

NATIONAL BANKRUPTCY CONFERENCE

REVISED M E M O R A N D U M

FROM: Committee on Avoiding Powers
DATE: (Original Version) November 22, 2005
DATE: (Revised Version) September 12, 2006
RE: Committee Report on BAPCPA

The Committee on Avoiding Powers has reviewed a number of amendments to the Bankruptcy Code under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”). The following is a capsule summary of our review and comments on several changes to the avoidance power provisions of the Bankruptcy Code:

1. Dollar Limitation – Section 547(c)(9) has been added to provide that the Trustee may not avoid a transfer under §547 if it is less than \$5,000 (and the debts are not primarily consumer debts). The BAPCPA amendment uses “transfer” in the singular. If several transfers occur which aggregate \$5,000 or more, it is unclear if the new provision focuses on each transfer or permits aggregation. While §102(7) of the Code provides that the singular includes the plural, we, nevertheless, recommend that the word “transfer” be changed to “transfers.”

We do not view the \$5,000 threshold as a deductible. See: Harr v. Paradigm Management Co., 1997 WL 41268 (Bankr. D.MD. 1997). If it is ultimately established

that a transfer of \$5,000 or more is preferential, the entire amount should be recoverable.

If it is \$1 less than \$5,000, then no amount should be recoverable.

Construction of a similar provision under § 547(c)(8) concerning individual consumer

cases permits aggregation: Electric City Merchandise v. Hailes, 77 F. 3d 873 (5th Cir.

1996). Contra: In Re Clark, 171 B.R. 563 (W.D. Ky. 1994); In Re Howes, 165 B.R. 270

(E.D. Mo. 1994).

2. Reclamation Rights – Section 546(c) has been rewritten. The right of reclamation that existed before the amendment was a derivative of state law (i.e. subject to a statutory or common law right of a seller of goods to reclaim the goods if received while insolvent). Moreover, a 10 day time period applied. The BAPCPA has eliminated reference to a statutory or common law right. The amendment thus appears to create a federal right of reclamation applicable to goods received by the debtor within 45 days before the commencement of the case. However, it may be construed to still rely on state law but the time to reclaim is extended by federal law. Indeed, reclamation rights are buried in the section concerning limitations on avoiding powers.¹

Reference is made in the amendment to an exception in §507(c). That section deals with the priority of claims of governmental units. We believe that this is a technical error, and that the exception was intended to refer to §507(b) which concerns failed adequate protection rights.

The BAPCPA amendment requires written demand for reclamation not later than 45 days after the date of receipt of the goods by the debtor. This appears to be an unnecessary provision in light of the fact that the reclamation period itself extends for 45 days.

Because the amendment provides an additional 20 days after the commencement of the case to give a reclamation notice, our Committee recommends that §546(c)(1)(A) be deleted.

Subsection 546(c)(1) amendment now makes it clear that the right of reclamation is “subject to the prior rights of a holder of a security interest in such goods or the proceeds thereof.” If the federally created right of reclamation supersedes the UCC right of reclamation in bankruptcy cases, then a number of elements from the UCC are not present in the federal statute. For example, the new right of reclamation is not expressly subject to the rights of buyers in the ordinary course of business, lien creditors or good faith purchasers. In addition, it is not clear whether the right of reclamation is limited to the debtor or if the seller can pursue others who have the goods. Finally, it is not clear if a seller can reclaim goods already paid for, as there is no requirement that the “sold goods” be on credit terms.

Apart from the right of reclamation, even if a seller fails to provide an appropriate reclamation notice, the seller may still assert rights under §503(b)(9) of the Code. This new section grants the seller an administrative priority for goods received by the debtor in

¹ There may also be a question of whether “insolvent” will be construed under the Code or state law if this is not an independent federal right.

the ordinary course of business within 20 days before the petition. Consequently, even if the goods are no longer there, and no reclamation right exists, or if the goods are there but timely notice is not given, the seller is entitled to administrative expense status for the “value” of goods received within the pre-petition 20 day period. In large retail cases, this will elevate many significant vendor claims to post-petition status and require substantially more funding for plan confirmation. Moreover, there is uncertainty as to the timing of the payment of the administrative expense (promptly after the petition, at confirmation, etc.?) This administrative expense status may also eliminate claims for preferential transfers to pay for goods delivered within the 20 day period². The administrative priority in § 503(b)(9) does not require an insolvency. However, if the aggregate amount of the vendor claims is substantial, it could lead to an administrative insolvency and a potential for a Chapter 7 liquidation.

Prior to the BAPCPA amendments, §546(c) permitted the court to deny reclamation and substitute a §503(b) administrative expense in its place. With that option being deleted in the amendment, there appears to be no alternative to the demand that available goods be returned.

