INSOLVENCY LAW REVIEW COMMITTEE

UNITED STATES' BANKRUPTCY ACT, 1978

(by the Secretary)

A Commission on the Bankruptcy Laws of the United States was set up early in 1970 and reported to Congress in July 1973. Since that date Congress has been studying a comprehensive revision of bankruptcy law and practice and various Bills have been drafted, revised and re-drafted. Congress completed action on the final version - Bill HR8200 - on 6 October 1978 and it is now awaiting the President's signature.

2 Attached at Appendix 'A' are listed some of the reasons put forward by the Commission in support of their recommendation that a major overhaul was necessary. Appendix 'B' summarises some of the provisions of the new Act which may be of particular interest to members of the Review Committee. Much of this information has been taken from a report which was obtained recently by Mr Muir Hunter.

Canadian Report

15.11.78

US BANKRUPTCY LAWS - THE NEED FOR CHANGE

1 The rising tide of consumer bankruptcies since World War II had placed a severe strain on the current system.

2 A substantial portion of the costs of operating the system was borne by cases which produced little or no benefit to creditors; the adversary process used to resolve these matters was inappropriate.

3 The Bankruptcy Laws were not uniformly applied as between different States.

4 Many of the procedural provisions of the Bankruptcy Act had been overtaken by amendments to the Bankruptcy Rules during the 1970's.

5 The substantive provisions of the Act were at least 40 years old.

6 Re-examination was needed to make sure that the dual bankruptcy principles of equality of treatment of creditors and the grant of a fresh start to the debtor remained viable.

7 The current Act was a hodge-podge and sections were out of order as well as out of style.

8 The present court system was inadequate; there was a requirement for an independent bankruptcy court with jurisdiction over all matters relating to the bankruptcy case.

9 Chapters X, XI and XII, dealing with compositions and arrangements available to individuals, partnerships and companies were too complex and inflexible; they should be consolidated into a single reorganisation chapter which was available to all debtors.

10 The existing requirement of proof of 'acts of bankruptcy' was archaic and a contributing factor to the delay between the first occurrence of inability to pay debts and the filing of a bankruptcy petition.

11 There was a requirement for debt counselling for consumers; also for improved 'wage earner plans' for consumer debtors.

12 Claims entitled to priority on distribution needed to be reduced.

POINTS OF INTEREST IN THE PROPOSED US BANKRUPTCY ACT

Voluntary petitions

1 There are no basic changes as to the debtors eligible for relief. Any individual, partnership or corporation is eligible to file a petition under the liquidation or business reorganisation chapters except for banks, insurance companies, homestead associations, credit unions, or savings and loan associations. An individual debtor with a regular income may petition for liquidation, reorganisation (ie. an arrangement) or a wage-earner plan (see para 25 below). The fee for filing a petition remains at £25; a proposal to waive the fee for indigents was defeated.

Petitioning creditors

2 If there are 12 or more creditors, at least 3 must join in the petition; otherwise one petitioning creditor will suffice. These provisions are applicable to both liquidation and business reorganisation cases. The reduction to one petitioning creditor is a new idea, intended to ease access to the courts in involuntary insolvency cases. How one determines the number of creditors in advance is not clear.

Acts of bankruptcy

3 Acts of bankruptcy are to be abolished, and the principal base upon which a bankruptcy petition may be presented will be that the debtor is generally unable to pay his debts as they become due. A general receivership or assignment for the benefit of creditors are also retained as additional grounds in support of a petition.

Property of the estate

4 The new Act will abolish insolvency or bankruptcy as a ground for default or termination of an interest in property (eg. termination clauses in leases). Defaults which are not based on insolvency or bankruptcy will, however, be enforceable against the estate, but with the trustee/liquidator having the right to cure the default and to provide adequate assurance of future performance.

5 The present right to disclaim onerous contracts and leases is continued. However, the limitation on damages is changed and will be equally applicable in liquidation and reorganisation cases. A landlord's future claim for damages is limited to the greater of one year's rent plus 10%, or the rent for the lease term not to exceed 3 years. Claims under employment contracts are limited to one year's future remuneration. No limit is placed on a damage claim for the rejection of a personal property lease.

After acquired property

6 It seems that the present law, whereby the future earnings of the debtor are not administered in bankruptcy liquidation cases, will continue.

