guity of §365(b)(2)(D) and reached a decidedly different outcome than that reached by the Ninth Circuit in *Claremont*.

In *Eagle Insurance Co. v. Bankvest Capital Corp.* (In re *Bankvest Capital Corp.*), 360 F.3d 291 (1st Cir. 2004), the First Circuit held that a debtor-equipment lessor could assume its pre-petition executory contracts with two lessees even though the debtor was unable to cure all nonmonetary defaults. Specifically, the court held that §365(b)(2)(D) served as an exception to §365(b)(1)'s general rule requiring cure for all nonmonetary defaults. *Id.* at 300-302.

In *Bankvest*, the debtor-lessor was the successor lessor under an agreement to lease 190 pieces of computer equipment to two lessees. Of the 190 pieces of equipment, the lessees had allegedly agreed to temporarily take 20 pieces of substitute loaner equipment because of delays in the production of certain critical equipment. Before delivery of the critical equipment could be made, however, an involuntary Chapter 11 petition was filed against the debtor.

Noting that the debtor's failure to deliver the critical computer equipment was "a quintessential example of a nonmonetary default," *id.* at 297, the First Circuit refused to follow the *Claremont* court's reading of §365(b)(2)(D). It found that the statute was ambiguous and therefore, Congress' intent when it amended the section in 1994 had to be discerned using other sources. The court looked to the same legislative history as the *Claremont* court, yet found such information to be of limited assistance. Notably, the First Circuit essentially disregarded the then-current draft of the Act, at the time still being debated by Congress and 1 year away from President Bush's signature, even though that draft contained revisions which showed that Congress favored the *Claremont* reading of §365(b)(2)(D). The First Circuit found that the proposed changes showed only that Congress recognized a problem under §365(b)(2)(D), but did not shed light on Congress' intent in 1994.

continued on page 4

Bankruptcy

continued from page 3

Ultimately, the First Circuit interpreted §365(b)(2)(D) to achieve a result that it deemed consistent with the “practical considerations of bankruptcy policy and Congress’ overarching purposes in the Bankruptcy Code.” 360 F.3d at 299. The court found that the *Claremont* decision had drawn wide-scale criticism because it created an impediment to successful reorganizations in that so many nonmonetary defaults are historical facts that cannot be cured. It noted, by way of an example, that, under *Claremont*, if a debtor-lessee had previously violated its covenant to maintain its leased equipment, such debtor would be unable to assume an equipment lease, irrespective of how important or valuable such lease was to a debtor’s reorganization. The First Circuit refused to enforce such a reading of the statute because it would serve only to undermine the very purpose of §365: “the successful rehabilitation of the business for the benefit of both the debtor and all its creditors.” *Id.* at 300. Accordingly, the court held that “under §365(b)(2)(D), Bankvest need not cure nonmonetary defaults before assuming its equipment leases with [the lessees].” *Id.* at 301.

Under the particular facts of *Bankvest*, the court had another reason for permitting the debtor to assume the lease. The debtor in *Bankvest* had committed no monetary defaults; as an equipment lessor it had received, and did not have to make, rental payments. Accordingly, the only default at issue was the debtor’s failure to deliver the critical equipment, and the two lessees were using such default to avoid having to pay in excess of \$1 million in rent that they had withheld. The First Circuit found that such a result would be inconsistent with the Code’s underlying purpose of maximizing estate value. The First Circuit acknowledged the lessees’ argument that the requirement to cure nonmonetary defaults reinforced a nondebtor’s right to receive the benefit of its bargain, but held that a debtor’s

right to receive a fresh start took precedence. *Id.* at 300, n.14.

Between publication of the *Claremont* decision in 1997 and enactment of the Act, a number of lower courts addressed a debtor’s obligation to cure nonmonetary defaults under §365(b)(2)(D). The outcomes of those cases and the facts on which they are based are as diverse as those discussed by the Circuit Courts. *See, e.g., Mirant Corporation*, No. 03-46590, 2004 Bankr. LEXIS 1377, *15-16 (Bankr. N.D. Tex. 2004) (disagreeing with *Claremont* decision because reading §365(b)(2)(D) so as to be in conformity with subsections (A), (B) and (C), creates improper “forced construction”); *In re Williams*, 299 B.R. 684 (Bankr. S.D. Ga. 2003) (Chapter 13 truck driver’s use of truck while not in employ of lessor, which was a requirement in the lease, created impossible-to-cure nonmonetary default); *In re New Breed Realty Enterprises, Inc.*, 278 B.R. 314 (Bankr. E.D.N.Y. 2002) (failure to timely close sale agreement when “time is of the essence” is *material* nonmonetary default under applicable state law that cannot be cured under §365); *Beckett v. Coatesville Housing Assoc.*, No. 00-5337, 2001 U.S. Dist. LEXIS 9281 (E.D. Pa. July 5, 2001) (debtor’s failure to maintain leased premises in a clean, orderly and safe condition amounted to a material breach of the lease that could not be cured).

