The Recent COVID-19 Legislation's Bankruptcy Code Amendments of Interest to Trade Creditors

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Like everyone, trade creditors are counting the days toward a restoration of normalcy as we can see the approaching light at the end of the COVID-19 tunnel. It cannot come soon enough, as the pandemic has caused economic challenges that have plagued many businesses spread across numerous industries over the past year. In order to help combat these challenges, on December 27, 2020, the President signed the Consolidated Appropriations Act of 2021 (the "CAA"). The CAA is a $2.3 trillion spending bill that combines $900 billion in relief intended to mitigate the adverse effects of the COVID-19 pandemic in the United States with a $1.4 trillion omnibus spending bill for the 2021 federal fiscal year.

The CAA includes a number of temporary amendments to the Bankruptcy Code that are intended to provide specific forms of relief for debtors that file for bankruptcy protection over the coming years, and for certain of their creditors, including trade creditors. Unless extended by Congress, many of these amendments will sunset on December 27, 2022, while applying to any bankruptcy case filed prior to that date.

This article discusses certain of the CAA's Bankruptcy Code amendments that will affect trade and other creditors' rights.

Section 547(j) – The New Preference Exception

The CAA amendment to the Bankruptcy Code of most interest to trade creditors is a new exception to preference liability. The CAA temporarily amended Section 547 of the Bankruptcy Code ("Section 547") to include a new Section 547(j) that shields from preference liability a "covered payment" of supplier or rental arrearages made pursuant to an "agreement or arrangement" entered into on or after March 13, 2020 to defer certain amounts owed under an "executory contract" or a nonresidential real property lease. The new covered payment exception to preference liability applies to bankruptcy cases filed before December 27, 2022 and sunsets for bankruptcy cases filed on and after December 27, 2022 (unless extended by Congress).

(i) Background on Preferences and the "OCB" Defense

As creditors have unfortunately experienced, a bankruptcy trustee or debtor-in-possession can avoid as preferences certain payments that a debtor made to its creditors within the 90 days preceding the debtor's bankruptcy filing. These "preference" payments can be recovered if the plaintiff proves all of following elements set forth in Section 547(b) of the Bankruptcy Code: (i) the debtor transferred its property to or for the benefit of a creditor, such as a debtor making a payment from its bank account; (ii) the transfer was made on account of antecedent or existing indebtedness a debtor owes to a creditor, such as outstanding invoices for goods sold and delivered to, and/or services rendered by, the creditor to the debtor; (iii) the transfer was made when the debtor was insolvent, based on a balance sheet definition of liabilities exceeding assets (with insolvency being presumed during the 90 day preference period); (iv) the transfer was made within 90 days of the debtor's bankruptcy filing (in the case of a transfer to a non-insider creditor, such as a trade creditor; with respect to insiders, the reach-back period is one year); and (v) the transfer enabled the creditor to receive more than the creditor would have received in a Chapter 7 liquidation of the debtor.

One of the most frequently invoked preference defenses is the "ordinary course of business"—or "OCB"—defense. The OCB defense reduces the creditor's preference exposure to the extent that the creditor can prove that an alleged preference had paid a debt that the debtor had incurred in the ordinary course of business between the debtor and creditor and was made either (i) in the ordinary course of business between the creditor and debtor, or (ii) according to ordinary business terms.

Unfortunately, a creditor that acts as a "good Samaritan" by deferring the due date of a financially distressed customer's outstanding invoices may later suffer unintended consequences if the customer files for bankruptcy protection and a trustee asserts a preference claim against the creditor. The creditor's deferral of the deadline for its financially distressed customer's payment of outstanding invoices prior to the customer's bankruptcy filing—say, for example, to provide breathing room for a customer adversely impacted by the COVID-19 pandemic—may seriously expose the creditor to increased preference liability. Giving credence to the old adage that no good deed goes unpunished, the good Samaritan creditor risked the loss of the OCB defense because the creditor's agreement to stretch out the due dates of the distressed customer's invoices may have been outside of the creditor's and customer's ordinary course of business. The "covered payment" exception to preference liability that the CAA had added to the Bankruptcy Code is designed to remedy this unfair and unintended consequence. However, whether the covered payment exception actually protects trade creditors that lend a helping hand to their distressed customers remains to be seen.

(ii) The "Covered Payment" Exception & Questions It Raises

The CAA adds a new exception to preference liability, codified in temporary new subsection 547(j). Section 547(j) states that a trustee or debtor-in-possession may not avoid a transfer under Section 547 for "*a covered payment of supplier arrearages*."[1] Under this new statute, a "covered payment" of supplier arrearages is a payment of arrearages in connection with "an agreement or arrangement . . . made or entered into on or after March 13, 2020" to defer or postpone amounts that a debtor owes a supplier of goods or services under an executory contract. A covered payment cannot include fees, penalties, or interest in an amount greater than what is scheduled to be paid under the contract or than what the debtor would have owed had the debtor fully made every payment due under the contract before March 13, 2020. Also, the payment of arrears must "not exceed the amount due under the executory contract . . . before March 13, 2020."

