



**Position Paper Submitted to the United States Congress  
by the Commercial Law League of America  
and its Bankruptcy Section**

**Critical Substantive Issues for Meaningful Bankruptcy Reform**

**March 3, 2003**

The Commercial Law League of America (“CLLA”), founded in 1895, is the nation’s oldest organization of attorneys and other experts in credit and finance actively engaged in the field of commercial law, bankruptcy and reorganization. Its membership exceeds 3,900 individuals. The CLLA has long been associated with the representation of creditor interests, while at the same time seeking fair, equitable and efficient administration of bankruptcy cases for all parties in interest.

The Bankruptcy Section of the CLLA is made up of approximately 1,200 bankruptcy lawyers and bankruptcy judges from virtually every state in the United States. Its members include practitioners with both small and large practices, who represent divergent interests in bankruptcy cases. The CLLA has testified on numerous occasions before Congress as experts in the bankruptcy and reorganization fields.

Most of the debate over bankruptcy reform has focused on consumer issues, i.e., means testing, in an attempt to channel more consumer debtors into repayment plans. While the CLLA believes reassessment of this and other consumer issues are an important element of ongoing bankruptcy reform efforts, the complex provisions previously proposed in reforming the Bankruptcy Code (the “Code”) reach far beyond consumer issues. Virtually overlooked in this debate are many other changes that could affect businesses and their ability to successfully reorganize. These changes must be given careful consideration, particularly in view of the increasing pressure on businesses to perform in the current financial climate.

The CLLA has actively participated in the bankruptcy reform process and has commented extensively on various legislative initiatives introduced since the 105<sup>th</sup> Congress. The purpose of this Position Paper is to set forth for consideration the substantive provisions that the CLLA believes are critical for the achievement of effective and meaningful bankruptcy reform. Although a full analysis of these critical issues is attached as Exhibit A, they may be summarized as follows:

- Venue for corporate debtors should be limited to the district in which the corporation has its principal place of business to prevent forum shopping and to ensure active participation by all interested parties, including consumers, workers, and retirees.

- A “fast track” Chapter 11 mechanism for small business debtors is unwise and should not be enacted. Any such provisions that are proposed should take account not only the size of the debtor, but also the practical realities of such cases.
- Should specialized small business reorganization provisions be retained, the duties of a small business debtor specifically set forth should be realistic from the standpoint of the availability of the information to the debtor and the value of such information to parties in interest.
- The serial filer provision, although necessary to curb abuse of the chapter 11 process, requires revision in order to carry out Congressional intent.
- Chapter 12, governing the reorganization of family farmers, must be made permanent.
- Provisions governing the unique circumstances that arise in cross-border insolvencies should be added to the Code.
- Lessors of non-residential real property currently have extensive power over debtor lessees. No further landlord protections should be enacted because lessors are already treated in a fair and balanced manner in the Code.
- Present law governing the assumption and assignment of “personal service contracts” requires revision to enable debtors to successfully reorganize and, at the same time, prevent trustees from compelling performance where it is undesirable or inappropriate.
- An amendment to current law is required to allow trustees to assume executory contracts without curing a breach arising from a non-penalty provision relating to the debtor’s failure to perform non-monetary obligations.
- Additional bankruptcy judgeships must be authorized if the integrity of the bankruptcy system and the quality of its jurists is to be maintained.
- The definition of disinterestedness requires clarification so that professionals with only minor potential conflicts are not precluded from retention on behalf of the bankruptcy estate, provided that full disclosure is made by such professionals to the court.

- Committees of unsecured creditors should be expressly empowered to undertake statutory actions where the debtor in possession unjustifiably fails or refuses to do so.
- The CLLA supports changes to the law concerning avoidance of preferential payments, and believes further improvements are warranted to properly carry out Congressional intent.
- Restrictions on the transfer of assets by nonprofit charitable corporations could have a devastating effect in the health care industry. Ultimately, unsecured creditors and patients will bear the consequence of these unwarranted restrictions.
- A homestead exemption cap must be adopted and be accompanied by language expressly precluding states from opting out. Otherwise, the current abuse by the affluent of shielding assets from creditors and forum shopping will not cease.
- Lien stripping in chapter 13 cases has been severely limited by bankruptcy reform legislation in direct contradiction of the stated purpose for bankruptcy reform, that is, greater repayment to unsecured creditors. Losses to unsecured creditors from passage of this proposal have been estimated to approach \$100 million annually.

In addition to the attached full analysis of these issues, the CLLA has also attached to this Position Paper suggested language to amend various provisions of Code. We hope that this analysis and the accompanying suggested language will enable the United States Congress to achieve effective and meaningful bankruptcy reform for all parties in interest.