By adding the word “penalty” to §365(b)(2)(D), Congress has adopted the Ninth Circuit’s reading set forth in *Claremont*, thereby making it clear that a debtor is obligated to cure both monetary and nonmonetary defaults prior to assumption. Although this result may appear to be somewhat harsh to debtors and, as set forth in *Bankvest*, possibly contrary to certain underlying tenets of the Code, Congress has put to rest the dispute that was created when §365 was last amended. Moreover, Congress has added additional language in §365(b)(1)(A) to mitigate the potentially harsh outcome that may result, under certain circumstances, from the changes to §365(b)(2)(D). *This new language will not, however, assist*

debtors who are lessees under personal property leases.

Under certain circumstances, §365(b)(1)(A), as revised, excepts from the general cure requirement defaults relating to nonmonetary obligations of real property leases if it is impossible to now cure such defaults by performing nonmonetary acts at or after assumption. It further requires that under certain circumstances, nonmonetary defaults shall be cured by performance after assumption and payment of losses resulting from such default.

As revised, §365(b)(1) reads as follows (new language in italics):

(b)(1) If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract or lease, the trustee —
(A) cures, or provides adequate assurance that the trustee will promptly cure, such default *other than a default that is a breach of a provision relating to the satisfaction of any provision (other than a penalty rate or penalty provision) relating to a default arising from any failure to perform nonmonetary obligations under an unexpired lease of real property, if it is impossible for the trustee to cure such default by performing nonmonetary acts at and after the time of assumption, except that if such default arises from a failure to operate in accordance with a nonresidential real property lease, then such default shall be cured by performance at and after the time of assumption in accordance with such lease, and pecuniary losses resulting from such default shall be compensated in accordance with the provisions of this paragraph.* 11 U.S.C. §365(b)(1)(A) (2005).

(As set forth below, the changes to §365(b)(1)(A) have a direct correlation to the changes made to §1124, which deals with the impairment of claims and interests for plan purposes.)

continued on page 5

Bankruptcy

continued from page 4

As aforesaid, the language added to §365(b)(1)(A) appears to apply only to leases of real property and not to executory contracts or unexpired leases of personal property. *In other words, the “impossibility” exception to cure contained in §365(b)(1)(A) does not appear to affect a debtor’s obligation to cure nonmonetary defaults in executory contracts or unexpired leases of personal property such as equipment leases.*

It should also be noted that the new language incorporated into §365(b)(1)(A), specifically, that which permits a prospective cure of a “failure to operate” default, appears to be applicable only to defaults under nonresidential real property leases. By limiting its amendment to operating defaults under such leases, therefore, Congress may have been demonstrating its intention to codify *Claremont*, which held that a debtor’s default under a “failure to operate” clause in an executory contract could not be cured.

How will the changes to §365(b) affect reorganization and liquidation cases on a going forward basis? At this early point, no answers are clear-cut. One might speculate, however, on the issues and questions that may soon arise:

1) By changing §365, did Congress, in fact, codify the *Claremont* decision and, therefore, render most, if not all, nonmonetary defaults of equipment leases impossible to cure and, accordingly, the lease involved impossible to assume and assign?

2) Will the materiality standard raised in *New Breed* become prominent in future cases analyzing §365(b)?

3) As a way of mitigating the potentially harsh result which may arise from requiring debtors to cure nonmonetary defaults, will bankruptcy courts permit debtors to make cash payments to lessors in lieu of, or as a substitute for, such cure? If, in fact, such payments are allowed, how will they be valued and what effect might this new layer of post-petition expense have on the debtor’s ability to reorganize?

4) Will courts applying §365(b)(1)(A) now attempt to “monetize” all defaults, essentially eliminating the existence of any nonmonetary defaults?

5) Will debtors be able to negotiate deals with lessors and potential assignees whereby the cost of curing a nonmonetary default is passed on to the assignee or will the default be waived if assigned to a financially responsible entity?

