

# hearsay!

The Law Offices of Hemar, Rouso & Heald, LLP

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## Sidebar

# New Bankruptcy Laws Swing Pendulum In Favor Of Creditors

**O**n April 20, 2005, President Bush signed the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005<sup>1</sup>. The Act, which is being hailed by the business community due to its pro-creditor tilt, should provide creditors with greater protection in the event of a default by a borrower/customer and/or personal guarantor.

For the year ended June 30, 2004, there were approximately 1.6 million bankruptcy filings resulting in the total or partial discharge of debt. Under the new Act, between 30,000 and 210,000 people, which account for 4 percent to 20 percent of those who discharge their debts in bankruptcy each year, will now be unable to do so<sup>2</sup>. The Act not only presents hurdles for a debtor before a bankruptcy petition can be filed, but once those hurdles have been cleared and the debtor is in bankruptcy, the debtor will now face a less debtor-friendly system. This article will highlight some of the major changes.

The intent of modern bankruptcy law is to give debtors a "fresh start," "a new opportunity in life, unhampered by the pressure and discouragement of pre-existing debt." Anybody familiar with portfolio management, whether as a businessperson or creditors' rights attorney, soon learns that in practical application, the bankruptcy system provided debtors a mechanism to evade full, and at times, any payment of legal debt, to the detriment of their honest creditors. More unscrupulous debtors used bankruptcy as a quasi-financial-planning tool. Overall, bankruptcy courts were less concerned with the impact upon the creditor than the debtor, and treated debtors with empathy. Many debtors aggressively sought to exploit loopholes

<sup>1</sup>Portions of which became effective immediately, and portions of which will become effective in 180 days.

<sup>2</sup>American Bankruptcy Institute.

in the bankruptcy code and abuses of the system were problematic. In 1997, the National Bankruptcy Review Commission submitted suggested changes to Congress designed to solve these problems. Over the next eight years, various business and political lobbies fought hard, resulting in this new legislation.

Against this background, President Bush signed the Act this past April, reversing the existing attitude of the bankruptcy system favoring debtors over creditors. As an example of this attitude, we were involved in one egregious case of bankruptcy abuse where a Chapter 7 debtor sought a complete discharge, despite annual household earnings of close to 7 figures, even though our formal discovery uncovered undeniable documentary evidence of unsecured assets and false backdated loan documents. This evidence and more was presented to the court in support of our client's Motion To Dismiss Bankruptcy, Or Alternatively to Convert to Chapter 11 (thereby requiring payments). Although we ultimately did prevail, the bankruptcy judge's initial inclination was not to summarily grant the motion; but rather to protect this debtor, commenting in open court, "Counsel, bankruptcy is not the place to point fingers, but to look forward".

The overall tenor of the overdue Act is confrontational, with debtors being held far more accountable for their plight, and designed to prevent debtors from being opportunists who use the bankruptcy system for financial benefit. While it remains to be seen what effect these changes will have on bankruptcy judges and courts, and consequently on debtors, the Act swings the pendulum in favor of creditors.



The latest buzz in the creditors' rights community surrounds the recent enactment of significant bankruptcy reform through the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. As its title indicates, the Act provides a shift in philosophy toward prevention of abuses of the bankruptcy system. In this issue of HearSay, we bring you a synopsis of the changes included in the Act and some insight as to their anticipated effect on the debtor—creditor relationship. We hope you find this article, and all of this issue, informative and enjoyable.

— Martin J. Rouso

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## New Bankruptcy Laws

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The Act is designed to impact existing debtors, as evidenced by the fact that certain provisions become effective immediately, with the remainder effective in only 180 days. Perhaps overlooked has been the prospective business impact on those who will be seeking credit. Many of these transactions rely on the financial strength of the personal guarantors. The new attitude towards debtors in bankruptcy court may be considered by a borrower/customer and guarantor in the decision to move forward with the creation of a start-up company, or in an existing company's decision to expand. The refuge previously provided by the bankruptcy court should no longer be so readily attainable. Of course, this impact may be negligible given the entrepreneurial spirit which drives business creation and expansion.