Antecedent transactions

7 There are substantial changes in the trustee's power to avoid pre-bankruptcy transactions. These changes are designed to:-

(a) clarify the present law,

(b) simplify the complex statutory language,

(c) modernise the powers to deal effectively and fairly with the all embracing 'personal property security interest',

(d) ease the burden of proof placed on the trustee, and

(e) exclude from attack transfers which were never intended as credit transactions.

Fraudulent transfers

8 Transfers or obligations incurred within one year of bankruptcy may be attacked when:-

(1) the transfer or obligation was with actual intent to hinder, delay or defraud creditors, without regard to the debtors solvency or insolvency; or

(2) the transfer was for inadequate consideration and

(i) the debtor was or became insolvent, or

(ii) had unreasonably small capital for a contemplated business transaction, or

(iii) intended or believed he would incur debts beyond his ability to pay as they became due.

9 The new Act makes it clear that payments in satisfaction of an antecedent debt cannot be attacked under the fraudulent transfer provisions.

Fraudulent preferences

10 This section is regarded as the most important of the trustee's avoiding powers. Its aim is to assure equality of distribution by enabling the trustee to recover payments for antecedent debts (with certain exceptions) which were made shortly before the commencement of insolvency proceedings.

11 The preference period has been reduced from 4 months to 3 months of the filing of a petition, but the debtor is presumed to be insolvent during the three-month period. This means that payment of all antecedent unsecured debts within three months, with limited exceptions, will be vulnerable.

"Insider" preferences

12 Under a new provision, payments to a "relative, partner, director, officer or affiliate of the debtor" may be recovered if made within one year of the bankruptcy upon proof:

(i) of the debtor's insolvency at the date of the transfer, and

(ii) if more than three months before bankruptcy, that the insider had reasonable cause to believe that the debtor was insolvent.

Protected transactions

13 Transactions which are exempt from attack as fraudulent preferences are:-

(i) payments to a fully secured creditor,

(ii) transactions intended to be "cash sales" but which, unavoidably, involved a very short extension of credit, and

(iii) payment of a debt incurred in the ordinary course of business or financial affairs of the debtor and the transferee, and made not later than 45 days after the debt was incurred, or made according to ordinary business terms.

14 The phrase "or financial affairs" has been specifically included to indicate that the exemption applies equally to consumer debtors as well as to transfers by commercial debtors.

Recovery of goods by unpaid seller

15 The new Act follows the basic provisions of the Uniform Commercial Code; namely, a seller would be entitled to reclaim goods if they were received while the debtor was insolvent and on credit but the seller must make a demand for reclamation within 10 days of receipt of the goods.

16 However, there is a new proviso which recognises that return of the goods may be impractical, particularly in a business reorganisation. In such circumstances the court may grant the seller's claim priority as an administrative expense and deny reclamation.

Preferences and the Floating Lien

17 In effect, the floating lien is similar to our floating charge in that it enables the lender to acquire a charge over the future assets of the borrower - that is, assets which he obtains subsequent to the date of the charge. This is done by inserting 'after acquired property' clauses in the charge document. It seems that there have been conflicting views and court decisions as to whether after acquired assets picked up by a floating lien were vulnerable as "fraudulent" preferences.

18 The new Act includes provisions to protect against preference attack the so-called "enabling loan", ie. where the acquisition of the debtor's collateral is, chronologically, later in time than the loan. However, there is also included an "improvement in position" test where the collateral is inventory or book debts. "To the extent that a secured party's collateral increases in value during the three-month preference period, and if that increase was not attributable to new loans but was at the expense of the estate, the extent of the improvement to the extent of the expense would be recoverable as a preference."
Example:
Assume that three months before bankruptcy the collateral was £5,000 worth of raw materials which by the date of the bankruptcy have been converted into finished products worth £10,000. Assuming an initial "deficiency" (the debt secured was, say, £12,500) then the £5,000 increase in value is not protected and goes to the trustee.

Set-off

19 Set off generally is allowed, both in bankruptcy and in reorganisations, unless it was in bad faith or violates a kind of preference test. Set-offs are prohibited only as to:-

(a) claims acquired after the "commencement" of the proceedings,

(b) claims acquired within 3 months before "commencement" (the debtor is deemed to be insolvent), or

(c) debts incurred (as distinct from claims acquired) within 3 months before "commencement", if incurred for the purpose of obtaining a right of set off.

