Primary Benefit Appears to Be for Creditors

How Bankruptcy Changes Could Affect Lessors

By Marc L. Hamroff and Leslie A. Berkoff

OFTEN CALLED the Bankruptcy Reform Act of 1998, significant legislation affecting all players in the credit markets is close to passage. On Oct. 7, a Joint Conference Committee of the House and Senate passed a compromise bill known as House Report 105-794. Since much of this bill is significantly different from the provisions of the Senate bill, S. 1301, which already represented a compromise with the president, it's possible that this joint bill may not be approved by the president. However, even before the bill is presented to the president, it must first be approved by both the Senate and House.

Assuming the legislation is approved, it will change the way Chapter 7 bankruptcies are used. Moreover, for once, the primary beneficiary of this legislation is intended to be the creditor. This article will focus solely on the changes affecting the leasing and lending community. Should the legislation become effective, a more specific analysis will follow in subsequent issue(s).

The most drastic change proposed under the new law will be the imposition of a "means test" on those debtors filing for Chapter 7. Prior to this legislation, there was little or no control over who could file for Chapter 7. This meant that an individual with substantial future earnings but little or no current assets could avoid debt repayment and still be able to discharge his obligations. The *only* restriction on filing for Chapter 7 was that it could not be used as a vehicle to avoid large amounts of consumer-related credit card debt. This restriction, known as "substantial abuse," was undermined by the fact that a creditor could not bring on a motion to dismiss a case on these grounds; rather, only the U.S. trustee or the court, sua sponte, could bring such a motion. See 11 U.S.C. §707(b).[1] Thus, in the face of trustee or court inaction, the creditors were powerless.

Under the new legislation, however, a debtor who can afford to pay 25 percent of his or her creditors through a Chapter 13 plan will essentially be precluded from filing a Chapter 7.[2] More specifically, under the Senate bill, if a debtor files for Chapter 7 and has the means to fund a Chapter 13 plan, the creditors can file a motion to convert the case to one under Chapter 13. It should be noted that, in order to convert the case to one under Chapter 13, the debtor will need to consent to the conversion, so as not to run afoul of the 13th Amendment. However, in the absence of consent, if the standard is met by the creditors, the case will simply be dismissed. Moreover, the attorney who prepares the initial Chapter 7 petition under these circumstances may find him- or herslef subject to sanctions by the court.[3]

Thus, the new law will empower creditors by allowing them to have much more control as to which debtors can avoid obligations in

Continued on Page 4

Court Nullifies Ability to Assess Late Fees & Enhanced Default Rates

fee failed to meet the "reasonableness test" that is a requirement when assessing whether a liquidated damage clause is enforceable. In *Met Life*, there was no showing on a quantified basis of costs, so that the fee amounts assessed were determined to be "pure speculation" and, additionally, at least some of the damages could have been ascertained.

As it pertains to the enhanced default interest rate, the court applied a similar two-pronged test and found that Met Life never was able to prove any specific costs as a result of the borrower's default, but simply offered general statements that included arguments pertaining to standards in the industry, and the loss of use of the money which they initially loaned.

The ruling will call into question the enforcement of late-fee provisions contained in millions of mortgages, leases and various other lending instruments that have been originated by mortgage brokers, bankers, lessors and car manufacturers that are serviced by firms nationwide and pooled and sold across the country. For this reason, the Mortgage Bankers' Association of America, the New Jersey League of Community and Savings Bankers, the New Jersey Bankers' Association and most of the well-known, large life insurance companies have all filed applications with the Supreme Court requesting permission to appear as amicus. In the interim, lenders should consider carefully documenting expenses in default situations.

Other states often look to New Jersey courts for guidance. It is conceivable that the floodgates to litigation will open should either the Supreme Court deny certification or choose to affirm the Appellate Division's decision. At the present time, Met Life Capital's petition for certification before the New Jersey Supreme Court is pending. ■

How Bankruptcy Changes Could Affect Lessors

bankruptcy. These provisions should prove particularly effective in the commercial lending arena with regard to guarantors or borrowers who seek to discharge loan or lease debt from a failed business. Should the guarantor find other gainful employment or set up another business, creditors can insist (subject to the 25 percent threshold test) to a contribution of those earnings to repay the lessee or borrower's debt.