Highlights of some of the changes are as follows:

### NEW PRE-FILING REQUIREMENTS

**Restricted Eligibility For Previously Discharged Debtors:** A Chapter 7 debtor may not receive a discharge if the debtor had previously received a discharge within the past 8 years. This extends the prior law of 6 years, in response to creditors' concerns that certain debtors were filing too frequently, essentially running up debt as they approached their pre-planned filing date.

**Mandatory Credit Counseling:** The Act provides that an individual may not file for Chapter 7 unless an approved nonprofit credit counseling agency assists the debtor in performing a budget analysis, no more than 180 days prior to filing, and advises the debtor on opportunities for available credit counseling. The debtor is also required to complete a personal financial management course before the debtor will be eligible for discharge.

**Attorney Representations:** The Act provides that the signature of the debtor's attorney on the bankruptcy petition certifies that:

(1) the attorney reasonably investigated the circumstances that gave rise to the petition; (2) the petition is grounded in fact and warranted by law; (3) after inquiry, the attorney has no knowledge that the information in the debtor's schedules is incorrect. A false certification may result in the debtor's attorney being liable for the creditors' legal fees and costs, in addition to sanctions. We are very pleased that the Act places a higher standard upon debtors' counsel. On numerous occasions, acting as creditors' counsel, or in conjunction with the trustee, we have discovered unscheduled assets and other material inaccuracies and omissions, only to have the debtor profess ignorance and submit amended schedules. The abuse was so rampant, that in one instance our discovery led to the debtor's imprisonment. In another instance, the Bankruptcy Judge thereafter issued a letter to the public chastising the practice<sup>3</sup>.

### CASE ADMINISTRATION

**Abusive Filings:** The Act provides that any party in interest can move to have the bankruptcy dismissed as "abusive". This changes prior law which only permitted the bankruptcy trustee to bring the motion, and only upon a showing of "substantial abuse". As a practical matter, many trustees were often reluctant to bring that motion, particularly given the high standard which needed to be satisfied. This change in the law will allow any creditor to challenge a bankruptcy, and it will be successful upon satisfying a lesser burden of proof.

**Automatic Stay In Repeat Filings:** The provision of the Bankruptcy Code governing the imposition of the automatic stay and a creditor's right to obtain relief from the automatic stay has been supplemented to discourage bad faith filings and serial filers. As contrasted with previous law, whereby a secured creditor was required to file a motion for relief from the automatic stay to repossess its collateral, under the Act, if a debtor files for bankruptcy, and was previously a debtor within the preceding one-

year period in which that bankruptcy was dismissed, the automatic stay shall terminate with respect to any action taken with respect to a debt or property securing such debt on the 30th day following the filing of the later case unless the debtor brings a motion for continuation of the automatic stay. That will be a contested motion at which the debtor will bear the burden of proving that the later case is filed in good faith as to the particular creditor sought to be stayed. Further, the second filing is subject to a presumption that it is not in good faith, and the debtor can overcome this presumption only upon a showing of clear and convincing evidence. This restriction makes it difficult for a debtor to reap the benefits of the automatic stay in a second filing, even if the creditor did not obtain a 180-day bar against refiling at the conclusion of the initial bankruptcy proceeding. Also, the Act provides that if two or more cases had been pending within one year, then a subsequent third filing does not create an automatic stay. The debtor will be required to demonstrate that the current filing is in good faith as to the creditors to be stayed. These changes are designed to block gamesmanship used by debtors in repeat filings. Secured creditors should be able to take advantage of this change to more easily recover their collateral.

**Means Test:** A key component of the Act, the means test, applies if the debtor's income is above the state's median income. Any creditor, as well as the bankruptcy trustee, can challenge a debtor's eligibility to file Chapter 7 if the debtor's current monthly income, excluding allowed deductions and payment of secured debt, is large enough that the debtor could pay approximately \$100 to \$160 per month to creditors over five years. The means test is designed to convert numerous Chapter 7 filings into Chapter 13 filings<sup>4</sup>.

**Homestead Exemption:** This change became effective April 20, 2005. The Act disallows the debtor's homestead exemption if the house was acquired within 3.3 years of filing

<sup>3</sup>Public letter located at: <http://www.canb.uscourts.gov/canb/Documents.nsf/e62b67d492050cae88256e150062d610/10cd8b2b0774064f88256e1a006f75eb?OpenDocument>

<sup>4</sup>The Administrative Office of the U.S. Trustee will provide tables based on U.S. Census data that show median income for each state for households with up to 4 family members. The 4 person median income ranges between \$47,550 (WV) and \$82,406 (NJ), with \$62,732 being the national median. For households with more than 4 members the Act provides for an additional \$525 per month per individual.

