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FOULSTON SIEFKIN ISSUE ALERT
BANKRUPTCY

Bankruptcy Reform: Certain Provisions Effective as of April 20, 2005

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On April 20, 2005, President Bush signed into law The Bankruptcy Abuse Prevention & Consumer Protection Act (the "Act"). The Act represents the most sweeping change to the United States bankruptcy system since the enactment of the 1978 Bankruptcy Code (the "Code"). While most provisions of the Act do not become effective until 180 days after enactment, there are significant exceptions that became effective immediately upon enactment. The exceptions include limitations on a debtor's ability to exempt his or her homestead in bankruptcy and the repeal of the Deprizio insider preference rule.

Homestead Limitations

Under the Code, States can opt out of the federal bankruptcy exemptions and apply their state exemptions in bankruptcy. Kansas opted out of the federal exemptions and applies its state exemptions in bankruptcies filed in Kansas by Kansas residents.

Kansas is still one of approximately seven states that still have no dollar limitation on the value of a debtor's exempt homestead. In Kansas, an individual may exempt one acre used as the debtor's principal residence located within an incorporated city, or if the debtor resides outside of a city, 160 contiguous acres of farming land used as the debtor's principal residence.

Under the Act, debtors may elect the state homestead exemption of the state in which the debtor has lived for 730 days (increased from 180 days under the current Code) prior to the filing of a bankruptcy. If the debtor has moved to a different state during the 730-day period, the applicable state homestead exemption is the state in which the debtor resided for the majority of the time for the 180 days before the 730-day period.

While states are still permitted to opt out of the federal exemptions under the Act, the Act imposes a restriction on the value of a homestead that a debtor can exempt in bankruptcy notwithstanding the state exemption under certain circumstances. The Act provides that a debtor may not exempt any amount of the debtor's interest in a homestead exceeding $125,000 that was acquired within 1,215 days prior to filing bankruptcy. The calculation of the $125,000 cap does not include any equity that has been rolled over during the 1,215 day period from one house to another within the same state. This provision was intended to prevent debtors from moving from a state that has a limited homestead exemption to a state that provides a more favorable exemption on the eve of filing bankruptcy, and to prevent debtor's residing in states like Kansas, that do not currently limit the value of the homestead exemption from increasing the value of their homestead on the eve of filing bankruptcy.

The $125,000 cap in the Act does not apply to the principal residence of the family farmer (as defined in the Act) which otherwise qualifies for the homestead exemption.

Under the Act, debtors who have violated securities laws or engaged in certain criminal conduct specified in the Act are limited to a maximum $125,000 interest in a homestead without regard to whether the debtor increased his or her interest in the homestead during the 1,215 day period before the bankruptcy filing.

To the extent that a debtor's interest in a homestead was obtained through the sale or other disposition of non-exempt assets during the 10 year period before the bankruptcy filing for the purpose of hindering, delaying or defrauding creditors, the exemption is reduced by the amount attributed to the fraud. This provision may make it more difficult for debtors to sell non-exempt assets to pay down the mortgage on their homestead prior to filing bankruptcy.

These provisions apply to all cases filed on or after April 20, 2005.

DePrizio Insider Preference Repeal

The elements of a preferential transfer that may be voided by a bankruptcy trustee or debtor in possession are a transfer of property of the debtor: to or for the benefit of a creditor; on account of an antecedent debt; made while the debtor was solvent; within 90 days before the debtor's bankruptcy or within one year if the transferee is an insider of the debtor; that enabled the creditor to receive more than the creditor would receive in a Chapter 7 liquidation had the transfer not been made.

The Deprizio insider preference rule was established in and named after a Chapter 7 bankruptcy filed by V.N. Deprizio Construction Co ("Deprizio"). In Deprizio, the court extended the one-year look-back period for insider preferences to transfers made to a non-insider creditor. Simply stated, the Deprizio insider preference rule provides that if a debt incurred by a debtor has been guarantied by a third party who is an insider of the debtor, then any payment made by the debtor on the debt or any transfer of collateral made by the debtor to secure the debt benefits the insider by reducing the insider's exposure on its guaranty. The insider guarantor is considered a creditor of the debtor by virtue of its contingent claim for indemnity against the debtor. The Deprizio insider preference rule permitted bankruptcy trustees to recover payments made by the debtor to banks or other non-insider creditors made within one year of the debtor's bankruptcy filing, if the debtor's debt to the non-insider was guarantied by an insider of the debtor.

As a result of extensive criticism of the application of the Deprizio rule, Congress attempted to legislatively repeal this rule in 2001 by amending Section 550(c) of the Bankruptcy Code to provide that the trustee who avoided an insider preference could not "recover" the property transferred or the value of the property transferred from the non-insider transferee. Unfortunately Congress' 2001 attempt to repeal Deprizio largely failed. Many commentators and some courts interpreted the 2001 repeal to apply only to a trustee's attempt to recover funds paid to the non-insider creditors and trustee's attempts to recover property, the ownership of which was transferred to the non-insider creditor. These commentators and courts reasoned that the 2001 repeal did not prevent a trustee from avoiding a mortgage or security interest granted by a debtor to the non-insider because the avoiding of the lien did not require the trustee to recover funds or the title to property from the non-insider creditor.

As a result of the ineffectiveness of the 2001 repeal, in the Act Congress has again attempted to repeal Deprizio as it applies to non-insider creditors and appears to have been successful. The Act adds a new subsection (i) to Section 547 of the Bankruptcy Code that provides that if the trustee avoids a transfer made to a non-insider between 90 days and one year before the debtor's bankruptcy filing, the transfer shall be considered avoided only with respect to the insider creditor. This new provision of the Act should effectively limit the non-insider creditor's risk of having its lien avoided as a preference to a period of 90 days prior to the debtor's bankruptcy filing rather than for a year as was the case under the Deprizio rule.

The repeal of the Deprizio Rule under the Act applies to all cases which were pending on, filed on or filed after April 20, 2005.

For Further Information

Foulston Siefkin regularly counsels clients on issues relating to Creditors' Rights Law. If you are interested in additional information regarding the bankruptcy reform, please visit our website at **www.foulston.com** or if you would like to discuss specific ways in which the author can help you, call **Terry C. Cupps** at (316) 291-9504, or email him at tcupps@foulston.com.

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