It would be remiss to conclude a discussion on the recent changes to §365 without also recognizing certain complementary changes to §1124 of the Code. Section 1124 establishes when a class of claims or interests is impaired under a plan of reorganization, a crucial point in the determination of who gets to vote on such plan.

Prior to the Act, §1124 of the Code required that a claim or interest be deemed impaired unless a plan: (i) leaves “unaltered the legal, equitable, and contractual rights” of the holder of such claim or interest; or (ii) cures any outstanding defaults, reinstates the maturity of such claim or interest, compensates the holder of such claim or interest for certain damages and does not otherwise alter the legal, equitable or contractual rights of the holder. 11 U.S.C. §1124 (1994). The pre-Act Code further specified that a default did not have to be cured if it was the kind of default specified in §365(b)(2). For example, if a lessor’s claim was based solely on a debtor’s violation of an *ipso facto* clause in an equipment lease, the lessor’s claim would be unimpaired under §1124. 11 U.S.C. §1124(2)(A) (1994).

In conjunction with the changes to §365 discussed above, §1124, as amended by the Act, now reads as follows (new language in italics):

Except as provided in §1123(a)(4) of this title, a class of claims or interests is impaired under a plan unless, with respect to each claim or interest of such class, the plan —

(1) leaves unaltered the legal, equitable, and contractual rights to which such claim or interest entitles the holder of such claim or interest; or

(2) notwithstanding any contractual provision or applicable law

that entitles the holder of such claim or interest to demand or receive accelerated payment of such claim or interest after the occurrence of a default —

(A) cures any such default that occurred before or after the commencement of the case under this title, other than a default of a kind specified in §365(b)(2) of this title *or of a kind that §365(b)(2) expressly does not require to be cured;*

(B) reinstates the maturity of such claim or interest as such maturity existed before such default;

(C) compensates the holder of such claim or interest for any damages incurred as a result of any reasonable reliance by such holder on such contractual provision or such applicable law;

(D) if such claim or such interest arises from any failure to perform a nonmonetary obligation, other than a default arising from failure to operate a nonresidential real property lease subject to §365(b)(1)(A), compensate the holder of such claim or such interest (other than the debtor or an insider) for any actual pecuniary loss incurred by such holder as a result of such failure; and

(E) does not otherwise alter the legal, equitable, or contractual rights to which such claim or interest entitled the holder of such claim or interest. 11 U.S.C. §1124 (2005).

As set forth in new subsection (D), a creditor holding a claim based on a nonmonetary default will be deemed impaired under §1124 unless, among other things, the plan provides for payment to the non-debtor party for any pecuniary losses incurred as a result of such default. In other words, even if the debtor-lessee is unable to cure a nonmonetary default under §§365(b)(1)(A) and (b)(2)(D) and, therefore, the underlying lease is rejected, the lessor is still entitled to a claim based on the nonmonetary default which, under the plan, may be rendered unimpaired pursuant to §1124(2). Section 1124(2)(D) could also apply, at least under certain circumstances, where a lease has been

continued on page 6

Bankruptcy

continued from page 5

assumed. For example, if a lessor consents to the assumption of an equipment lease despite the existence of an incurable nonmonetary default, the debtor may still have to compensate the lessor pursuant to §1124(2)(D) in order to render the lessor's claim unimpaired.

Interestingly, the amendment to §1124(2)(A) appears to create a redundancy (*ie*, two references to §365(b)(2)) which doesn't appear to express Congressional intent and which may, in fact, be an error in the Act. A more logical reading of the statute would change the second reference to §365(b)(2) in §1124(a)(2) to §365(b)(1)(A), which is the only other provision of §365 that has been amended to expressly state exceptions to the cure requirement set forth in §365(b)(1) (*ie*, all nonmonetary defaults arising under unexpired lease of real property that are impossible to cure except for "failure to operate" defaults under leases of nonresidential real property).

AVOIDANCE ACTIONS AND AMENDMENTS TO CODE-GRANTED DEFENSES

Preference Actions

At one time or another, most lessors have probably experienced a lessee trying to play "catch-up" on past due lease payments only to have such lessee become a debtor under the Code shortly thereafter. The same lessors have inevitably received a subsequent letter from a debtor or trustee, sometimes months or even years after the bankruptcy case was filed, threatening legal action unless the so-called "preference" payment received by the lessor is immediately returned to the bankruptcy estate. A "preference" is essentially: 1) a transfer made by a debtor, 2) within 90 days prior to its bankruptcy filing, 3) to or for the benefit of a creditor, 4) on account of an antecedent debt, and 5) made while the debtor was insolvent. Liability on a preference claim is certainly not limited to lessors and may involve many different types of creditors. For example, a party with a valid security inter-

est in property of the debtor may also be subject to a preference claim if any preferential transfer received by such creditor within the 90-day preference period is in excess of the value of such property.