If the seller agrees, then goods can still be returned post petition for credit against the pre-petition debt. Such a determination must be made no later than 120 days after the order

² Note, however, that critical vendors may still be subject to preference claims; In Re Fultonville Metal Product Co., 330 B.R. 305 (Bankr. M.D. FL. 2005); In Re Hayes Lemmerz International, Inc., et al. 313 BR 189 (Bankr. D. Del. 2004). Also, § 503 (b)(9) is limited to vendors of goods and does not embrace service providers. Unfortunately, no reference is made in § 503(b)(9) to goods already paid for or reclaimed.

for relief in Chapter 11, and the return is considered in the best interests of the estate and the debtor. Here again, the amendment makes it clear that a return of goods is, nevertheless, subject to the prior rights of a holder of a security interest in such goods or the proceeds thereof (§546(h)). It should be noted that the amendment does not establish criteria for determining value of goods being returned for credit as, for example, seasonal goods.

3. Venue for Preference Actions – 28 USC §1409(b) has been amended to provide that a Trustee’s proceeding to recover a debt (excluding consumer debt) against a non-insider of less than \$10,000 can only be brought in the district court for the district in which the defendant resides. The provision regarding consumer debts of \$5,000 has been increased to \$15,000.

Code §101(12) defines “debt” as a “liability on a claim.” This is a question of whether “debt” includes avoidance actions. Our Committee presently assumes that a proceeding to recover multiple preferential transfers can be aggregated to exceed the threshold amount and will be so construed by the courts. There is also a question whether a reduction in a claim because of a supportable defense which reduces the aggregate below \$10,000 would then require a transfer of the case to the defendant’s district. For example, if partial summary judgment were entered to the point where the disputed amount remaining is less than \$10,000, this may trigger the right of the defendant to then request a transfer to his or her district for final resolution of the open items. For

clarification purposes, here again the word “debt” could be pluralized, the section expanded to add the words “in the aggregate” after \$10,000, and to clarify that it applies to avoidance actions.

4. Non-Profit Supported Transfers – A new subsection (h) has been added to §547 which provides that a transfer cannot be avoided if it is made part of an alternative repayment schedule created by an approved non profit budget and credit counseling agency. This amendment uses the word “transfer” generally and does not refer just to transfers under §547(b). This raised the question of whether new §547(h) goes beyond the preference section.
5. Ordinary Course Payments – The BAPCPA amends the ordinary course defense provision contained in §547(c) to reduce the number of elements needed to establish the defense. Before the amendment, the transferee was required to establish both ordinary course of both the debtor and the transferee and made in accordance with ordinary business terms. The “and” has been changed to “or” and one element will now suffice. This may be the most significant change made in §547.
6. Support Payments – Section 101 now contains a broad provision concerning a “domestic support obligation.” Section 547(c)(7) prevents avoidance of a transfer to the extent it was a “bona fide payment of a debt for a domestic support obligation.”
7. Insider Transfers – Section 547(i) has been added by the BAPCPA concerning transfers made between 90 days and 1 year prior to the petition. Under this amendment, if the

debtor makes a transfer to a non insider for the benefit of an insider during this period, it can only be avoided with respect to the insider creditor and not the non insider transferee. This should overcome the uncertainty about transfers that were not payments and should be read together with §550 (c).

8. Statutory Liens – Section 546(i)(1) protects a Warehouseman’s lien from a trustee’s attack. This insulation is to be applied in a manner consistent with state statutes (§7-209 of the UCC).

Section 545(2) permits avoidance of statutory liens that cannot stand up to an actual or hypothetical bona fide purchaser at the time the case is commenced. This section has been amended to preclude avoidance in any case where a purchaser fits the definition described in §6323 of the Internal Revenue Code or in any similar provision of state or local law (See IRC §6323 (h)(6)). The Conference previously rejected this proposed amendment.

9. Miscellaneous Changes

- a. Perfection of a security interest for an enabling loan is extended from 20 days to 30 days (§547(c)(3)). State law priority rights may contain a shorter period. Perfection of other security interests to be a contemporaneous transaction will now allow for 30 days instead of ten (10) days (§547(e)(2)(A)).

The result will be, in the preference context, that it will be less relevant for deferred perfection whether the security interest secures an enabling loan or secures another obligation. Even though the 30-day period for an enabling loan security interest runs from the date on which the debtor acquired the property and the 30-day period for another security interest runs from the date of the security interest becomes effective between the parties (i.e., attaches), the 30-day period in either case will in most instances likely be approximately the same. However, it will still be important for a secured creditor to perfect a purchase-money security interest by filing a financing statement against the debtor within 20 days after the debtor receives delivery of the collateral in order for the secured creditor to be protected under UCC § 9-317(e) against an intervening lien creditor.

Also, in an ordinary loan transaction prompt filing is still necessary to protect against intervening liens and against the risk of a bankruptcy of the debtor occurring during the 30-day period and the trustee in bankruptcy asserting its “strong arm” rights under § 544(a).

- b. The general lookback period for fraudulent transfers under the Code is extended to 2 years (§548(a)(1)). Transfers by a partnership to a general partner (§548(b)) are, likewise, affected. These amendments will not take effect until April 21, 2006. State law lookback periods are unaffected.