Respectfully submitted,

John P. Wanderer  
President  
Commercial Law League of America

Judith Greenstone Miller  
Co-Chair, National Governmental  
Affairs Committee  
Chair, Bankruptcy Section  
Commercial Law League of America

Jay L. Welford  
Co-Chair, National Governmental  
Affairs Committee  
Co-Chair, Legislative Committee

Peter C. Califano  
Co-Chair, Legislative Committee  
Bankruptcy Section  
Commercial Law League of America

Bankruptcy Section  
Commercial Law League of America

**Commercial Law League of America**  
*“Critical Substantive Issues for Meaningful Bankruptcy Reform”*  
Presented March 3, 2003

[www.clla.org](http://www.clla.org)  
ph: 312-781-2000

Page 4

## TABLE OF CONTENTS

|   |           |
|---|-----------|
| Analysis of Critical Substantive Issues for<br>Meaningful Bankruptcy Reform ..... | Exhibit A |
| Sec. _____. Local Filing of Bankruptcy Cases.....                                 | Exhibit 1 |
| Sec. _____. Executory Contracts and Unexpired Leases .....                        | Exhibit 2 |
| Sec. _____. Permitting Assumption of Contracts .....                              | Exhibit 3 |
| Sec. _____. Defaults Based on Nonmonetary Obligations .....                       | Exhibit 4 |
| Sec. _____. Preferences.....  | Exhibit 5 |
| Sec. _____. Transfers Made by Nonprofit Charitable Corporations .....             | Exhibit 6 |
| Sample Small Business Bankruptcy Cases.....                                       | Exhibit 7 |
| Sample Venue Bankruptcy Case.....   | Exhibit 8 |

## **EXHIBIT A**

### **Analysis of Critical Substantive Issues for Meaningful Bankruptcy Reform**

**Submitted to the United States Congress  
by the Commercial Law League of America  
and its Bankruptcy Section**

**March 3, 2003**

The Commercial Law League of America (“CLLA”), founded in 1895, is the nation’s oldest organization of attorneys and other experts in credit and finance actively engaged in the field of commercial law, bankruptcy and reorganization. Its membership exceeds 3,900 individuals. The CLLA has long been associated with the representation of creditor interests, while at the same time seeking fair, equitable and efficient administration of bankruptcy cases for all parties in interest.

The Bankruptcy Section of the CLLA is made up of approximately 1,200 bankruptcy lawyers and bankruptcy judges from virtually every state in the United States. Its members include practitioners with both small and large practices, who represent divergent interests in bankruptcy cases. The CLLA has testified on numerous occasions before Congress as experts in the bankruptcy and reorganization fields.

#### **Forum Shopping**

A principal concern of the CLLA is the need for an amendment requiring that domicile and residence for venue of corporate debtors be conclusively presumed to be the location of the debtor’s principal place of business without regard to the debtor’s state of incorporation. Such a change would benefit creditors and prevent an unacceptable degree of forum shopping by debtors who are in search of a venue that will be friendly to its needs. More important, however, requiring that a corporate bankruptcy take place locally ensures that the distinct needs of the community are not overlooked or, worse, ignored by a group of professionals residing hundreds of miles away.

The consequences of a corporate bankruptcy are often most profound in the community in which the debtor’s principal place of business is located, especially in the relatively smaller cases. Not only are there typically more jobs involved locally, but also the local economy will depend, to a large extent, on business from that debtor. Many critical

issues of local importance arise. The debtor may be, for example, one of the community's larger employers, or it may sustain many small businesses that provide various goods and services. The consequences could extend even further, affecting the number of hospital beds that are available, the quality of elder care, or even waste removal. These are but a few of the countless possible issues and each affected community has a vested interest in the outcome of the debtor's case.

Those affected by a corporate bankruptcy have the right to believe that their interests are being adjudicated fairly and openly in their own communities. Permitting a bankruptcy filing in a distant forum effectively bars many creditors – especially those who are most vulnerable such as consumers, workers, retirees, or small trade creditors – from participating in the bankruptcy process based on nothing more than their inability to afford the travel expenses. It is not enough that the Code provides for the appointment of an unsecured creditors' committee because such committees are not always appointed and, even where there is an active committee, its members will likely be the debtor's largest creditors whose interests differ from or even conflict with those of smaller, less powerful, creditors.

More fundamentally, allowing the practice of forum shopping by debtors undermines the bankruptcy process and creates unwarranted competition among the courts. Before filing, the debtor is able to determine which courts have taken friendly views of the debtor's particular needs and select such a court with the intent of creating a disadvantage for creditors. Indeed, some corporate debtors have even commenced bankruptcy cases for a financially healthy subsidiary solely to acquire the preferred venue.

Much has been said among members of Congress that bankruptcy reform is necessary to prevent what it perceives as abuse of the bankruptcy process. A venue provision that requires corporate bankruptcies to be filed at the principal place of business furthers that goal and ensures that the distinct needs of the affected communities are not overlooked, avoided or ignored and provides due process to all parties involved. Suggested language for such a provision is attached as Exhibit 1; Exhibit 8 presents a case that exemplifies the inappropriate use of the state of incorporation venue option.

## **Small Business Bankruptcy**

### **1. “Fast Track” Chapter 11 Reorganization**

The CLLA is generally opposed to the creation of a “fast track” Chapter 11 procedure for small businesses. The underlying assumption of such provisions, that the

size of the business is determinative of the complexity of the case, is simply not true, as shown in the examples set forth in Exhibit 7. Indeed, the very opposite may be true because large cases typically have creditors of equal size and sophistication, while in the small business case, creditors tend to be more leery of the bankruptcy process, which causes greater operating concerns that need time to settle.