## New Bankruptcy Laws

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the petition. In purchases where the debtor rolls the equity from a previous homestead into a new homestead, the debtor retains the existing exemption, but the debtor cannot increase equity in the homestead by more than \$125,000 in the 3.3-year period. This is designed to prevent debtors from successfully concealing their equity in real property in states with very favorable homestead exemptions, minimizing the attractiveness of debtor havens such as Florida and Texas.

**Insider Compensation/Bonuses:** This change is effective immediately. Executive compensation has been drawing attention, and the Act continues the trend. If a company files bankruptcy, an insider may have to give back some or all compensation received under an employment contract during the two years before the bankruptcy if 1) the contract was not in the ordinary course of the employer's business and 2) the employer did not receive reasonably equivalent value. Additionally, Chapter 11 debtors are restricted in paying retention bonuses to employees during the bankruptcy.

**Avoidable Preferences:** The Act creates a new preference exception for aggregate transfers totaling less than \$5,000. Even the most savvy creditor has likely faced the experience of a preference lawsuit whereby the trustee seeks recovery of payments received during the 90 days before a debtor's bankruptcy. The Act has strengthened the creditors' ability to keep ordinary course of business payments.

**Expanded Statute of Limitations for Fraudulent Transfers:** The Act increases from one year to two years the period of time in which the bankruptcy trustee or the debtor may set aside fraudulent transfers.

**Trade Creditors and Administrative Expenses:** Under the Act, if a debtor buys goods on credit in the ordinary course of business within 20 days of the bankruptcy, the seller will have an administrative expense priority for the value of the goods. Administrative expenses are paid before general unsecured claims, and must be paid in full in cash upon confirmation of a Chapter 11 plan.

**Creditors Committees:** The Act permits the U.S. Trustee to adjust the number and makeup of committee members to ensure adequate representation of creditors. Whereas Creditors Committees are normally made up of creditors with the largest claims, creditors that are deemed small businesses may be added if their claims are disproportionately large in comparison to their annual gross revenue. Additionally, Creditors Committees now have an affirmative duty to be more responsive to creditors. The Committee must now "provide access to information" for, and solicit and receive comments from, creditors.

**Exclusive Period to File Plan:** The Act provides that the debtor's exclusive period to file a plan may not be extended beyond 18 months, as contrasted with prior law, for which there was no absolute limit on the court's power to extend the exclusive period. This greatly empowers creditors to take action where a debtor is seemingly languishing in bankruptcy.

**Small Business Bankruptcy (Chapter 11):** The Act defines a small business for Chapter 11 purposes as one with debts under \$2,000,000, excluding debts owed to one or more affiliates or insiders. Only the debtor may file a plan within 180 days after the date of the order for relief, unless the Bankruptcy Court orders otherwise. A plan and disclosure statement must be filed with the Bankruptcy Court not later than 300 days after the date of filing the bankruptcy petition, and the plan must be confirmed by the Bankruptcy Court not later than 45 days after the plan is filed, unless the Bankruptcy Court extends the deadline. If the debtor does not have a confirmable plan before the passage of such deadlines, the case can be converted or dismissed.

**Conditional Mandatory Appointment of Chapter 11 Trustee:** The Act requires the U.S. Trustee to move for the appointment of a Chapter 11 trustee if there are reasonable grounds to suspect that current members of the governing body of the debtor committed actual fraud, dishonesty or criminal conduct.

**Elimination of Chapter 13 Super-discharge:** Previously, a Chapter 13 debtor was able to discharge numerous debts not

dischargeable in Chapter 7. The Act minimizes these differences. A Chapter 13 debtor will now be prohibited from discharging claims arising from the use of false financial statements to obtain credit, and from claims arising from fraud by a fiduciary, embezzlement, or larceny.