The new "covered payment" exception set forth in Section 547(j) is not the height of clarity and may raise more questions than it actually answers:

- ***Who holds the burden of proof under Section 547(j)?*** Section 547(j) directly amends Section 547(b), the subsection that lists the elements of proof that a trustee must satisfy to avoid and recover a preference claim, rather than amending Section 547(c), the subsection that lists the affirmative defenses to a preference claim. As a result, the burden arguably rests on a trustee to prove that alleged preference payments are not "covered payments" as part of its preference action. However, a trustee will likely argue that the creditor has the burden of proving that the preference payments are "covered payments" as an additional affirmative defense to preference liability. And, in any event, in practice the creditor might be stuck with having to prove the applicability of the "covered payment" exception since the creditor likely possesses much of the factual support for a "covered payment" argument.

- ***What constitutes an "agreement or arrangement" under Section 547(j)?*** The covered payment exception only applies to an "agreement or arrangement" to defer payments that a distressed customer owes a creditor. An "arrangement" may presumably include informal modes of a creditor deferring the due dates of invoices—such as a creditor's e-mail to its customer, an oral understanding between the creditor and the customer, or perhaps even a handshake agreement. However, in light of the uncertainty over what factors the courts will consider when deciding whether an "agreement or arrangement" exists, the best practice for a creditor seeking to invoke the covered payments exception to preference liability would be to memorialize any deferral of invoice due dates in a written, executed agreement.

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1 The CAA also added new Section 547(j)(2)(A), which provides that a trustee or debtor-in-possession may not avoid a "covered payment of rental arrearages" under a nonresidential real property lease. This additional "covered payment" exception is substantially similar to the "covered payment of supplier arrearages" exception discussed in this article.

- ***Was the payment made pursuant to an "executory contract"?*** The covered payment exception appears to protect trade creditors from only payments made pursuant to an "executory contract."[2] That could drastically limit the availability of the exception where the creditor and its customer are not parties to an executory contract. Executory contracts include supply contracts, consignment agreements and long-term purchase orders. This suggests that payments on account of the provision of goods or services under individual short-term purchase orders, or less formal arrangements, are not "covered payments" and are subject to increased preference risk because they are not payments under an executory contract. Creditors should be mindful of whether their extensions of credit terms are being made pursuant to an agreement that would be considered an executory contract, and be prepared to end up litigating over whether that agreement is, in fact, an executory contract.

- ***Can fees, penalties, or interest ever qualify as a "covered payment" and, conversely, does seeking such additional charges jeopardize the covered payment exception entirely?*** Section 547(j) states that fees, penalties, or interest cannot exceed what "the debtor would owe if the debtor had made every payment due . . . on time and in full before March 13, 2020." This language could be construed to entirely preclude these charges under any new agreement or arrangement from being protected as covered payments as, by definition, these amounts would be in addition to the base amounts due and owing before March 13, 2020. Unless the underlying executory contract includes a provision authorizing fees, penalties or interest, it is hard to imagine what fees, penalties, or interest would be owed under an executory contract if the debtor were current as of March 13, 2020. Also, to the extent that a creditor's charging of fees, penalties, or interest constitutes a violation of Section 547(j)'s parameters, it is unclear whether that violation results in the creditor being unable to assert the covered payment exception solely with respect to the additional charges at issue (i.e., the creditor may still enjoy partial coverage for the exception), or whether the violation precludes the creditor from invoking the exception entirely.

- ***What is the meaning of the requirement that the payment of arrears must "not exceed the amount due under the executory contract . . . before March 13, 2020"?*** This may be the most important question of all, as the answer to it will drastically impact the ultimate impact of the covered payment exception. Congress clearly intended to draw some line in the sand at the start of the COVID-19 pandemic and related economic shutdowns (i.e., March 13, 2020)—but where exactly is that line? Perhaps the March 13, 2020 limitation only means that the agreement or arrangement cannot add additional recurring charges (such as late fees, interest or other charges) that would not have been incurred under the initial underlying executory contract prior to March 13, 2020. However, this interpretation would make the aforementioned limitation of fees, penalties, and interest largely duplicative. Another narrower interpretation is that the covered payment exception is only applicable to the extent of any amounts that were outstanding as of March 13, 2020, and not to any claims incurred on or after March 13, 2020. Finally, the narrowest interpretation is that the covered payment exception can be applied only to payments of arrears that were actually outstanding as of March 13, 2020. This interpretation would all but entirely pull the teeth out of the covered payment exception and significantly undermine the exception's purpose, since it would preclude a creditor from asserting the exception with respect to any arrears that arose after the start of the COVID-19 pandemic, i.e., March 13, 2020. Also, both of the latter narrower interpretations would preclude the covered payment exception from applying to payments of arrears owing under executory con¬tracts that were entered into on and after March 13, 2020 since it is impossible for there to have been any amounts owing before March 13, 2020 had the executory contract not even existed yet.