- c. Insider employment contracts have specific coverage for fraudulent transfers even where the debtor is solvent (§548(a)(1)(B)(i)(IV)).
- d. Section 548(e)(1) is added to permit the trustee to avoid transfers by a debtor to a self-settled trust or similar device created within 10 years before the petition. The debtor must be a beneficiary, and actual intent must be established. Transfers in anticipation of judgments, etc. for violation of securities laws and related claims will trigger avoidance. Future creditors are included in the class protected.
- e. The provisions dealing with avoidance of post petition transfers of real property under §549(c) have been amended. Under §549(c) prior to the amendment, a transfer of real estate for present fair equivalent value to a good faith purchaser, acting without knowledge of the filing and without the filing or notice thereof being of record in the applicable real estate registry, could not be avoided as a postpetition transfer. However, the types of good faith purchasers protected by §549(c) may not have embraced purchasers of partial or other interests in the real estate. By the amendment providing that the transfer may be "of an interest" in the real estate, a protected good faith purchaser can now include a tenant acquiring a leasehold interest in real estate, a buyer of an easement in or right of way over real estate and (especially given the amendment to the term "transfer" in §101(54) to include "the creation of a lien") even a lender acquiring a mortgage

or deed of trust over the real estate to secure a loan. See definition of "purchaser" in §101(43).

While it would seem unlikely that an institutional lender would, as a practical matter, ever acquire a real estate mortgage or deed of trust postpetition without knowledge of the filing, such an occurrence may be possible in a casual loan transaction by an unsophisticated non-institutional lender. If the lender meets the lack of knowledge and other requirements of amended §549(c), the lender would appear to be protected from the mortgage or deed of trust being avoided as a postpetition transfer.

If §549 (c) requirements are met, the transfer will not violate the automatic stay (see amendment §362(b)(24)).

- f. Consistent with the other protections given to master netting agreements and other financial contracts by Section 561 (and other sections), Section 547(j) makes it clear that prepetition transfers made by or to a "master netting participant" under or in connection with a "master netting agreement" cannot be avoided unless they constitute intentional fraudulent transfers under Section 548(a)(1)(A)."

Observations and Recommendations

We have recommended that technical amendments be made to reflect that §507(c) was meant to be §507(b). In addition, we have recommended that the word "transfer" should be amended to aggregate transfers to leave no doubt that alleged preferential transfers can be

aggregated to meet the threshold of \$5,000. If §547(c)(9) is so amended, then a similar change should be made to §547(c)(8).

We also recommend that 28 USC §1409(b) be further amended to clarify that it is intended to apply to avoidance actions.

Our Committee is concerned that the reclamation provisions now contained in §546(c) create a highway of legal potholes. The considerable uncertainty will lead to costly and time consuming litigation made necessary to bring some sense of order to the reclamation process. Below is a description of UCC §2-702 for comparison to §546 (c) of the Code.

We recommend a rewrite of §546 (c). In that regard, we recommend that §546 (c) be amended to more closely follow the state law reclamation right in UCC §2-702 at least in two respects: first, to clarify that a seller has a reclamation right in goods only to the extent of the unpaid purchase price of the goods; and, second, to protect from reclamation claims a buyer in ordinary course and other good faith purchaser of the goods from the debtor, not merely a secured creditor.

New York UCC Reclamation Provision

§ 2-702. Seller's Remedies on Discovery of Buyer's Insolvency

(1) Where the seller discovers the buyer to be insolvent he may refuse delivery except for cash including payment for all goods theretofore delivered under the contract, and stop delivery under this Article (Section 2-705).

(2) Where the seller discovers that the buyer has received goods on credit while insolvent he may reclaim the goods upon demand made within ten days after the receipt, but if misrepresentation of solvency has been made to the particular seller in writing within three months before delivery the ten day limitation does not apply. Except as provided in this

subsection the seller may not base a right to reclaim goods on the buyer's fraudulent or innocent misrepresentation of solvency or of intent to pay.

(3) The seller's right to reclaim under subsection (2) is subject to the rights of a buyer in ordinary course or other good faith purchaser under this Article (Section 2-403). Successful reclamation of goods excludes all other remedies with respect to them.

Proposed Changes to UCC Reclamation Provisions

Uniform Commercial Code §2-702 – Seller's Remedies on Discovery of Buyer's Insolvency

(1) If the seller discovers that the buyer is insolvent, the seller may refuse delivery except for cash including payment for all goods theretofore delivered under the contract, and stop delivery under Section 2-705.

(2) If the seller discovers that the buyer has received goods on credit while insolvent, the seller may reclaim the goods upon demand made within a reasonable time after the buyer's receipt of the goods. Except as provided in this subsection, the seller may not base a right to reclaim goods on the buyer's fraudulent or innocent misrepresentation of solvency or of intent to pay.

(3) The seller's right to reclaim under subsection (2) is subject to the rights of a buyer in ordinary course of business or other good-faith purchaser for value under Section 2-403. Successful reclamation of goods excludes all other remedies with respect to them.

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