Under the Code, any party alleged to have received a preference from the debtor has the opportunity to avoid disgorgement to the bankruptcy estate if it can satisfy any one of the defenses listed in §547(c) of the Code. One such defense, commonly known as the "ordinary course" defense, provided, prior to the Act, that:

(c) The trustee may not avoid under this section a transfer —

...

(2) to the extent that such transfer was —

(A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee;

(B) made in the ordinary course of business or financial affairs of the debtor and the transferee; and

(C) made according to ordinary business terms. 11 U.S.C. §547(c) (1994).

Accordingly, to successfully defend a preference action using the ordinary course defense under the pre-Act Code, a creditor-transferee had to prove that: 1) the underlying debt was incurred in the ordinary or usual course of business between the debtor and the transferee; 2) the payment was made in the ordinary or usual course of business between the debtor and transferee (commonly known as the "subjective" test); *and* 3) such transfer was made according to ordinary or common business terms (*ie*, industry standards and practices) (commonly referred to as the "objective" test). Because the three-part test set forth in the pre-Act version of §547(c)(2) is written in the conjunctive, the ordinary course defense has not always been easy to satisfy, particularly with respect to establishing and satisfying industry standards. The recent amendments to the Code, however, should make the ordinary course defense much more tenable.

In its amended form, §547(c)(2) is now written in the disjunctive, at

least with respect to the subjective and objective tests. Specifically, once a creditor demonstrates that the underlying debt was incurred in the ordinary course of business between the creditor and debtor, the creditor is then only required to show that the alleged preferential payment was made by the debtor in the ordinary course of its business dealings with the creditor *or* that such transfer was made under common, or industry, business terms. It is likely that the revised version of §547(c)(2) will make it easier for creditors to avoid having to turn over alleged preference payments. At the very least, the lower standard will provide a creditor with a better opportunity to negotiate a settlement in lieu of litigation.

The preferential transfer defense relating to the perfection of security interests has also been amended. Prior to the amendment, that section provided that a trustee (or debtor) could not avoid a transfer which created a purchase money security interest in property acquired by the debtor if, among other things, such security interest was perfected on or before 20 days after the debtor takes possession of such property. 11 U.S.C. §547(c)(3)(B) (1994). The new amendment extends the perfection deadline to 30 days. 11 U.S.C. §547(c)(3)(B) (2005).

Other changes to the Code should generally reduce the volume of preference actions currently filed. Section 547(c) now contains a "*de minimis* preference clause," essentially providing that, in certain cases, a preferential transfer cannot be avoided if the value of the property affected by such transfer does not exceed \$5000. Debtors and/or trustees may also be discouraged from commencing preference actions because of other new legislative changes. Section 1409(b) of Title 28 of the U.S. Code has also

continued on page 7

The publisher of this newsletter is not engaged in rendering legal, accounting, financial, investment advisory or other professional services, and this publication is not meant to constitute legal, accounting, financial, investment advisory or other professional advice. If legal, financial, investment advisory or other professional assistance is required, the services of a competent professional person should be sought.

Bankruptcy

continued from page 6

been amended by the Act to provide that, among other things, if a preference action seeks avoidance of a transfer of consumer debt of a value that is less than \$15,000, or a debt (excluding a consumer debt) against a non-insider for less than \$10,000, proper venue for such preference action is in the jurisdiction where the defendant resides.

Fraudulent Conveyance

'Look-back' Period Extended

One major change that could affect equipment lessors is the extension of the "look-back" period for fraudulent conveyances from 1 to 2 years. Under the pre-Act version of the Code, a trustee seeking to avoid a transfer that took place more than 1 year prior to the filing date, would have to look to §544(b) to employ applicable state law fraudulent conveyance statutes. Although those state statutes extend the trustee's look-back period to each state's statute of limitations for fraud (for example, 6 years in New York), the trustee can only assert a cause of action under §544 if it can identify a creditor of the debtor who could have, on its own, asserted such fraudulent transfer claim but for the fact that the debtor is in bankruptcy. Because the trustee does not need to "stand in the shoes" of such a creditor under §548(a)(1) (the section in the Code authorizing recoveries of fraudulent conveyances), the extension to 2 years may allow a trustee to avoid transactions that may otherwise be unreachable under §544(b). Moreover, the extension of the look-back period from 1 to 2 years may also benefit trustees and debtors to the extent that the burden of proving a fraudulent conveyance claim in state court is more difficult than that imposed by the Code.