In sum, a creditor seeking to invoke the covered payment exception should be cognizant of the uncertainties created by the newly enacted and less than clear Section 547(j). It is important to stay tuned as the courts weigh in and answer some of the above questions when tasked with determining the extent and applicability of

2 The most widely used definition of an "executory contract" is the Countryman definition, that an executory contract is one under which both parties to the contract have unperformed obligations such that the failure of either party to continue or complete performance would constitute a material breach that excuses the other party from performance.

the covered payment exception to preference liability.

Section 364 – PPP Loans

The Coronavirus Aid, Relief and Economic Security Act (the "CARES Act"), enacted on March 27, 2020, established the famous Paycheck Protection Program ("PPP"), which provides eligible businesses with the opportunity to obtain guaranteed loans ("PPP loans") that could ultimately be forgiven so long as the loan proceeds are used to cover qualifying operating expenses. However, the CARES Act is silent as to whether debtors filing for bankruptcy are eligible borrowers to obtain PPP loans. As a result, courts have reached conflicting decisions on a bankruptcy debtor's eligibility for PPP loans, and the Small Business Administration (the "SBA"), which administers the PPP, has generally denied debtors' requests for PPP loans. Congress sought to remove this roadblock through the CAA's amendment of Bankruptcy Code section 364 to provide that "small business" debtors[3] would be eligible to obtain PPP loans only in the event that the SBA Administrator sends a letter to the Director of the Executive Office for United States Trustees approving the availability of PPP loans in bankruptcy cases. As of the date this article was written, it is unclear whether and when PPP loans will be available to debtors in bankruptcy since the SBA Administrator has not provided confirmation of such authorization. This CAA amendment is currently scheduled to sunset on December 27, 2022, unless extended by Congress.

Section 365(d) – Amendments Relating to Commercial Real Property Leases

As illustrated in the Chapter 11 cases of well-known companies like Pier 1 and Modell's Sporting Goods, the COVID-related economic shutdowns that commenced in March 2020 raised a major hot-button issue as to whether and to what extent a debtor is required to pay post-petition rent and other obligations to its landlord where the government had shut down or limited the operation of a debtor's business and the debtor was, therefore, unable to utilize the leased premises. Moreover, even if a debtor could utilize the premises, the debtor likely still had difficulty paying post-petition rent and other obligations due to the substantially reduced demand caused by the pandemic. Bankruptcy courts' hands were potentially tied because Bankruptcy Code Section 365(d) grants a debtor a grace period of up to only 60 days after the bankruptcy filing date to pay post-petition rent and also explicitly requires the debtor to perform all commercial lease obligations after that 60-day period. In response, the CAA amended Section 365(d)(3) to extend the grace period by an additional 60 days, to 120 days altogether, for small business debtors facing pandemic-related hardship to pay post-petition rent and perform all their other post-petition obligations under the lease.

Additionally, the CAA amended Section 365(d)(4) to extend the deadline for a trustee or debtor in possession to assume or reject its commercial real estate lease by an additional 90 days, for a total of 210 days, from the commencement of the applicable Chapter 11 case as a matter of course. The debtor can then seek an additional 90-day extension of the time to assume or reject commercial leases, for a total of 300 days after the bankruptcy filing, if the debtor can show "cause" for the additional 90-day extension. Extensions beyond that require the consent of the applicable landlord.

These provisions sunset for bankruptcy cases filed on and after December 27, 2022, unless extended by Congress.

Conclusion

Navigating the choppy waters of a customer's insolvency or bankruptcy 11 filing can be extremely challenging, particularly given the apparent fluidity of the Bankruptcy Code and related law. The CAA's amendments to the Bankruptcy Code were designed to help creditors extending a helping hand to their financially distressed customers adversely affected by the COVID-19 pandemic. While Congress had the best intentions, the CAA's amendments to the Bankruptcy Code will ultimately be subject to the interpretation of the courts—particularly with respect to Section 547(j), as its less than clear language raises a number of questions. As a result, it may be a while before creditors can confidently assess the extent to which they will be impacted, and hopefully protected, by the CAA's amendments.

3 Currently, a "small business" debtor is a debtor with aggregate debt of $7.5 million or less, thanks to an amendment to the Bankruptcy Code made by the CARES Act that raised the maximum debt threshold from $2,725,625. The CARES Act's amendment will sunset on March 27, 2021, unless extended by Congress. To that end, a bipartisan pair of U.S. senators, Senators Durbin (D-Ill.) and Grassley (R-Iowa), have introduced the COVID-19 Bankruptcy Relief Extension Act, which, if passed, would extend for one year (through March 27, 2022) the bankruptcy-related provisions of the CARES Act that are currently due to expire on March 27, 2021.

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