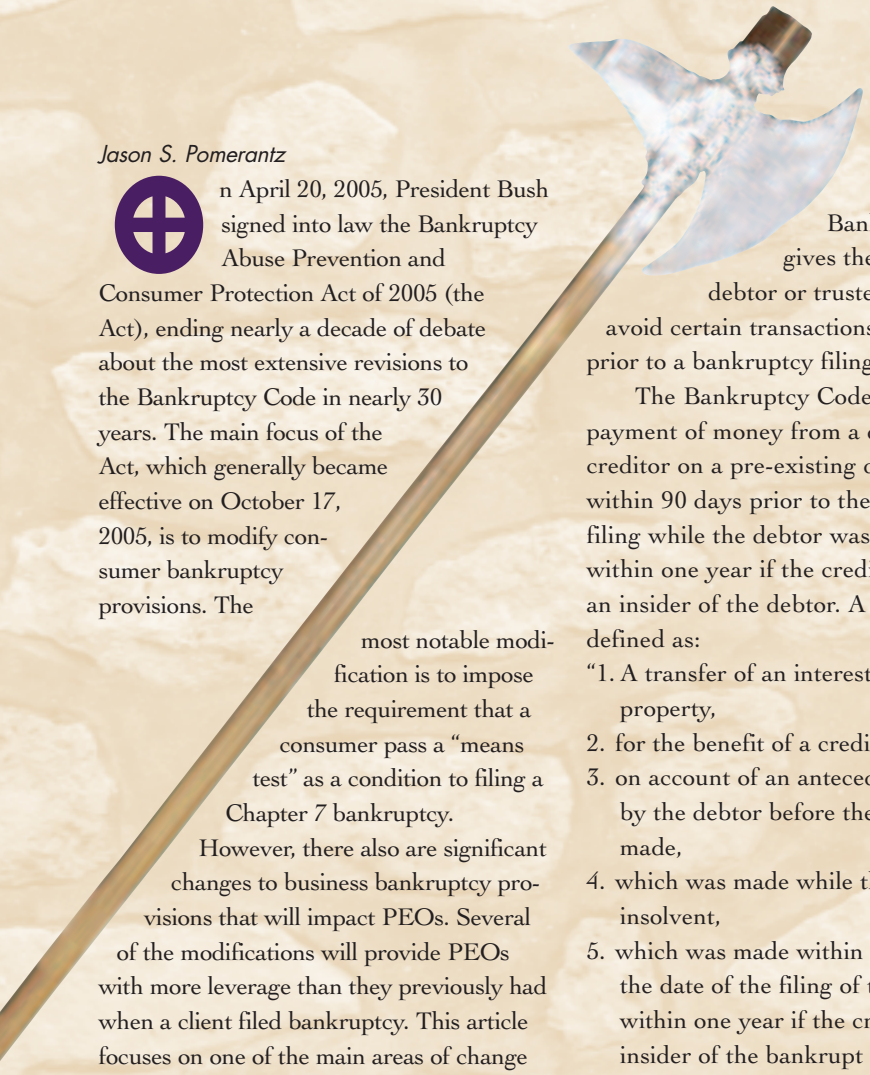
Some Revisions to the Bankruptcy Code Offer PEOs Leverage in the Bankruptcy Process



Jason S. Pomerantz

On April 20, 2005, President Bush signed into law the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the Act), ending nearly a decade of debate about the most extensive revisions to the Bankruptcy Code in nearly 30 years. The main focus of the Act, which generally became effective on October 17, 2005, is to modify consumer bankruptcy provisions. The most notable modification is to impose the requirement that a consumer pass a "means test" as a condition to filing a Chapter 7 bankruptcy.

However, there also are significant changes to business bankruptcy provisions that will impact PEOs. Several of the modifications will provide PEOs with more leverage than they previously had when a client filed bankruptcy. This article focuses on one of the main areas of change that should benefit PEOs — the provisions regarding preferences. PEOs commonly are forced to defend preference actions when a Chapter 11 debtor or trustee attempts to recover payments the PEO received from the debtor during the 90-day period prior to the bankruptcy filing.

Preferences — A Brief Recap

Sections 547 and 550 of the Bankruptcy Code allow the recovery (repayment) of certain "preference payments" received by a creditor prior to bankruptcy. The Bankruptcy Code gives the Chapter 11 debtor or trustee the power to avoid certain transactions that occurred prior to a bankruptcy filing.

The Bankruptcy Code prohibits the payment of money from a debtor to a creditor on a pre-existing debt made within 90 days prior to the bankruptcy filing while the debtor was insolvent, or within one year if the creditor is deemed an insider of the debtor. A preference is defined as:

"1. A transfer of an interest of the debtor in property,
2. for the benefit of a creditor,
3. on account of an antecedent debt owed by the debtor before the transfer was made,
4. which was made while the debtor was insolvent,
5. which was made within 90 days before the date of the filing of the petition (or within one year if the creditor was an insider of the bankrupt company), and
6. which enables a creditor to receive more than a creditor would receive if the case were a Chapter 7 (liquidation) or the transfer had not been made."

The purpose of the preference laws is to equalize the treatment of similarly situated creditors by preventing a debtor from preferring certain creditors to others. The preference laws also discourage creditors from racing to the courthouse to dismember a debtor, thereby quickening its slide into bankruptcy.

Changes Under the Act

Minimum Threshold to Sue for a Preference

Before the Act, a PEO could be sued on a preference for any amount. When a PEO was faced with a preference lawsuit for a small dollar amount, it was typically not cost effective for the PEO to hire counsel and defend the action, even if the PEO had valid defenses. Under the Act, a trustee or debtor will not be able to avoid transfers that, in the aggregate, do not exceed $5,000 in a case where the debts are primarily commercial debts. The Act also prevents a trustee or debtor from recovering transfers of less than $600 in an individual debtor case involving primarily consumer debts.