Moreover, the operations of small business debtors are extremely varied. The availability of raw materials to manufacture goods or the sources of merchandise to maintain inventories are not all the same. The desirability of the location of their physical facilities varies depending on the cities in which they operate. The reasons why small businesses seek bankruptcy protection are not all based on a bad economy, poor management, or incomplete books and records.

Viewed generally, proposals to streamline small business bankruptcies appear intended to address systematic abuses that do not exist on a scale that would demand dramatic reform, especially reform that would ensure the liquidation of otherwise viable businesses that are capable of successful reorganization.

## **2. Duties in a Small Business Case**

Should specialized small business reorganization provisions nevertheless be considered, the CLLA believes that a debtor/debtor in possession should be required to file a statement within three days after the case is commenced verifying that it has been informed of its duties.

The CLLA further believes that the reporting requirements previously considered are both unworkable and onerous. Accordingly, the CLLA suggests that the financial information required to be filed by a debtor consist of the following most recent financial documents prepared on a monthly or quarterly basis during the one year preceding the filing of the bankruptcy petition: (i) tax returns, (ii) balance sheet, (iii) income statements, and (iv) cash flow statements. This information is more likely to be in the possession of or readily obtainable by the debtor. Moreover, this information is more accurate in setting forth the status of the debtor and identifying the problems that led to the bankruptcy filing, facilitating a plan for reorganizing.

## **3. Serial Filer Provisions**

The CLLA agrees that a remedy is needed to curb abusive serial bankruptcy filings. However, remedial efforts have tended to focus only on small business serial filings. It is not clear why such a proposed remedy should apply only in small business cases, rather than in all business cases that are abusive. The standards for imposing a stay to protect the estate for the benefit of creditors should not depend on a debtor's size or form of organization. Further, the CLLA believes that the period between bankruptcies in which a presumption of abuse arises should not exceed 18 months. Finally, bona fide purchasers of assets from a bankruptcy estate should not be subjected to these same restrictions on the automatic stay.

### **Family Farmer Bankruptcy**

The CLLA strongly supports making permanent the provisions of Chapter 12 of the Code, which provide a specially tailored reorganization process for family farmers. Prior to the enactment of Chapter 12, many family farmer bankruptcies failed simply because the existing Bankruptcy Code provisions were unworkable in the unique circumstances involved in farming operations. Since its enactment, Chapter 12 has by all accounts proven successful and there is no evidence that Chapter 12 is not fulfilling the purpose it was intended to serve.

Since Congress first considered overhauling the nation's bankruptcy laws in the 105<sup>th</sup> Congress, family farmers have been subjected to continued uncertainty because the provisions of Chapter 12 have expired and been extended on numerous occasions. In fact, there have been gap periods during which there was no authority for family farmers to utilize the Chapter's provisions.

All the while, however, Congress expressed its clear intent that Chapter 12 should be made permanent. Doing so now, irrespective of any other decision Congress might make regarding other aspects of the Code, is the only means of ensuring fairness and predictability for family farmers and their creditors.

### **Cross-Border Bankruptcy/Insolvency**

Many leading experts in the field of international insolvency have advocated for some time that the Code be amended to add a new chapter specifically tailored to address the unique problems that arise when a financially distressed company has interests that span the globe. Toward this end, the United Nations Commission on

International Trade Law (“UNCITRAL”) has promulgated its Model Law on Cross-Border Insolvency.

According to UNCITRAL’s Guide to Enactment of the UNCITRAL Model Law on Cross-Border Insolvency, the insolvency laws of various nations have not kept pace with the increasing expansion of global trade and investment. This hinders the liquidation or rehabilitation of distressed businesses in a variety of ways and ultimately works to the detriment of creditors.

The CLLA, whose members include international credit, collections, and bankruptcy professionals, is in agreement with the concept of incorporating a cross-border insolvency chapter into the Bankruptcy Code, so long as it is consistent with UNCITRAL.

## **Executory Contracts and Unexpired Leases**

### **1. Unexpired Nonresidential Real Property Leases**

Strict time periods within which leases of nonresidential real property must be assumed or rejected are inappropriate and unworkable, especially if consent of the lessor is required to obtain an extension of that time. Such a proposal has been considered as a part of bankruptcy reform, but should not be included as it will make the reorganization of businesses that have multiple commercial locations virtually impossible. Although the time period for assumption or rejection of unexpired leases of nonresidential real property has been increased from the Code’s current 60 days, the court would have no discretion to grant an extension of this time period. Rather, the only way the time period may be extended is with the consent of the landlord. This change vests too much power with the landlords, will harm unsecured creditors and the debtor, and will place landlords in the position of exerting pressure and seeking concessions in exchange for granting the debtor an extension.

Current law is working well. Landlords have appropriate safeguards, including a statutory requirement that debtors timely pay postpetition rent, administrative priority treatment for postpetition rent not paid, and a 60 day period during which the lease must be assumed or rejected with extensions by the court upon a showing of cause. If additional remedies are needed for lessors, a more appropriate response would be to provide other

sanctions for debtors' failure to pay rent. However, under current law, landlords are receiving what they bargained for – they are paid their rent, and if they are not paid, then they receive the highest priority claim.