In forcing more debtors to use a Chapter 13, there are some tradeoffs. For example, in Chapter 13, a creditor cannot seek to block a debtor's entire discharge, but only the discharge of a specific debt (or debts). There are also some monetary restrictions (i.e., debt limits) on who can file a Chapter 13. Presumably those who exceed these limits will either have their cases dismissed or will be forced to file a Chapter 11 (a more expensive process that may affect creditors indirectly in terms of the amount of distribution available after fees and costs of estate administration are paid).

Adequate Protection

One of the other major changes parallels one of the more significant changes made to Chapter 11 under the 1994 amendments. Under the new law, in a Chapter 13 case, a debtor will now be required, commencing 30 days after the filing of a petition, to make monthly cash payments in the nature of adequate protection to lessors of personal property and/or any creditor holding a claim secured by personal property to the extent that the claim is attributable to the purchase of that property. The payments are intended as a measure to bridge the gap between the filing date and the time within which payments to that creditor under the Chapter 13 plan commence.[4] The determination of the amount of these payments is correlated to the contract amount. This measure is procedurally similar to § 365 (d)(10), which requires payment of the monthly lease obligations to personal property lessors, commencing 60 days after filing a Chapter 11. Additionally, debtors will now have an affirmative obligation to provide evidence of insurance coverage of the personal property to creditor(s) and lessor(s), within 60 days of the date of filing.

Marc L. Hamroff *is a partner, and* **Leslie A. Berkoff** *an associate, with the Garden City, N.Y., law firm of Moritt, Hock & Hamroff, LLP. Ms. Berkoff is a former law clerk to the Honorable Jerome Feller, U.S. Bankruptcy Court, E.D.N.Y., and a member of the 1998 task force to revise the bankruptcy rules in the Eastern District of New York.*

Homestead

Another boon to creditors is an attempt to restrict a debtor's unfettered right to avail itself of certain state unlimited homestead exemptions. Some states (i.e., Florida and Texas) that presently have no cap on the homestead exemptions simply allow debtors to purchase large expensive homesteads and exempt the entire home. Now a debtor must reside in that state for two years before being able to file for bankruptcy and claim this homestead exemption.

Reaffirmation Agreements

Provisions have also been included to address the widespread abuses associated with reaffirmation agreements. Under the proposed legislation, reaffirmation agreements must now contain a clear and conspicuous statement that advises a debtor which portion of the reaffirmed debt is attributable to principal, interest, late fees and/or attorney fees. Moreover, with respect to the reaffirmation of unsecured debts, or debts secured by property worth less than $250 at the time of purchase, the court will now have the right to determine whether the reaffirmation agreement is in the debtor's best interest, imposes an undue hardship, was entered into as a result of coercion on the part of the creditor or is unfair because the debt exceeds the value of the collateral.

Treatment of Secured Claims

The Code will also be amended to provide for "fair treatment of secured creditors." Several basic changes will be made to the Bankruptcy Code, all of which center around a significant modification to the manner in which a secured creditor's claim is fixed in individual Chapter 7 and Chapter 13 cases (and, in some cases, in an individual Chapter 11 case). Primarily, the goal of Congress was to remove claim bifurcation — the act of splitting a secured claim based on the value of the underlying collateral into secured and unsecured portions, each of which presently receive different treatment — in individual bankruptcy cases.

The proposed legislation would provide that as long as the debt was incurred within five years of the bankruptcy filing, and such debt is secured solely by the personal property purchased as a result of the loan, then bifurcation of the claim would not apply and the claim would be considered to be an allowed secured claim in the full amount of the unpaid principal balance, along with any accrued and unpaid interest and charges. In such cases, the value of the collateral becomes irrelevant and a creditor with quickly depreciating collateral will benefit. Otherwise, the claim shall be valued at the value of the collateral (replacement value in Chapter 13 and Chapter 7 cases, and market value in Chapter 11 cases).

Depending on the value of the collateral, it will be either the secured

creditor or the debtor who will bear the brunt of this change. Thus, if the collateral is worth little as compared to the outstanding indebtedness, then the creditor will do very well. However, if the debtor is able to replace the collateral or simply does not need the collateral, the debtor will now be able to surrender the collateral in full satisfaction of the claim. This means that if the collateral is worth significantly less than the amount of the debt, the secured creditor will have lost its right to file an unsecured deficiency claim.