Suing a PEO Where it Has its Principal Place of Business

Prior to the Act, a PEO could be sued for a preference in the bankruptcy court where the debtor filed bankruptcy. Often the bankruptcy court was not in the state where the PEO was located. Being sued in the bankruptcy forum increased the cost and inconvenience of defending the action. The Act eliminates this problem for PEOs when the amount at issue is between $5,000 and $9,999. The Act requires that a preference action seeking to recover less than $10,000 be brought in the bankruptcy court where the PEO has its principal place of business. When the client files bankruptcy in a state other than the state where the PEO's principal place of business is located, the PEO (at least when the amount at issue is between

$5,000 and $9,999) will no longer have to defend in an out-of-state forum. The amendment prevents the trustee from gaining leverage by suing the PEO in an inconvenient and more costly forum. Debtors and trustees will have to rethink whether it is cost effective to pursue PEOs to seek recovery of preferential transfers in the range of $5,000 to $9,999.

The Ordinary Course Defense

The most commonly asserted defense to a preference action by a PEO is the "ordinary course of business" defense. The policy supporting this defense is two-fold: to protect customary transactions and to encourage creditors to continue extending credit to financially troubled debtors, possibly helping the debtor avoid bankruptcy.

Before the Act (in bankruptcy cases filed before October 17, 2005), to qualify for the ordinary course of business defense, a PEO had to prove three elements:

- That the payment was of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and PEO;
- That the payment was ordinary as between the parties; and
- That the payment was ordinary in relation to prevailing industry standards.

The court determined "ordinary course of business" payments through comparison with prevailing business standards, which include common terms used by other trade creditors in the same industry facing similar problems.

The Act makes it easier for the PEO to prove an ordinary course of business defense by allowing the PEO to establish either that the payment was ordinary between the debtor and the PEO or that the payment was ordinary in comparison to the terms in the industry. The PEO is no longer required to prove both elements. Thus, even if the preference payments between the PEO and bankruptcy client are all out of the ordinary as compared to their pre-preference period payments, the PEO can prevail by showing that the preference payments were incurred in the ordinary course of business and are ordinary according to prevailing industry standards.

This provision makes it easier for a PEO to successfully defend against a preference action. The PEO should prevail by showing that either the payment was in the ordinary course of business between the PEO and the debtor or that the payment was made according to ordinary industry practices. However, PEOs may not have an opportunity to take advantage of this change for several years. Under the Bankruptcy Code, a preference action may be filed up to two years after the bankruptcy case is commenced. Thus, many preference actions will continue to be brought in bankruptcy cases filed prior to October 17, 2005, to which the prior law will still apply.

Defense for Payment Plans or Restructuring Debts

PEOs sometimes have knowledge that a client is going to file bankruptcy before the client actually files. Even when there is no specific notice, indicators such as late payments, non-payments, and downsizing of staff should give the PEO reason for concern. By far the best way to avoid becoming a preference defendant is to carefully monitor the financial well being of clients, avoid extending credit to clients, and, if the circumstances warrant, terminate the client service agreement before the client actually files for protection under the Bankruptcy Code. A PEO should ensure its client service agreement permits termination in such circumstances. Despite its best efforts, a PEO may find itself with a client in bankruptcy. A PEO should be prepared for such a situation. Its client service agreement should provide for modification of payment terms.

The client's financial troubles may cause the PEO to agree, even reluctantly, to renegotiate terms or restructure a missed payment. Prior to the Act, a debt restructuring was a strong indicator that the payments relating to it were out of the ordinary, negating the chance for the PEO to prevail in asserting an ordinary course defense to the payments. Now, under the Act, a trustee may not avoid a transfer if such transfer was made as a part of an alternative repayment schedule between the debtor and any creditor created by an approved nonprofit budgeting and credit counseling agency. Although this provision was likely created to apply to consumer debt restructuring (for example, credit card payments), it is arguably also applicable to business debts. If applicable, the key is to have the payment plan created by an approved nonprofit budgeting and credit counseling agency. A list of approved agencies should be available by contacting the Office of the United States Trustee in your local area.

Conclusion

Client bankruptcies are becoming more prevalent in the PEO industry. Acting quickly when confronted with a client in bankruptcy, through counsel and the PEO's personnel, can significantly reduce, and sometimes eliminate, the PEO's financial exposure. As the Act goes into effect, PEOs can further minimize their financial risk by taking precautions before the client files bankruptcy. This article focuses on preferences, one of the most common aspects of bankruptcy PEOs are faced with when their client files bankruptcy. Future articles will address other revisions to the Bankruptcy Code that impact PEOs, such as increases in employee priority wage claims, the "means test" now needed to qualify for Chapter 7 bankruptcies, and new requirements for small business Chapter 11 bankruptcies.■

Jason S. Pomerantz practices law with Pachulski, Stang, Ziehl, Young, Jones & Weintraub P.C., Los Angeles, California. He specializes in bankruptcy, commercial, and business litigation. He has particular expertise in handling the financial aspects of a PEO's relationship with its clients, with an emphasis on minimizing a PEO's exposure in bankruptcy and insolvency situations. Pomerantz can be reached at *jpomerantz@pszyjw.com*.

For more information about this topic, see NAPEO *Legal Review* Volume 1, Issue 11, "PEOs and Client Bankruptcy," by Jason S. Pomerantz, Esq., and Rufus E. Wolff, Esq., available at *www.napeo.org/members/ legal_reviews.cfm* with your NAPEO member password.