Notwithstanding, the CLLA recognizes that the Congress may desire to limit the court's discretion in granting extensions of the period in which unexpired leases of nonresidential real property must be assumed or rejected. Toward that end, suggested language is attached as Exhibit 2.

## **2. Assignability of Personal Service Contracts**

An amendment to Section 365(c)(1) of the Code is needed to address the substantive difference between the trustee and the debtor in possession when it relates to the assumption of a “personal service contract.” Confusion has existed since the enactment of the 1978 Code that has come to the forefront as a result of the Ninth Circuit Court of Appeals' “*Catapult*” decision. See *Perlman v. Catapult Entertainment, Inc. (In re Catapult Entertainment, Inc.)*, 165 F.3d 747 (9<sup>th</sup> Cir. 1999), *cert. denied*, 528 U.S. 924 (1999), (debtor in possession cannot assume an executory contract without consent of the nondebtor party if applicable nonbankruptcy law precludes assignment, even though debtor does not intend to assign the contract).

When Section 365(c)(1) was originally adopted, its purpose was to prohibit a trustee from assuming or assigning a contract that by its terms was personal to the debtor, and therefore, not assignable under applicable bankruptcy law. For example, if Mark McGuire filed bankruptcy, the trustee should not be able to effectuate an assumption and assignment of his contract, but McGuire, individually, should be able to assume the contract. Unfortunately, the provision was never quite drafted correctly, and the technical amendments in 1984 made it worse. Moreover, the legislative attempt to prohibit the assignment of “personal service contracts” by its terms and original intent was broader than just “personal service contracts.” Neither version expressly permitted the debtor to assume the “personal service contract” or prohibited the nondebtor party from terminating the contract.

A debtor in possession should be able to assume his or her own “personal service contract,” as well as other contracts that fit within Section 365(c)(1) but which are not personal to the debtor, as that may be the only way for the reorganization to create any cash flow. So long as the nondebtor party is receiving the benefit of its bargain and will continue to receive that benefit postconfirmation from the entity with which it contracted, there is no reason to deprive the debtor of a vital asset it may need to retain in order to

successfully reorganize. Language contained in attached Exhibit 3 would resolve the problems attendant to Section 365(c)(1) and the *Catapult* decision.

### **3. Defaults Based on Nonmonetary Obligations**

Prior versions of the bankruptcy reform legislation have sought to correct what was viewed by virtually everyone but the 9<sup>th</sup> Circuit as a drafting issue. The genesis for amending Section 365(b)(2)(D) of the Code is the decision by the Ninth Circuit Court of Appeals in *Worthington v. General Motors Corp. (In re Claremont Acceptance Corp.)*, 113 F.3d 1029 (1997).

The concept underlying the original statute was that the trustee cannot assume any executory contract without curing defaults. The Code makes an exception, excusing from the trustee's performance

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)(D).

*Claremont* and some other courts have interpreted this phrase such that “penalty” modifies both “rate” and “provision.” Although this interpretation may be correct as a matter of statutory construction, it nevertheless impairs the trustee's ability to act in the best interests of the estate. Oftentimes, nonmonetary defaults are not capable of being cured, thereby precluding assumption of a valuable executory contract of the estate. In *Claremont*, for example, the business subject to the contract had been closed for a period of time that exceeded what the contract permitted. Cure was impossible and the court accordingly held the contract could not be assumed. Such a result was not intended by the drafters of the Code and should be remedied. Suggested language is attached as Exhibit 4.

## **Bankruptcy Professionals, Committees, and the Courts**

### **1. Bankruptcy Judgeships**

There is a clear need to increase the number of bankruptcy judgeships. According to the Judicial Conference of the United States, since Congress last authorized additional judgeships in 1992, the courts' caseloads have increased by 59 percent. In addition to an

increase in the overall number of bankruptcy filings since 1992, the bankruptcy courts have seen the size and complexity of their business cases grow as well, placing further strain on the courts' resources.

Without additional judgeships, serious consequences are likely. Delays in the administration of cases are costly to creditors, who must await payment for no other reason than the sheer volume of work to be done, while debtors are hindered in their ability to receive bankruptcy's fresh start. Moreover, faced with burdensome or seemingly unmanageable workloads, highly competent and qualified jurists may abandon the bench in the belief that they are simply unable to properly administer justice in such a constrained environment.

Adding bankruptcy judgeships would alleviate the current burden on the bankruptcy courts, avoid the potential consequences of taking no action, and ensure that the Code and justice itself are properly administered.

There has been no serious objection to this proposal. Rather, Congress has refused to grant such acknowledged needed relief outside the context of an overall bill with hopes that the pressure from not moving forward on this issue would ultimately aid support for the overall bills. This has not happened.

## **2. Disinterestedness**

Past bankruptcy reform measures have made minor amendments to the definition of disinterestedness, but have failed to address concerns about potential conflicts that could preclude the appointment of a professional in a case.

