

An Overview of the 2005 Bankruptcy Act

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The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the “Act”) has now become law. While the Act principally focuses on consumer and small business¹ bankruptcy issues, it also includes significant changes to the Bankruptcy Code affecting large corporate Chapter 11 cases. With some exceptions, the Act generally has prospective application only – applying to cases commenced more than 180 days after its enactment.

The following is an overview of the Act as it relates to large Chapter 11 cases:

1. Debtors’ Exclusive Period: The Act amends Bankruptcy Code §1121(d) by imposing a “drop dead” date on a debtor’s exclusive right to file a plan. Currently, a debtor has the exclusive right to (i) file a plan within the first 120 days of a case and (ii) obtain acceptance of such plan within the first 180 days. These periods may, however, be extended or reduced for cause shown. There is no express limitation on the number or duration of such extensions and courts have broad discretion in granting such motions. In general, debtors have been more successful in obtaining extensions than parties in interest have been in reducing or terminating exclusivity. For example, the *United Airlines* bankruptcy case has celebrated its two-year anniversary in Chapter 11 and the debtors retain exclusivity. The current balance favors secured and DIP lenders, which, more often than not, support the stability of a debtor in possession retaining the exclusive right to file a plan, over other parties in interest, such as unsecured creditors committees, unions and the PBGC, which are more often than not advocating a termination of exclusivity as a perceived negotiating advantage. Pursuant to the Act, the balance may shift when exclusivity ends at 18 months and 20 months, respectively. The Act provides:

- (A) The 120-day period specified in paragraph (1) may not be extended beyond a date that is 18 months after the date of the order for relief under this chapter.
- (B) The 180-day period specified in paragraph (1) may not be extended beyond a date that is 20 months after the date of the order for relief under this chapter.

The court still has broad discretion to extend or terminate the debtor’s original exclusive periods, but now only up to the 18-month anniversary of the case. As discussed below, other than in a small business case, this revision does not require a

¹ Small Business bankruptcies concern non-real estate businesses with liquidated secured and unsecured debts of not more than \$2 million. Consumer and small business changes are beyond the scope of this discussion.

debtor to file or confirm a plan within a specified period of time, nor does it require dismissal or conversion of the case if the debtor fails to file and confirm a plan within the exclusive periods but is otherwise able to file and confirm a plan within a reasonable period of time. Even though these finite exclusive periods do not require the filing and confirmation of a plan by the end of the 18- and 20-month periods, they do serve to place added pressure on a debtor to file a plan before it is otherwise ready in order to avoid the distraction and cost associated with opposing competing plans.

To the extent that DIP Lenders and Pre Petition Secured Lenders are concerned about the ability of a debtor to file and confirm a plan within the 18- and 20-month periods and the consequential loss of control over the plan process, consideration may be given to:

- (i) limiting the term of any DIP loan or cash collateral use to not more than 18 months so that it can be determined whether a feasible plan can be proposed by the debtor which will satisfy all DIP and adequate protection obligations; and
- (ii) in an appropriate case, where tighter controls are necessary, including a covenant and/or DIP order provision requiring the approval of a disclosure statement, the filing of a plan and entry of a confirmation order by dates certain which provide an opportunity for negotiation and amendments prior to the expiration of the exclusive periods.²

2. Conversion and Dismissal: Related to the changes discussed in Section 1 above, the Act may increase the risk of conversion or dismissal if a party in interest demonstrates cause (as defined in the statute) in support of a motion to convert or dismiss. The debtor must now demonstrate “unusual circumstances” to establish that conversion or dismissal is not in the best interests of creditors and the estate, including that there is a reasonable likelihood that a plan will be confirmed within a reasonable period of time.³

The Act strikes in its entirety Bankruptcy Code §1112(b), which provided the court with broad discretion to grant or deny a motion to convert or dismiss. Bankruptcy Code §1112(b) provided:

on request of a party in interest or the United States Trustee or bankruptcy administrator, and after notice and a hearing, the court may convert a case under this chapter to a case under chapter 7 of this title or may dismiss a

² Such a provision is likely to trigger substantial challenge by creditors committees and the U.S. Trustee.

³ The language in Bankruptcy Code §1112(b)(2), which appears to require dismissal or conversion if a plan has not been filed within the exclusive periods, refers to small business cases only.

case under this chapter, whichever is in the best interest of creditors and the estate, for cause

In its place, the Act inserts, in relevant part:

(b)(1) Except as provided in paragraph (2) of this subsection, subsection (c) of this section, and section 1104(a)(3), on request of a party in interest, and after notice and a hearing, absent unusual circumstances specifically identified by the court that establish that the requested conversion or dismissal is not in the best interests of creditors and the estate, the court shall convert a case under this chapter to a case under chapter 7 or dismiss a case under this chapter, whichever is in the best interests of creditors and the estate, if the movant establishes cause.

