Secured Lenders, Bondholders and Retail Debtors Lose, Landlords and Trade Vendors Win, Under Proposed Bankruptcy Code Revisions

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, passed by the U.S. Senate on March 10, 2005 and reported to be on a fast track for enactment into law, is not limited to consumer bankruptcies.

The proposed act creates new obstacles for lenders financing retail borrowers. The act's provisions for the benefit of landlords and trade vendors will increase costs for bankruptcies of retail borrowers, and hinder the sale of valuable lease designation rights and store locations to repay debt.

In a change helpful to landlords, the bankruptcy court may not allow a debtor to assume or reject commercial real estate leases beyond 210 days after the bankruptcy filing date. In a typical Chapter 11 case, a retail debtor requires a much longer period to maximize the value of its store leases: several months to formulate a business plan and to decide on an optimal schedule for store closings, and significant subsequent time to conduct store liquidation sales and to market store leases for sale to other retailers. In many cases, Chapter 11 retailers prefer to sell lease designation rights -- the right of a third party to sell particular leases at a future date. A purchaser of lease designation rights needs an extended period of time to market and sell the leases. The new 210-day deadline for lease assumption will constrain the ability of retail debtors to sell lease designation rights and will reduce the value of real estate leases as assets available for sale.

Trade vendors will also benefit at the expense of lenders to a retail borrower. The proposed act grants a new administrative priority claim to trade vendors for payment of goods received by the borrower up to 20 days <u>before</u> a Chapter 11 case is filed. In addition, trade vendors will be entitled to assert reclamation claims to recover goods received by an insolvent borrower within 45 days <u>before</u> the bankruptcy filing date. As a result, vendors will be able to increase realization of their prepetition claims in Chapter 11 cases. The effect of this change will be to shift more of the losses in a reorganization to bondholders and secured lenders. This change will also increase the retail borrower's cash requirements to be financed through debtor-in-possession financing or cash collateral orders.