

CREDITORS' RIGHTS UPDATE

Recent Developments in Creditors' Rights & Bankruptcy from the SandersBaker Financial Institutions Practice Group*

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TRADE CREDITORS AND BUSINESS LENDERS COULD BENEFIT FROM BANKRUPTCY REFORM

The following is the first in a series of commentaries about the Bankruptcy Reform Act, most of which takes effect October 17, 2005. This edition focuses on changes affecting preferential transfers and protections for sellers of goods shortly before a commercial or business based bankruptcy.

PREFERENTIAL TRANSFERS

Ordinary Course of Business Defense Strengthened

Current Law: A bankruptcy trustee (or debtor in possession) may recover certain "preferential transfers" (payments, etc.) made within 90 days before bankruptcy. A creditor could establish the ordinary course of business defense if (1) the original debt was incurred in the ordinary course of business of both parties, (2) the payment was made in the ordinary course of business of both parties, *and* (3) the payment was made according to ordinary business terms. The transferee/creditor bears the burden of proof, which had arguably become much more difficult than Congress intended.

New Law: The Defendant need only prove the first element (debt incurred in the ordinary course of business) and that the transfer/payment was made either: in the ordinary course *or* according to ordinary business terms. This should broaden the protection afforded ordinary payments in the days before bankruptcy, exposing fewer trade creditors to preference claims.

Amendments Affecting Insider - Guaranteed Debt

Current Law: Regarding payments to or for the benefit of an *insider*, the look-back period is one year. What became known as the *DePrizio* Rule developed, under which payments to third party creditors up to a year before bankruptcy could be avoided if the payment or transfer was made on debt guaranteed by an insider. Congress tried to fix this unintended consequence in 1994; however, some ambiguity remained regarding non-payment transfers such as the taking of a lien.

New Law: A transfer (whether in the form of a payment, perfection of a security interest, or otherwise) made to a non-insider is avoidable only with respect to the insider who benefited from the transfer. In other words, third party lenders should not be exposed for any transfers outside of the original 90 day preference period. This clarification takes effect immediately.

Threshold and Venue Changes for Small Preference Cases

Current Law: The venue (location) of a preference action is in the same court as the bankruptcy. Thus, preference defendants throughout the United States have to retain local counsel to defend themselves, often in distant locations.

New Law: Preference actions against non-insiders for less than \$10,000.00 must be brought in the defendant's home district. Additionally, most transfers that total less than \$5,000.00 will not be avoidable.

Safe Harbor Lien Perfection Period Extended

New Law: In the context of preferential transfers, the grace period for perfecting liens has been extended from 10 to 30 days without being subject to a preference attack as a "transfer" of the debtor's property.

SELLERS OF GOODS—RECLAMATION

New Law: Sellers of goods now have more than twice as long to make a reclamation demand to reclaim possession of goods sold to the debtor on credit right before bankruptcy. The demand must be made within 45 days after the debtor's receipt of goods or within 20 days after the bankruptcy is filed if the 45 day period expires after the bankruptcy filing.

Sellers of goods may also have an administrative claim for goods sold to the debtor on credit in the ordinary course of business within 20 days before the case is filed, regardless of whether a reclamation demand is made.

OUR CONCLUSION

First, what had become in some cases an abusive practice by trustees should be curtailed. Those who provide credit in the ordinary course of business or under ordinary business terms should be more protected. This should put some check on the mass filing of preference actions and provide better defenses to those "ordinary course" lenders and trade creditors who still find themselves as preference defendants.

Second, lenders to small businesses whose loans are guaranteed by insiders should be a bit more protected against preference claims for transfers outside 90 days pre-bankruptcy.

Finally, sellers of goods may have more protection, provided they know what relatively simple actions need to be taken and when.

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This newsletter is for general information only, and it is not intended as legal advice, nor is it intended as a statement of a specific position in any pending litigation, bankruptcy, or transactional matter. We urge our readers to consult with their own legal counsel regarding the issues discussed above.

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