

CREDITORS' RIGHTS AND BUSINESS RESTRUCTURING

ALERT

FEBRUARY 2021

New Bankruptcy Code Section Will Help Landlords and Suppliers & Their Tenants and Customers Affected by Covid-19

By Richard A. Barkasy and Kenneth R. Puhala

In the Consolidated Appropriations Act of 2021 (the "Act"), signed into law by President Trump on December 27, 2020, Congress reduced the risk for companies in working with businesses that have been negatively impacted by Covid-19. The Act allows landlords and suppliers of goods or services to enter into agreements to postpone payment by tenants or customers of past due amounts without concern that the late payments will later be clawed back as preferences under the Bankruptcy Code.

BACKGROUND

Preference liability has long been the scourge of those dealing with financially troubled businesses. In order to attempt to ensure that creditors with similar priority are treated equally in bankruptcy cases, Section 547 of the Bankruptcy Code allows the bankrupt business (or its Trustee) to claw back certain payments made within 90 days of the bankruptcy filing (one year if the payment is made to an "insider"), which funds are then shared with other creditors. If the payments are clawed back as preferences, the recipient is allowed an unsecured claim against the bankrupt company's estate for the clawed-back amount. However, since in most Chapter 11 bankruptcy cases, unsecured creditors receive only a small percentage of their claims, the recipient of preferential payments usually recoups only a fraction of the sum it has to return.

A payment may be clawed back as a preference if it: (a) is made by or on behalf of the bankrupt business; (b) on account of an antecedent debt, such as a past due invoice; (c) while the bankrupt company is insolvent; and (d) that allows the creditor to recover more than it would if the bankrupt company's assets were liquidated in a Chapter 7 bankruptcy.

However, to give creditors an incentive to continue to transact business with companies in financial distress with the hope that they will be able to avoid bankruptcy, the Bankruptcy Code provides certain defenses to preference liability. Under Section 547, a payment is not required to be returned if it is a "contemporaneous exchange for new value." The clearest example of a qualifying "contemporaneous exchange" is a COD payment.

There is also a "new value" defense that may be asserted. Under this exception, the amount of new credit extended by a creditor may generally be set-off against the amount of previous payments that would otherwise be considered preferential.

Perhaps the most commonly raised defense provided pursuant to Section 547 is for transactions that are within the "ordinary course of business" of the bankrupt company and the recipient of the allegedly preferential transfer, or are "made according to ordinary business terms." Lump-sum payments of deferred amounts or settlement payments received during the 90-day preference period are typically considered by courts to be outside of the ordinary course and are, therefore, not eligible for this defense. As a result, there is normally a clawback risk for creditors that want to enter into agreements to provide breathing room for struggling companies with whom they do business.

THE CONSOLIDATED APPROPRIATIONS ACT OF 2021

This clawback risk was eliminated for forbearance arrangements entered into during the pandemic. The Act created a new Section 547(j) to the Bankruptcy Code. Under this new provision, a bankrupt company

may not obtain the return as a preference of a payment for “rental arrearages” or “supplier arrearages.”

The exclusion for “rental arrearages” protects payments of arrearages “made in connection with an agreement or arrangement” between the bankrupt company and a landlord “to defer or postpone rent or other periodic charges.” This exemption only applies to leases of nonresidential real property. Additionally, the applicable agreement or arrangement must have been made on or after March 13, 2020. Further, the payment: (a) must not exceed the amount of rental or other periodic charges agreed to under the lease agreement signed before March 13, 2020; and (b) may not include fees, penalties or interest that are more than those allowed under the lease or that the bankrupt company would owe if it had made such payments on time in full before March 13, 2020.

The new carve out for “supplier arrearages” applies to payments of arrearages between the bankrupt company and “a supplier of goods or services to defer or postpone the payment of amounts due under an executory contract for goods and services.” As with nonresidential real property leases, the deferral agreement or arrangement must have been made or entered into on or after March 13, 2020. The limitations on the amount of the payment and fees, penalties and interest are also the same as those addressing covered leases.

The new provisions of Section 547(j) expire on December 27, 2022. However, they will continue to apply to bankruptcies filed prior to the sunset date.

TAKEAWAYS

The Act should benefit the economy and save jobs by encouraging creditors to assist tenants and customers as they try to navigate their way through the financial pressures resulting from Covid-19. It should also increase the recovery of creditors who agree to postpone payments during the pandemic by helping to keep their tenants and customers out of bankruptcy and by shielding deferred payments from clawback if they ultimately have to seek bankruptcy protection.



This summary of legal issues is published for informational purposes only. It does not dispense legal advice or create an attorney-client relationship with those who read it. Readers should obtain professional legal advice before taking any legal action.

For more detailed analysis on a wide range of legal issues, please see Schnader’s Covid-19 Resource Center at <https://www.schnader.com/blog/covid-19-coronavirus-resource-center/>.

For more information about Schnader’s Creditors’ Rights and Business Restructuring Practice Group, or to speak with a member of the firm, please contact:

*Richard A. Barkasy
Chair, Creditors’ Rights and Business Restructuring
Practice Group
215-751-2526
rbarkasy@schnader.com*

*Kenneth R. Puhala
Partner
212-973-8140
kpuhala@schnader.com*

www.schnader.com

© 2021 Schnader Harrison Segal & Lewis LLP
All rights reserved.

* See: www.schnader.com/jakarta