To be disinterested under present law, an entity may not have "any direct or indirect relationship to, connection with, or interest in, the debtor." This phrase, contained in Section 101(14) of the Code, has been interpreted by some courts quite broadly to preclude retention of individuals and/or entities when they have "any connection" to the debtor even though such connection is not "materially adverse" and even after full disclosure of all connections has been made as part of the retention process under applicable Federal Rules of Bankruptcy Procedure. *See e.g.* Fed. R. Bankr. P. 2014. *See also* 11 U.S.C. § 327.

The CLLA believes the statute should be amended to provide that any person seeking to be retained in a bankruptcy case make full disclosure of any relationship to, connection with, or interest in, the debtor. Based on that disclosure, the court would then

be in a position to determine if any interest disclosed is materially adverse to the estate and, if not, the retention of the professional should be approved. Adoption of this standard would permit the retention of professionals who have minor connections with the estate, so long as such connection is not found by the court to be materially adverse to the estate. A process requiring full disclosure and determination by the court sufficiently protects the estate from any potential conflict of interest or abuse.

### **3. Rights, Powers, and Duties of the Unsecured Creditors Committee**

Section 1103(c) of the Code should be amended to expressly permit official committees of unsecured creditors in Chapter 11 cases to pursue remedies provided under the Code that are currently afforded only to the debtor in possession or, if appointed, the trustee.

The problem in this respect does not represent a significant change or substantive alteration from that which has been taking place, but rather an anomaly based upon rules of statutory construction. The Code provides that a variety of transactions can be avoided for the benefit of unsecured creditors of the estate under certain defined circumstances, including those that are fraudulent, preferential, or not properly perfected.

The Code expressly permits the Chapter 11 debtor in possession to pursue these actions under Section 1107 of the Code, but no such comparable express authority is granted to unsecured creditors' committees when the debtor in possession fails or refuses to pursue valid causes of action. In some courts, this lack of express authority has been held to preclude the committee from taking any action, irrespective of the value to be derived from pursuing such action to the creditor body or, perhaps more important, even where the debtor in possession has no just excuse for refusing to act.

In a number of instances, debtors in possession refuse or fail to act because it would require them to sue their principals, officers, directors, and affiliates to seek to seek recovery of assets improperly transferred to them prior to or on the eve of bankruptcy.

The CLLA does not urge granting sweeping changes to the powers of the committee. Rather, Section 1103(c) should simply be amended in a manner consistent with those courts permitting committee action in the face of the debtor in possession's unjustifiable failure to act in the estate's best interests.

## **Preferences**

### **1. The *DePrizio* Problem**

Despite the clear intent of Congress as expressed in The Bankruptcy Reform Act of 1994 to reject and eliminate the *DePrizio* doctrine, it nevertheless continues to find life in the courts. This issue, which arose primarily from the holding in *Levit v. Ingersoll Rand Financial Corp. (In re V.N. DePrizio Construction Co.)*, 874 F.2d 1186 (7<sup>th</sup> Cir. 1989), was well articulated by Congress:

Several recent court decisions have allowed trustees to recapture [preferential] payments made to non-insider creditors a full year prior to the bankruptcy filing, if an insider benefits from the transfer in some way. Although the creditor is not an insider in these cases, the courts have reasoned that because the repayment benefited a corporate insider (namely the officer who signed the guarantee) the non-insider transferee should be liable for returning the transfer to the bankrupt estate as if it were an insider as well.

140 Cong. Rec. H. 10,767 (October 4, 1994) (citations omitted).

In 1994, the intent of Congress was clear: “This section [202 of Pub. L. No. 103-394] overrules the *DePrizio* line of cases and clarifies that non-insider transferees should not be subject to the preference provisions of the Bankruptcy Code beyond the 90-day statutory period.” *Id.*

The effect of the 1994 amendment, however, has differed markedly from this stated intent, largely because at that time Congress did not amend Section 547, which actually governs preferences. Instead, Congress only amended Section 550 to preclude trustees from recovering avoided transfers from the non-insider parties. Courts have subsequently distinguished avoidance under Section 547 from recovery under Section 550, thereby allowing the *DePrizio* holding to have continued effect. That is, secured creditors’ liens are subject to avoidance under the one-year lookback period under Section 547 if an insider is benefited. That the trustee cannot recover from the creditor is of no significance because once the lien is avoided, the newly unencumbered property can be sold. *See e.g., Roost v. Associates Home Equity Servs., Inc. (In re Williams)* 234 B.R. 801 (Bankr. D. Or. 1999). This interpretation clearly creates results unintended by Congress when it amended the Code in 1994.

Suggested language to properly eliminate the *DePrizio* problem is attached hereto as Exhibit 5.

## **2. “Ordinary Course” Exception**

Section 547 of the Code, which governs preferences, provides that payments made in the “ordinary course” are not avoidable. The policy behind this exception, according to the section’s legislative history, is to “leave undisturbed normal financial relations, because it does not detract from the general policy of the preference section to discourage actions by either the debtor or his creditors during the debtor’s slide into bankruptcy.”

In practice, however, the Section 547(c)(2) ordinary course exception has led to significant legal uncertainty and increased costs through the development of complicated standards that the courts apply on a case by case basis.