20 Whenever set off is permitted, the amount that may be set off may not exceed the amount that was owing on the claim 3 months prior to "commencement".

Priority of debts

21 In the distribution of the proceeds of the estate certain claims are to be paid in priority but, unlike our preferential claims, they do not rank pari passu but are to be paid in the following order:-

(1) Administrative claims and expenses.

(2) Wage claims up to £1200. Wages must have been earned within 3 months of the filing of the petition or the cessation of business whichever is the earlier, but there is no time limit on the accrual of holiday pay or sick leave pay.

(3) Contributions to employee benefit plans (within certain limitations).

(4) Consumer creditors' claims arising from the deposit of money for goods or services not delivered or provided (up to £1200 each).

(5) Taxes within 3 years of filing of the petition.

Assets of the bankrupt not divisible amongst his creditors

22 The exemptions to which a bankrupt is entitled are:-

(a) £5,000 equity in a residence;

(b) £750 equity in a motor vehicle;

(c) routine household furnishings and personal apparel;

(d) £375 of jewelry;

(e) £500 of books and tools of trade;

(f) life assurance;

(g) alimony and child support;

(h) social assistance benefits;

(i) rights in a pension and profit sharing plan; and

(j) awards from personal injury causes of action.

Discharge

23 An individual debtor may be denied discharge if he has:-

(1) within one year, fraudulently transferred or concealed property with intent to hinder, delay or defraud his creditors;

(2) failed to keep adequate financial records;

(3) engaged in misconduct during the bankruptcy proceedings;

(4) failed to give a satisfactory explanation of his losses; or

(5) obtained a discharge within the last 6 years.

Non- dischargeable debts

24 The following debts are not released by the debtor's discharge:-

(a) taxes less than 3 years old;

(b) debts incurred by use of a false financial statement;

(c) debts not scheduled in time for a dividend;

(d) debts incurred by reason of embezzlement or larceny;

(e) alimony and child support obligations;

(f) liability for wilful and malicious injury;

(g) governmental fines and penalties.

Wage earner plans

25 Chapter 13 plans, as they are known, are limited to individuals with regular income whose unsecured liabilities are less than £50,000 and secured liabilities are less than £250,000. Regular income means that which is sufficiently stable and regular to enable the individual to make payments under a plan under Chapter 13. Stockbrokers and community brokers are excluded, special provisions being included for those two groups.

Compositions, Arrangements and Reorganisations

26 Under the old Bankruptcy Act, a debtor seeking an alternative to liquidation can choose between one of three reorganisation chapters. Individuals and partnerships engaged in business may file under Chapter XI or, if secured real estate is involved, Chapter XII. Companies may file under Chapters X or XI.

27 In so far as companies are concerned, Chapter X substitutes an independent trustee for debtor control and involves the absolute priority rule, the active participation of the Securities and Exchange Commission and court approval of the plan. In general, it was felt that the chapters were too inflexible, cumbersome and costly.

28 The new Act consolidates all three rehabilitation chapters into a single reorganisation chapter which is equally applicable to all business entities, ie. individuals, partnerships and private and public corporations. Some of the advantages of the new procedures are said to be:-

(1) A minimum of court supervision.

(2) Effort to keep costs to a minimum.

(3) Enhancing of creditors control.

(4) Emphasis on negotiation and agreement by the parties themselves to the terms of the plan.

(5) A plan may affect any debt, whether public or private, secured or unsecured and any equity interest, public or private.

(6) There is flexibility as regards trustee or debtor control.

(7) A creditors' committee takes an active role in the proceedings.

(8) Continuation of the business is the norm.

(9) The debtor, or the trustee, is vested with most of the powers of a trustee in bankruptcy including disclaiming onerous contracts, recovery of fraudulent preferences and avoidance of fraudulent transfers.

(10) There is an automatic stay on the commencement or continuation of almost all proceedings against the debtor and on the enforcement of all judgments and judicial or consensual liens. To obtain relief from the stay the secured party or creditor must apply to the court and show either that lifting the stay will not interfere with the administration of the estate, or that his interest is not adequately protected.

(11) The debtor or trustee may borrow money, for the purposes of the reorganisation, on "certificates of indebtedness". The certificates may be secured or unsecured but in any event they constitute an expense of the administration and in certain cases, subject to the court's approval may rank in priority to secured creditors.