(2) The relief provided in paragraph (1) shall not be granted absent unusual circumstances specifically identified by the court that establish that such relief is not in the best interests of creditors and the estate, if the debtor or another party in interest objects and establishes that—

(A) there is a reasonable likelihood that a plan will be confirmed within the timeframes established in sections 1121(e) and 1129(e) of this title, or if such sections do not apply, within a reasonable period of time

(3) The court shall commence the hearing on a motion under this subsection not later than 30 days after filing of the motion, and shall decide the motion not later than 15 days after commencement of such hearing, unless the movant expressly consents to a continuance for a specific period of time or compelling circumstances prevent the court from meeting the time limits established by this paragraph.

(4) For purposes of this subsection, the term “cause” includes—

(A) substantial or continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation;

(B) gross mismanagement of the estate;

(C) failure to maintain appropriate insurance that poses a risk to the estate or to the public;

(D) unauthorized use of cash collateral substantially harmful to 1 or more creditors;

(E) failure to comply with an order of the court;

(F) unexcused failure to satisfy timely any filing or reporting requirement established by this title or by any rule applicable to a case under this chapter;

- (G) failure to attend the meeting of creditors convened under section 341(a) or an examination ordered under rule 2004 of the Federal Rules of Bankruptcy Procedure without good cause shown by the debtor;
- (H) failure timely to provide information or attend meetings reasonably requested by the United States trustee (or the bankruptcy administrator, if any);
- (I) failure timely to pay taxes owed after the date of the order for relief or to file tax returns due after the date of the order for relief;
- (J) failure to file a disclosure statement, or to file or confirm a plan, within the time fixed by this title or by order of the court;
- (K) failure to pay any fees or charges required under chapter 123 of title 28;
- (L) revocation of an order of confirmation under section 1144;
- (M) inability to effectuate substantial consummation of a confirmed plan;
- (N) material default by the debtor with respect to a confirmed plan;
- (O) termination of a confirmed plan by reason of the occurrence of a condition specified in the plan; and
- (P) failure of the debtor to pay any domestic support obligation that first becomes payable after the date of the filing of the petition.

These modifications raise the potential for substantial mischief. For example, cause now includes the “failure to file a disclosure statement, or to file or confirm a plan, within the time fixed by this title or by order of the court,” rather than the “inability to effectuate a plan.” Again, while the failure to file and confirm a plan within the now finite exclusive periods should not constitute cause in and of itself, new subdivision (J) appears to be a lower threshold for establishing “cause” than the previously required showing of “inability to effectuate a plan.” Assuming, however, that a moving party is able to establish cause based upon some combination of factors, including the failure to file and confirm a plan within the exclusive periods, will “unusual circumstances” be established if the debtor demonstrates that it is working with an investor or buyer or is in serious negotiations with various creditor constituencies and expects to promptly file and confirm a plan? The new standard of “unusual circumstances” is not defined in the Act. Since the phrase does not appear in the Bankruptcy Code, it has not been defined by case law. Thus, the import of the provision is, at best, uncertain.

Accordingly, revised §1112 may pose an increased risk of conversion or dismissal for creditors, including DIP Lenders. Currently, DIP orders grant broad protections to DIP Lenders in the case of a dismissal or conversion by, among other things, providing that (i) a motion by the debtor to convert or dismiss or the entry of an order converting or dismissing a case shall constitute an event of default; (ii) pursuant to Bankruptcy Code §§105 and 349, any order dismissing a case shall preserve the liens claims and obligations established by the DIP order until satisfied in full; and (iii) the bankruptcy court shall retain jurisdiction, to the maximum extent permitted by law, to enforce the prior orders with respect to DIP and adequate protection obligations. However, these provisions have not been seriously contested in the courts and there is authority for the proposition that, upon dismissal of a case, the bankruptcy court loses its jurisdiction, property reverts to the debtor and creditors are left to their own devices. In *In re Western Pacific Airlines, Inc.*, 218 B.R. 590 (Bankr. Ct. 1998), the bankruptcy court denied a motion to dismiss a chapter 11 case which was being run essentially for the secured lenders and the DIP Lender on the ground that dismissal would undermine the bargained-for rights of the DIP Lender as set forth in the financing order and could serve as a precedent to dissuade future post-petition lenders from extending credit to debtors in possession based upon an order of the bankruptcy court. While a good result, the case highlights the risks in the event of a dismissal.⁴

Clearly, the risk of dismissal currently exists. However, practice has demonstrated that dismissal of large Chapter 11 cases is rare. To the extent that revised §1112 increases the risk of dismissal, the attendant risks to DIP Lenders being left to enforce the provisions of a DIP order in a state court are increased.