According to current case law, Section 547(c)(2)(B), the “subjective test,” requires a creditor to show that a voidable payment received was ordinary in relation to prior dealings between the creditor and the debtor. Under Section 547(b)(2)(C), the “objective test,” a creditor must show that the payment received was not “unusual” within relevant industry norms. Evaluating relevant industry norms requires courts to consider typical payment intervals in the creditor’s industry, an often costly and time consuming process.

Adding another layer to the ordinary course analysis, courts have found that the degree to which a creditor will be permitted to deviate from relevant industry norms is directly related to the length of the debtor’s and creditor’s pre-insolvency relationship. Clearly, these complex and cumbersome standards produce legal uncertainty in the application of the ordinary course exception.

The CLLA recommends amending Section 547(c)(2) to create an objective standard. Suggested language is attached hereto as Exhibit 5. If adopted, this recommendation would substantially decrease the legal uncertainty that pervades current case law involving the ordinary course exception and would make preference litigation more efficient and more predictable. It would reduce the number of preference suits filed and encourage the settlement of claims. Additionally, the CLLA’s recommendation would give debtors and trustees a greater ability to distinguish between valid versus marginal claims, which would presumably reduce the latter category of cases. Thus,

administrative costs relating to preference suits would be diminished, leaving more assets available for distribution.

### **Transfers Made by Nonprofit Charitable Corporations**

The CLLA opposes limitations on transfers made by nonprofit charitable organizations because they would significantly impact cases involving hospitals and other nonprofit organizations. Such a limitation would be particularly devastating in the health care arena because a majority of the health care facilities are nonprofit charitable corporations. If viable alternatives to reorganizing calling for the transfer of assets from a nonprofit health care facility to a profit entity are no longer possible, the harm is not limited to creditors, but extends to patients who could be left in limbo. The existing but troubled nonprofit may be equally unable to provide the requisite care or effectively transfer assets to a for-profit corporation that might be better able to use those assets to continue providing the medical care needed by the patients. If the health care facility is unable to reorganize and must cease operating and close its doors, where are the patients in the facilities going to be sent and how will they then be cared for? The community interest in providing care for the patients surely is not furthered by this provision.

The CLLA recognizes that Congress has considered restricting transfers by nonprofit charitable corporations. Accordingly, if such a provision is adopted, several technical corrections should be considered. See attached Exhibit 6 for suggested corrective language.

### **Consumer Bankruptcy**

#### **1. Homestead Exemption**

A cap on the homestead exemption combined with a prohibition on state opt-out is clearly in order. Limiting the homestead exemption would eliminate forum shopping and the attendant bankruptcy homestead planning affluent debtors have practiced in recent years. In addition, a cap on the homestead exemption would also bring uniformity to the bankruptcy laws across the United States. Without an express prohibition on a state opt out, however, the abusive practice of forum shopping and attendant bankruptcy homestead planning by the affluent may continue unaffected.

#### **2. Anti-Strip Down Amendments**

The predominant purpose of consumer bankruptcy reform – to divert greater numbers of consumer debtors into chapter 13 through mandatory means testing – is severely undercut by provisions affecting the valuation of collateral.

Lien-stripping must be preserved in Chapter 13. As a matter of fundamental fairness, loans should be bifurcated into their secured and unsecured portions, and no creditor should be able to collect 100 percent of the unsecured portion of its debt simply because that debt is also partially secured. Proposals to eliminate lien-stripping are in direct contradiction of the stated purpose for bankruptcy reform, that is, greater repayment to unsecured creditors. Losses to unsecured creditors from passage of this proposal have been estimated to approach \$100 million annually.

Whether viewed from the perspective of current law or the stated intention of the proposed legislation, this provision significantly reduces the incentive to attempt repayment pursuant to a chapter 13 plan because the debtor's surrender of the collateral will be necessary in a greater number of cases. Moreover, this change diverts value from unsecured creditors in favor of undersecured creditors, again running contrary to the stated intention of the proposed legislation and undercutting the proposed means testing. The Code should give creditors what they otherwise would receive under state law; treating a creditor as fully secured when that creditor's interest is substantially undersecured deviates from this fundamental principle and ultimately harms both debtors and their unsecured creditors.

## **Conclusion**

The CLLA appreciates this opportunity to set forth and discuss these significant concerns regarding proposed bankruptcy reform. The CLLA is committed to working with members of the United States House of Representatives and the United States Senate to achieve effective and meaningful bankruptcy reform legislation.

Respectfully submitted,

John P. Wanderer  
President  
Commercial Law League of America

Judith Greenstone Miller  
Co-Chair, National Governmental  
Affairs Committee  
Chair, Bankruptcy Section  
Commercial Law League of America

Jay L. Welford  
Co-Chair, National Governmental

Peter C. Califano  
Co-Chair, Legislative Committee

Affairs Committee  
Co-Chair, Legislative Committee  
Bankruptcy Section  
Commercial Law League of America

Bankruptcy Section  
Commercial Law League of America

**EXHIBIT 1**

**SEC. \_\_\_\_\_. LOCAL FILING OF BANKRUPTCY CASES.**

Section 1408 of title 28, United States Code, is amended –

- (1) by striking “Except” and inserting “(a) Except”; and
- (2) by adding at the end the following:

“(b) For the purposes of subsection (a), if the debtor is a corporation, the domicile and residence of the debtor are conclusively presumed to be where the debtor’s principal place of business in the United States is located.”