ADDITIONAL PROVISIONS

AFFECTING PERSONAL PROPERTY LEASES AND SECURITY INTERESTS

The Act contains several new provisions to the Code relating to leases of personal property, mostly in the context of an individual debtor. To the extent that a lessor has executed

a lease with an unincorporated sole proprietorship as lessee, these provisions may be relevant.

One new section, which relates to both individual and corporate debtors, is §365(p)(1), which reads as follows:

(p)(1) If a lease of personal property is rejected or not timely assumed by the trustee under subsection (d), the leased property is no longer property of the estate and the stay under §362(a) is automatically terminated. 11 U.S.C. §365(p)(1) (2005).

This section appears to have been added to end any confusion that lessors may have with respect to their rights to the leased property post-rejection. The addition of this section now makes clear that once the lease is rejected, the equipment is no longer property of the bankruptcy estate and the lessor may, assuming the debtor does not consent, commence an action under applicable state law to recover the property without first having to seek relief from the automatic stay.

Section 365 has also been amended to allow an individual Chapter 7 debtor to, under certain circumstances, assume a lease. Unlike §365(p)(1), however, this new subsection, (p)(2)(A), applies to both personal property and real property leases. This new addition to §365: 1) sets forth the procedure by which the individual debtor may request such assumption; 2) states that the lease, when assumed, becomes the liability of the debtor and not the bankruptcy estate; and 3) authorizes the parties to negotiate a cure payment without violating the automatic stay. 11 U.S.C. §365(p)(2)(A) (2005).

With respect to the determination of a creditor's secured status, §506(a)(2) of the Code has been amended to clarify how the value of an individual debtor's personal property is determined in a Chapter 7 or 13 case. 11 U.S.C. §506(a)(2) (2005). Under §506(a)(1), a creditor asserting a claim secured by a lien on property of the debtor is deemed a secured creditor to the extent of the value of the collateral. Based on the new changes to the Code, in an individual's Chapter 7 or 13 case, the value

of the property securing a secured creditor's claim shall be based on the "replacement value" of such property. "Replacement Value," at least "with respect to property acquired for personal, family, or household purposes, ... shall mean the price a retail merchant would charge for property of that kind considering the age and condition of the property at the time value is determined."

CHANGES AFFECTING THE

DURATION OR USUAL

COURSE OF A BANKRUPTCY CASE

Many of the changes to the Code will affect, either directly or indirectly, the duration, or anticipated course, of new bankruptcy filings. For example, it has been well publicized that under the revised version of the Code, an individual filing a Chapter 7 liquidation may have his/her case dismissed or, with the debtor's consent, converted to a case under Chapter 11 or 13. The Act revises the Code so as to set forth the criteria on which a bankruptcy court must base its decision to convert or dismiss. These new rules should have a significant impact on the ways in which lessors relate to their consumer lessees.

In order to stem the tide of delays frequently associated with the filing of disclosure statements and plans of reorganization in Chapter 11 cases, Congress has made several changes to §1121 of the Code. 11 U.S.C. §1121 (2005). Whereas both versions of the Code provide that only a debtor may file a plan during the first 120 days of a Chapter 11 case (commonly known as the "exclusive period"), and only a debtor may solicit acceptances to a plan within the first 180 days of a Chapter 11 case (commonly known as the "solicitation period"), the revised version of §1121 now provides that the exclusive period and solicitation period may not be extended for more than 18 and 20 months, respectively, from the beginning of the case (the date that the order for relief was entered). This limitation to the duration of the exclusive period, as well other changes to the Code regarding pre-petition and post-petition plan

continued on page 8

Bankruptcy

continued from page 7

solicitation, may cause more debtors to consider filing pre-packaged Chapter 11 reorganizations, thereby resolving most, if not all, of their concerns before they ever step into bankruptcy court.

