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Bankruptcy rules open window for small creditors

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The new federal bankruptcy rules may be aimed primarily at consumers but there is plenty for businesses to learn, too.

Signed by President Bush on April 20, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 is intended to make it tougher for people to file under Chapter 7 of the bankruptcy law, which wipes out old debts. More filers will need to resort to Chapter 13, which still requires debts to be repaid.

What hasn't gotten much ink are the provisions aimed specifically at businesses filing for bankruptcy protection -- or what effect they could have on bankruptcy lawyers.

"As a business creditor you may have more leverage in a few ways," says Shelly Crocker, a bankruptcy attorney with Crocker Kuno Ostrovsky LLC in Seattle.

A lot of decisions in a business bankruptcy must be approved by a committee of creditors, which in the past was made up of the seven creditors owed the most money. That often left small businesses out in the cold. Now, if the money owed is a disproportionately large percentage of a small business's annual gross revenue, the court can add that business to the creditors committee.

"That's a big advantage," says Crocker.

Since the committee holds greater power than any single unsecured creditor, that can give a small business a big voice. Also, the committee's legal fees have to be paid by the debtor.

Another area of change concerns single-asset real estate cases, typically a shopping center or office building owned by a limited liability company that does little besides collect rent.

"The story is always the same: It doesn't lease up fast enough, and they are in foreclosure, and you file the case to prevent the foreclosure," says Crocker. Before, the section dealing with single-asset cases had a cap of $4 million. Now the cap is off, shifting the bargaining power from the debtor to the creditors.

Don't be surprised to see such companies in the near future trying to get around the single-asset rule, Crocker says.

Then there are the "Ken Lay" rules, referring to the former chairman of Enron.

"If the CEO or CFO is suspected of fraud, the U.S. Attorney's Office is required to make a motion to get a trustee appointed," Crocker says.

Other limitations will make it much more difficult to pay executives to stay through a Chapter 11 filing, and will allow recovery of payments made to insiders through employment contracts in the two years prior to the filing. (The old rule was only one year.)

Jan Ostrovsky, one of Crocker's partners in the firm, sees some changes showing up in subtle ways. Speeding up bankruptcy proceedings will have an impact on retail chains, for instance.

"Often when a retailer files Chapter 11 after Christmas, it doesn't assume or reject its leases right away -- it waits for plan confirmation," he says. That lets the retailer examine how each store is performing. Now there will be less time for that.

"In many retail bankruptcies, which locations you keep and which you abandon are the name of the game," says Ostrovsky.

"From the landlord's perspective, this is a good thing. The problem is that if you can't get out of some of your debts, you can't reorganize, and if you can't reorganize nobody gets anything. To the extent it helps somebody, it hurts somebody else."

Under the new rules, lenders should be able to get repaid on better terms, says Crocker, which means they will be able to redeploy the money faster in terms of new business loans, and generally bolster the local economy.

In consumer bankruptcies, however, the new law may have the opposite effect, says Seattle bankruptcy lawyer Marc Stern. Most consumer debt is owed to credit card companies, so the money will flow to wherever that company is based.

"There are some statistics I've seen that says a dollar spent locally is transferred four or five times," says Stern. That multiplier effect will mean a loss of four or five dollars locally for every one sent to a credit card company instead of being forgiven under Chapter 7.

"Talk about economic disincentives," says Stern, who is also co-chairman of the Bankruptcy Committee of the American Bar Association's General Practice, Solo & Small Firm Section.

On the other hand, there may be fewer people blocked from Chapter 7 than people think.

The test is whether the filer's household income is above the state median. If it is, and there's at least $100 a month available for paying down debts, the filer will have to go with Chapter 13.

But the formula for figuring out that extra $100 has a few exemptions, Stern points out. It doesn't count money paid for secured debts like mortgages and car loans, or repayment of loans to 401(k) plans.

"If you can't pass the means test, your lawyer couldn't pour water out of a boot -- even if you put the instructions on the heel," says Stern.

That is, if you can find a bankruptcy lawyer.

Stern says he's not sure if he wants to stay in the profession under the new rules.

One of those rules is that the filer's attorney must certify the accuracy of the financial data supplied by his or her client.

"The argument I made when I was lobbying is that one of my favorite shows is 'Antiques Road Show.' Say I look at this stone that is carved -- you bought it in a yard sale -- it's worth $10," says Stern. "All of a sudden one of your creditors recognizes it as a Michelangelo. How was I supposed to know that? How was I supposed to know you had money in a bank account in Delaware that you didn't tell me about?"

The attorney must do a reasonable inquiry into the accuracy of the numbers, but Stern says "reasonable" hasn't been defined. Will he be required to make a nationwide search for secret bank accounts? "I really don't know what I'm going to do," Stern says about his solo practice. "I just don't know."

He's got a short window to figure it out. Most of the provisions take effect in just six months.

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