**EXHIBIT 2**

**SEC. \_\_\_\_\_. EXECUTORY CONTRACTS AND UNEXPIRED LEASES.**

Section 365(d)(4) of title 11, United States Code, is amended by adding at the end the following –

“The court may not extend the period during which the trustee or plan proponent must elect to assume or reject a lease of nonresidential real property beyond the date of entry of the order confirming the plan, but such assumption or rejection may occur on or before the earlier of –

- (A) the effective date of the plan; or
- (B) dismissal of the case.”

### **EXHIBIT 3**

#### **SEC. \_\_\_\_\_. PERMITTING ASSUMPTION OF CONTRACTS.**

(a) Section 365(c) of title 11, United States Code, is amended to read:

"(c)(1) The trustee may not assume or assign an executory contract or unexpired lease of the debtor, whether or not the contract or lease prohibits or restricts assignment of rights or delegation of duties, if:

"(A)(i) applicable law excuses a party to the contract or lease from accepting performance from or rendering performance to an assignee of the contract or lease, whether or not the contract or lease prohibits or restricts assignment of rights or delegation of duties; and

"(ii) the party does not consent to the assumption or assignment; or

"(B) the contract is a contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor, or to issue a security of the debtor.

"(2) Notwithstanding paragraph (1)(A) of this subsection and applicable nonbankruptcy law, in a case under chapter 11 of this title, a debtor in possession or a trustee for a debtor that is a corporation may assume an executory contract or unexpired lease of the debtor, whether or not the contract or lease prohibits or restricts assignment of rights or delegation of duties.

"(3) The trustee may not assume or assign an unexpired lease of the debtor of nonresidential real property, whether or not the contract or lease prohibits or restricts assignment of rights or delegation of duties, if:

"(A) the lease has been terminated under applicable nonbankruptcy law before the order for relief; or

"(B) the debtor is the lessee under the lease of an aircraft terminal or aircraft gate at an airport at which the debtor is the lessee under one or more additional leases of an aircraft terminal or aircraft gate and the trustee, in connection with the assumption or assignment, does not assume all such leases or does not assume and assign all of such leases to the same person, except that the trustee may assume or assign less than all of such leases with the airport operator's written consent."

(b) Section 365(e) of title 11, United States Code, is amended to read:

"(e)(1) Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on:

"(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; or

"(C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.

"(2) Paragraph (1) of this subsection does not apply to an executory contract or unexpired lease of the debtor to the extent that the trustee may not assume or assign, and the debtor in possession may not assume, the contract or lease by reason of the provisions of subsection (c) of this section."



**EXHIBIT 4**

**SEC. \_\_\_\_\_. DEFAULTS BASED ON NONMONETARY OBLIGATIONS.**

(a) EXECUTORY CONTRACTS AND UNEXPIRED LEASES. – Section 365 of title 11, United States Code, is amended –

(1) in subsection (b) –

(A) in paragraph (1)(A) by striking the semicolon at the end and inserting the following:

“other than a default that is a breach of a provision relating to –

“(i) 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; or

“(ii) 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 executory contract, if it is impossible for the trustee to cure such default by performing nonmonetary acts at and after the time of assumption and if the court determines, based on the equities of the case, that this subparagraph should not apply with respect to such default;”, and

(B) by amending paragraph (2)(D) to read as follows:

“(D) the satisfaction of any penalty rate or penalty provision relating to a default arising from a failure to perform nonmonetary obligations under an

executory contract or under an unexpired lease of real or personal property.”,

(2) in subsection (c) –

(A) in paragraph (2) by adding “or” at the end,

(B) in paragraph (3) by striking “; or” at the end and inserting a period, and

(C) by striking paragraph (4),

(3) in subsection (d) –

(A) by striking paragraphs (5) through (9), and

(B) by redesignating paragraph (10) as paragraph (5).

(4) in subsection (f)(1) by striking “; except that” and all that follows through the end of the paragraph and inserting a period.

(b) IMPAIRMENT OF CLAIMS OR INTERESTS. – Section 1124(2) of title 11, United States Code, is amended –

(1) in subparagraph (A) by inserting “or of a kind that section 365(b)(1)(A) of this title expressly does not require to be cured” before the semicolon at the end,

(2) in subparagraph (C) by striking “and” at the end,

(3) by redesignating subparagraph (D) as subparagraph (E), and

(4) by inserting after subparagraph (C) the following:

“(D) if such claim or such interest arises from any failure to perform a nonmonetary obligation, compensates 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”.

## EXHIBIT 5

### SEC. \_\_\_\_\_. PREFERENCES.

(a) IN GENERAL. – Section 547 of title 11, United States Code, is amended –

(1) in subsection (b), by striking “subsection (c)” and inserting “subsections (e) and (i)”; and

(2) by adding at the end the following:

“(i) If the trustee avoids under subsection (b) a transfer made between 90 days and 1 year before the date of the filing of the petition, by the debtor to an entity that is not an insider for the benefit of a creditor that is an insider, such transfer may be avoided under this section only with respect to the creditor that is an insider.”