This is just an overview of some of the changes. The Act effectively reduces the number of bankruptcy candidates. Significantly, it also will hold debtors' counsel accountable. The Act requires debtors' counsel to investigate his or her clients' financial situation and to honestly and properly present it to the court. Judge Jaroslovsky's (United States Bankruptcy Judge for California, Northern District) message contained in his open letter to debtors' counsel, to wit: "I strongly recommend that any of you harboring a cavalier attitude toward the [bankruptcy] schedules replace it with a good healthy dose of paranoia,"<sup>5</sup> is now embodied in the United States Bankruptcy Code.

As is apparent from even a cursory review of the changes, the Act is intended to have a significant impact. Core components of bankruptcy such as the ability to obtain a discharge and the benefits of the automatic stay have been modified in favor of creditors, as well as secondary concepts such as issues of dischargeability of debt where credit is obtained through the use of false financial statements, are being scrutinized and tightened. While the specific terms of the Bankruptcy Code have been changed, equally important is the overall change in the spirit of the Code. The lawmakers intended to send a clear message to the business community and the bankruptcy courts by cementing a change of philosophy into the Bankruptcy Code's treatment towards those who reap the advance rewards of obtaining credit and then use the bankruptcy system to avoid the costs.

We are optimistic the bankruptcy courts and judges will appreciate the message and will breathe life into this philosophy as these new laws meet real life application.

— Irwin M. Wittlin

<sup>5</sup>See footnote 4.

# HRH

# Happenings

## NEW TO THE FIRM

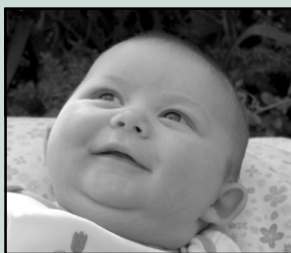
We welcome associate Lee Mendelson, who brings a touch of Southern hospitality to HRH. Retaining a trace of his native Tennessee accent, Lee now finds himself in sunny California where he and his wife of nine months can be nearer her family. A graduate of Northwestern Law School in Chicago, Lee is licensed to practice in Tennessee, Georgia and Mississippi, as well as California. In his time away from the office, Lee enjoys training for and running in marathons. At this time, he is working toward running in next year's Los Angeles marathon, having already run in the marathons of New York, Chicago and Memphis.



## OTHER NEW ARRIVALS:

An HRH welcome also goes out to new legal assistants Sherry Bernal and Teresa Pulido, and collector Debbie Sierra, all of whom joined the firm within the past several months.

HRH congratulations go out to associate Pamela Cox and her husband, Thomas, who welcomed their first-born, Danielle Charlotte Cox, on February 25, 2005. This fair-haired beauty entered the world at 6 lbs. 13 ozs. and 19 inches. Pam reports that all are doing well, although both she and Thomas are acquiring a far better understanding of the term "sleep deprivation."



We also congratulate legal assistant Edgar Pacheco, his wife Lisa, and big brother Damien, on the birth of adorable little sister, Jocelyn Adriana Pacheco, on March 6, 2005. Jocelyn came into the world at 9 lbs. 1 oz. (2 lbs. of which were hair, according to Edgar) and 21 inches. Mother and father are going great. Damien is adjusting.



# Spring & Summer 2005

## RECENT TRAVELS

Partners Martin Rouso, Daniel Heald, and Stephen Jenkins attended the ELA convention in Miami, Florida from May 15-17, 2005, where Steve spoke on the timely topic of E-Waste legislation.

Partners Daniel Heald and Susan Breen participated in the California Bankers Association 38th Annual Bank Counsel seminar held April 7-8, 2005 in Newport Beach, California.

Partner Daniel Heald and Associate Irwin Wittlin (pictured) attended the UAEL convention. Irwin, author of this issue's bankruptcy article, is the UAEL Legal Committee Vice-Chairman. Irwin assisted in organizing and planning the convention, which was held the weekend of April 21, 2005 in Scottsdale, AZ. At the convention, Irwin led a group panel presentation entitled, "When a Salesman Leaves" dealing with employment and unfair competition issues.



The Law Offices of Hemar, Rouso & Heald, LLP 15910 Ventura Blvd., 12th Floor, Encino, CA 91436, 818/501-3800, FAX 818/501-2985. The firm specializes in the fields of commercial and consumer litigation, collections, bankruptcy and general corporate matters. Individual lecturers on the topics contained herein, as well as others on request.

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