3. Forward Contracts, Repurchase Agreements, Swap Agreements, Etc.: In addition to expanding existing definitions to include such products as commodity transactions, equity swaps, total return swaps and weather derivatives, the Act builds into the Bankruptcy Code protections for master netting agreements that parallel the protections already in place for swap and master agreements.

The Act defines a master netting agreement as “an agreement providing for the exercise of rights, including rights of netting, setoff, liquidation, termination, acceleration, or close out” under or in connection with one or more qualifying agreements,⁵ and includes a definition of a “master netting agreement participant” as an entity that, on a pre-petition basis, “is a party to an outstanding master netting agreement with the debtor.”

⁴ For example, following dismissal, while the liens granted to a DIP Lender would be valid liens, since such liens would have been granted and/or perfected subsequent to the pre-petition liens, applicable state law may not recognize the priming priority granted under the Bankruptcy Code. Similarly, administrative claims granted during the bankruptcy would be general unsecured claims outside of bankruptcy. In the case of a subsequent bankruptcy filing, new DIP liens and administrative claims may further subordinate the liens and claims granted in prior bankruptcy cases.

⁵ Qualifying agreements are defined in the amended §561 to be securities contracts, commodity contracts, forward contracts, repurchase agreements, swap agreements and master netting agreements.

As commonly understood, a “master netting agreement” is a blanket agreement (much like a master swap agreement) which lays out the rules for, among other things, close-out and setoff of the positive and negative balances with respect to underlying contracts specified within the master netting agreement. Its primary purpose is to mitigate the aggregate credit exposure of counterparties to each other across multiple products.⁶ An example of such an agreement is The Bond Market Association’s Cross-Product Master Netting Agreement.

The new provisions with respect to master netting agreements should bring greater certainty to counterparties relying on risk-reducing netting agreements and are designed principally to (a) exclude from the §362 automatic stay provisions the setoff by a master netting agreement participant of a “mutual debt and claim” under or in connection with one or more master netting agreements or any contract or agreement subject to such master netting agreements and (b) make inapplicable the §365(e)(1) prohibition on *ipso facto* clauses to the extent included in master netting agreements.

The Act does not resolve the question as to whether cross-product close-out netting and setoff among affiliates party to a master netting agreement (with all such affiliate parties themselves being debtors) falls within the definition of master netting agreement and, therefore, benefits from the proposed exclusions from §§362 and 365(e).

4. Executory Contracts/Leases: The Act modifies the treatment of executory contracts and claims related thereto under Bankruptcy Code §§365 and 503(b) in several respects.

First, the Act expressly requires that if there has been a monetary or nonmonetary default in an executory contract or unexpired lease of real property, the debtor must cure the default or give adequate assurance that the default will be cured (except nonmonetary defaults in executory contracts which are impossible to cure and nonmonetary defaults in leases of real property which are cured by performance post-assumption). One of the implications of the Act is that landlords will have an administrative claim against the estate for the cost to cure nonmonetary defaults (such as repairs, etc.) upon the debtor’s assumption of a lease. Under the pre-amendment Bankruptcy Code, debtors have successfully argued that only monetary defaults must be cured, and assignees that did expressly assume such obligations have successfully argued that they were not obligated to cure debtors’ defaults (monetary or nonmonetary), leaving landlords to bear the costs. See, e.g., *In re Bankvest Capital Corp.*, 360 F.3d 291 (1st Cir.), *cert. denied*, 124 S. Ct. 2874 (2004). Landlords convinced the drafters of the Act that this needed to be fixed. As a practical matter, this change should not have a dramatic impact on the assumption process. To the extent, however, that this represents a change in the way that nonmonetary defaults are resolved, it may result in a reduction of proceeds available for

⁶ Some market participants have expanded the scope of master netting agreements to include netting across products among affiliates, further enhancing the benefits of reduced credit exposure between families of companies and counterparties.

creditors. Assignees that assume the liability will certainly seek a price adjustment and estates that assume the liability now must satisfy an administrative claim.