(b) Paragraph 2 of subsection (c) is amended to read as follows:

“(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) (i) made not more than 90 days after the payment was originally due based on a writing agreed to by the debtor and the transferee; or

(ii) if no such writing relating to the due date of the payment exists, made not more than 120 days from the delivery of goods, provision of services or extension of credit upon which the transfer was made; and

(C) not made subsequent to the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor to recover such debt.”

(c) APPLICABILITY. – The amendments made by this section shall apply to any case that is pending or commenced on or after the date of the enactment of this Act.

**EXHIBIT 6**

**SEC. \_\_\_\_\_. TRANSFERS MADE BY NONPROFIT CHARITABLE CORPORATIONS.**

(a) SALE OF PROPERTY OF ESTATE. – Section 363(d) of title 11, United States Code, is amended –

(1) by striking “only” and all that follows through the end of the subsection and inserting “only –

“(1) if the debtor is a corporation that is not a moneyed, business, or commercial corporation, in accordance with applicable nonbankruptcy law that governs the transfer of property; and

“(2) to the extent not inconsistent with any relief granted under subsection (c), (d), (e), or (f) of subsection 362 of this title.”

(b) CONFIRMATION OF PLAN FOR REORGANIZATION. – Section 1129(a) of title 11, United States Code, is amended by adding at the end the following:

“(15) If the debtor is a corporation that is not a moneyed, business, or commercial corporation, all transfers of property under the plan shall be made in accordance with any applicable provisions of nonbankruptcy law that govern the transfer of property.”

(c) TRANSFER OF PROPERTY. – Section 363 of title 11, United States Code, is amended by adding at the end the following:

“(p) Notwithstanding any other provision of this title, property that is held by a debtor that is a corporation described in section 501(c)(3) of the Internal Revenue Code

of 1986 and exempt from tax under section 501(a) of such Code may be transferred to an entity that is not such a corporation, but only under the same conditions as would apply if the debtor had not filed a case under this title.”

(d) APPLICABILITY. – The amendments made by this section shall apply to a case pending under title 11, United States Code, on the date of the enactment of this Act, except that the court shall not confirm a plan under chapter 11 of this title without considering whether this section would substantially affect the rights of a party in interest who first acquired rights with respect to the debtor after the date of the petition.

(e) RULE OF CONSTRUCTION. – Nothing in this section shall be deemed to require the court in which a case under chapter 11 is pending to remand or refer any proceeding, issue, or controversy to any other court or to require the approval of any other court for the transfer of property.

(f) STANDING. – Section 1109 of title 11, United States Code, is amended by adding at the end:

“(c) The attorney general of the State in which the debtor is incorporated, was formed, or does business may appear and be heard in any proceeding under section 363(p) or 1129(a)(15) of this title.”

## **EXHIBIT 7**

### **Sample Small Business Bankruptcy Cases**

- A marina located on the Jersey Shore had approximately \$2 million in debt. Because the business is seasonal (generally April through October), the requirements for filing a plan under the proposed Small Business provisions could act to significantly reduce the potential return. The case was filed in late fall. Having the opportunity to wait until the start of the next season allowed the business to be packaged for sale as a going concern. If the plan had to be filed within 90 days, or even the extended 150 days set forth in the small business provisions of the bills, the business would not have been able to reorganize, and most likely have been liquidated, thereby providing significantly less for a distribution to unsecured creditors.
- A bar/restaurant with about \$2 million in debt required a year to be in a position to propose a plan because of pending legal action seeking a declaratory judgment as to whether its insurance company was required to provide a defense to a Dram Shop action brought against it. The ultimate determination of this litigation impacted the ability of the debtor to successfully reorganize.

## **EXHIBIT 8**

### **Sample Venue Bankruptcy Case**

Debtor, an appliance and electronics retailer, filed a voluntary chapter 11 petition in mid-September, 1998, in Delaware. Less than two months later, the Debtor announced that, rather than reorganizing, a liquidation of all assets would take place.

The Debtor's headquarters were located in Columbus, Ohio. Of its 59 stores at the time of filing, more than half were located in Ohio. Another 11 were located in Pennsylvania, and the remainder were in Indiana, New York, West Virginia, Virginia, Tennessee and Kentucky, each of which had between one and five retail outlets.

The Debtor also owned 11 parcels of real estate, three of which were located in the Columbus, Ohio, region. Seven other parcels were scattered throughout Ohio. The only parcel of land owned outside of Ohio was situated in Erie, Pennsylvania, just east of the Ohio border. No land was owned, nor stores operated, in the state of Delaware.

Among the Debtors creditors were an unknown number of consumers, whose claims would be entitled to priority due to the Debtor's failure to deliver goods or the termination of extended warranties purchased by customers. The majority of these consumers likely resided in Ohio, given the proportion of retail outlets located in that state. In addition, approximately one-third of the Debtor's 2,900 employees worked in Ohio, most of those in Columbus.