Second, the Code will be changed to provide that, in Chapter 13, a secured creditor will retain its lien in collateral until such time as its claim is paid in full. If bifurcation is not applicable, then the benefits afforded by this change are somewhat moot, since the full amount of the claim must be paid before such lien is released. This change only has meaning if a creditor will have its claim bifurcated and is left with an unsecured deficiency claim, as the creditor will then have the security of knowing that, until all of its claim is paid (both the secured and unsecured portions), the lien would not be released, thereby protecting the creditor in case of a default under the plan.

Additionally, in a Chapter 7, a debtor may no longer retain personal property to which a creditor has an allowed secured claim as a result of a purchase money security interest, unless the debtor, within 45 days of the 341 meeting, enters into a reaffirmation agreement with respect to the debt or redeems the property from the security interest by paying the value of the collateral (presumably the replacement value). Failure by the debtor to act in a timely manner will result in the property automatically being deemed not to be property of the estate. Furthermore, failure to file a timely statement of intention within 30 days of the 341 meeting, expressing the debtor's intention to reaffirm or redeem the collateral, will result in automatic lifting of the automatic stay as to that property.

Preferences

Sec. 547(c)(2) is also being amended to provide that a defense to a preference action may be that the payment was made pursuant to the ordinary course of the business *or* that the payment was made according to ordinary business terms. This change will avoid a creditor having to prove that payment was in the ordinary course of business dealings and that it was made according to business terms in the industry. Moreover, payments less than $5,000 are now protected in cases by debtors who do not primarily have consumer debts.

In re Claremont

The bill also proposes to clarify the language of § 365(b)(2)(1) in order to address recent debate over a debtor's obligation to cure defaults and remain current in its postpetition obligations. The proposed technical amendment preserves congressional intent, as recognized by the U.S. Court of Appeals for the Ninth Circuit in *In re Claremont Acquisition Corp.*, 186 B.R. 977 (C.D. Calif. 1995), by clarifying that debtors are required to cure both monetary and nonmonetary defaults, but are not required to comply with penalty provisions or pay penalty rates as a condition of an assumption of an unexpired lease or executory contract. However, provisions have been made for the debtor to argue that circumstances exist that make it impossible to cure such defaults, thereby allowing courts to relieve it of this obligation.

Assumption/Rejection of Personal Property Leases

Under the proposed bill, in a Chapter 7, if the trustee fails to assume or reject a lease within 60 days of the date of the bankruptcy filing, then the subject property is not only considered no longer to be property of the estate, but the automatic stay is now automatically lifted. This change avoids considerable motion practice on the part of creditors. Moreover, in the case of an individual Chapter 7 debtor, the debtor can now advise the creditor that it wishes to assume the lease in question (presumably if the trustee does not wish to do so). If the creditor is willing to allow the lease to be assumed, then the creditor may condition assumption on the curing of all outstanding defaults under the lease (or simply allow them to be paid over time).

In a Chapter 11 or 13 case, where the debtor is an individual, if the lease is not assumed in a confirmed plan, then the lease is deemed rejected and the stay is now automatically lifted with respect to the subject property. Again, this change avoids a lot of unnecessary motion practice.

Effective Date

Finally, the bill is said to be effective 180 days from the date of enactment, i.e., when the president signs it. No provisions appear to be retroactive. ■

---

(1) The text of Sec. 707(b) at present reads as follows: "[a]fter notice and a hearing, the court on its own motion or on a motion by the U.S. trustee, *but not at the request or suggestion* of any party in interest, may dismiss a case filed by an individual debtor under this chapter [7] whose debts are primarily consumer debts if it finds that the granting of relief would be a *substantial abuse* of the provisions of this chapter." (Emphasis added.)

(2) If the debtor's monthly income, after deduction for approved living expenses (as dictated by guidelines established by the Internal Revenue Service) and secured and priority claims, multiplied by 60 months, is not less than 25 percent of the debtor's nonpriority unsecured claims, or $5,000, whichever is less, then the test is met.

(3) This position may prove subject to a challenge as it impedes an attorney's right to counsel clients.

(4) Thus, should a plan provide for deferred payments to a creditor, these adequate protection payments will continue until the payments to that creditor under the plan begin.