In small business cases, the time in which a debtor must file a plan is extended to 180 days (up from 100). In addition, §1121 has been amended to reflect that a plan and disclosure statement in a small business case must be filed no later than 300 days from the entry of the order for relief but that, under certain circumstances, both the 180 day and 300 day periods may be extended. Section 1129(e) of the Code, as amended, further provides that, if the plan in a small business case complies with all relevant provisions of Title 11, the court shall confirm the plan within 45 days from the time it is filed subject to further extensions. 11 U.S.C. §1129(e) (2005). Interestingly, the Code has now also been amended to reflect that, in a small business case, it is unnecessary for a debtor to file a disclosure statement if the bankruptcy court determines that the plan contains adequate information. 11 U.S.C. §1125(f)(1) (2005).

Another change to the Code likely to speed up Chapter 11 cases relates to the provisions regarding the assumption or rejection of nonresidential real property leases. Prior to the Act, a lease of nonresidential real property was deemed rejected if it was not assumed within 60 days after entry of the order for relief although such 60-day period could be extended by order of the court. 11 U.S.C. §365(d)(4) (1994). In many large, and even not so large, Chapter 11 cases, it has not been unusual for a debtor to seek several extensions of this assumption deadline in order to await the completion of the often-lengthy reorganization and plan process. Under the new amendments, unless the debtor's plan has been confirmed, the debtor must decide within 120 days after the order for relief whether it wants

to assume its leases. 11 U.S.C. §365(d)(4)(A) (2005). The deadline may be extended for an additional 90 days upon a showing of cause, but any additional extensions may only be granted with the lessor's written consent.

Other changes to the Code may also have direct or indirect effects on the manner in which cases transpire on a going forward basis. For example, certain amendments to the Code may lead to an increase in administrative claims, which, in turn, may cause debtors difficulty in funding a plan of reorganization. See, e.g., 11 U.S.C. §503(b)(9) (2005) (under certain circumstances, provides an administrative claim for the value of goods delivered within 20 days before the filing date), and 11 U.S.C. §546(c) (2005) (increasing reclamation reachback period to 45 days).

CROSS-BORDER INSOLVENCIES

Pursuant to the Act, a new chapter has been added to the Code. This new chapter, titled "Ancillary and Other Cross-Border Insolvencies," was created to provide a mechanism for dealing with international bankruptcy/insolvency cases with the goal of, among other things, fostering cooperation between U.S. courts and courts of other competent foreign jurisdictions, providing greater legal certainty for conducting trade in foreign markets or with an international clientele, and establishing a protocol for the fair and efficient administration of cross-border insolvencies. 11 U.S.C. §1501 (2005).

EFFECTIVE DATES

Although the Act has a general effective date of Oct. 17, 2005 (meaning it applies only to cases filed on or after that date), certain provisions contained therein are subject to different effective dates. Of the changes discussed in this article, it appears that only one will not be effective on Oct. 17. Specifically, the extension of the look-back for fraudulent conveyances from 1 to 2 years found in §548 of the Code. That section will apply only to those bankruptcy cases that are filed more than 1 year after enactment of the Act.

CONCLUSION

As set forth above, because the majority of the Act was promulgated by a desire to control individual debtor's abuses in Chapter 7 cases, most of the new changes have only a tangential effect on equipment lessors. However, certain other amendments, such as the changes to §547(c) (ordinary course defense for preference actions) and, especially, §365(b) (cure and assumption of leases), will have a much larger and practical effect on leasing transactions. Although implementation of revised §365, and the questions arising therefrom, now rests in the hands of the bankruptcy courts, by virtue of Congress' apparent codification of the *Claremont* decision, equipment lessors may have come away from the Act with a new and decidedly advantageous position over their lessee counterparts. It is also possible, however, that in applying revised §365, courts may try to mitigate the severe effect that such section may have on equipment lessees and provide some sort of alternative relief (such as, for example, allowing debtors to pay for a cure) in an effort to reconcile competing legal, economic and practical interests.

In its attempt to resolve certain issues, such as the *Claremont-Bankvest* dispute, Congress has clearly created new ones. It is likely that only time, anticipated litigation and the resulting well-reasoned opinions will provide answers to these new questions.



LAW JOURNAL NEWSLETTERS REPRINT SERVICE

Reprints of this article or any other article published by LAW JOURNAL NEWSLETTERS are available in bulk quantities.

Call Syndia Torres
at 212-545-6111 or e-mail
storres@amlaw.com
for a free quote.

Reprints are available in
paper and PDF format.