Second, the time for a debtor to decide whether to assume or reject nonresidential real property leases is curtailed. Bankruptcy Code §365 provided that a debtor must assume a nonresidential real property lease within 60 days of the commencement of the case or, within such 60-day period, obtain an order extending the time to decide whether to assume or reject. There is no limit on the number or duration of extensions that may be granted. The failure to do either of the foregoing resulted in the deemed rejection of the lease and the surrender of the property. The practice in large cases involving numerous leases (e.g., *Kmart*) has been that debtors routinely obtain orders substantially extending the time to assume or reject – oftentimes through confirmation of a plan. In response to courts granting such extensions, the Act imposes an absolute 210 day “drop dead” date for debtors to assume as follows:

- (A) Subject to subparagraph (B), an unexpired lease of = nonresidential real property under which the debtor is the lessee shall be deemed rejected, and the trustee shall immediately surrender that nonresidential real property to the lessor, if the trustee does not assume or reject the unexpired lease by the earlier of—
 - (i) the date that is 120 days after the date of the order for relief; or
 - (ii) the date of the entry of an order confirming a plan.
- (B)
 - (i) The court may extend the period determined under subparagraph (A), prior to the expiration of the 120-day period, for 90 days on the motion of the trustee or lessor for cause, [and thereafter]
 - (ii) . . . the court may grant a subsequent extension only upon prior written consent of the lessor in each instance.

In cases where leases comprise a material component of the collateral package or are material to the going-concern value of the enterprise, a debtor may be forced to prematurely assume or reject leases without the benefit of a complete analysis or marketing effort. The net result may be that the estate will not fully realize the value of the collateral and/or the going-concern value of the reorganized entity may be impaired. In such cases, additional due diligence may be appropriate and consideration may be given to including additional provisions in the DIP Credit Agreement and/or the DIP Order such as:

- i) delivery of a lease assumption/rejection/assignment plan or budget prior to the expiration of the initial 120-day period, which plan must be acceptable to the lender;

- ii) a detailed budget of cure costs (both monetary and nonmonetary); and
- iii) required notice in the event lessors advise the debtors that they will not consent to extensions beyond 210 days

Third, in connection with the changes to assumption and assignment, the Act modifies Bankruptcy Code §503(b) to cap a claim which may be asserted if a real property lease is rejected subsequent to assumption. Former Bankruptcy Code §§365 and 503 required that, once assumed, all future obligations under the lease were granted administrative claim priority status (without a cap). Thus, a debtor now needs to be extremely cautious about which contracts it assumes. Given the truncated period for assumption of nonresidential real property leases under the Act, there may be insufficient time to exercise the care required. In recognition of this, the Act caps the administrative portion of the claim arising from assumption if there is a subsequent rejection.

New Bankruptcy Code §503(b)(7) caps the administrative claim at an amount equal to all monetary obligations due for the two-year period following the later of the rejection or the actual turnover of the premises. Other than amounts actually received on account of such premises from an entity other than the debtor, the estate has no right of setoff or reduction with respect to such amount. The balance of the former administrative claim gets treated as an unsecured lease rejection claim under Bankruptcy Code §502(b)(6), which is subject to a cap of its own.⁷

Finally, the Act mandates adherence to use, radius and exclusivity clauses.

5. Preferences: The Act modifies Bankruptcy Code §547(c), relating to the ordinary course of business defense for avoidance actions. Under the former section, to successfully assert such a defense, a defendant had to demonstrate that

- (A) the debt was incurred in the ordinary course of business or financial affairs of the debtor and the transferee and the transfer was
 - (i) made in the ordinary course of business or financial affairs of the debtor and the transferee; **and**
 - (ii) made according to ordinary business terms.

⁷ This cap is calculated as the lesser of (i) the amount due under the lease or (ii) the lesser of (x) the rent reserved under the lease, without acceleration, for one year (from the earlier of the petition date or the surrender date) or (y) 15% of the rent reserved under the lease, without acceleration, for the remaining term of the lease (from the earlier of the petition date or the surrender date), not to exceed three years; plus unpaid rent due under the lease without acceleration.

Thus, there had to be proof of both a subjective ordinary course (as between the debtor and the transferee) and an objective ordinary course (industry standard) to successfully assert the defense. (*See, e.g., In re M Corp.*, 44 B.C.D. 49 (Bankr. D. Del. 2005). The Act appears to ease the burden of proving the defense by substituting “or” for “and” as follows:

- (i) made in the ordinary course of business or financial affairs of the debtor and the transferee; **or**
- (ii) made according to ordinary business terms.

Pursuant to the Act, as long as the payment was made either in the ordinary course of business or financial affairs between the parties or according to ordinary business terms, it may be protected by the ordinary course defense. Thus, if the debtor and its creditor have a business practice that is ordinary for them but at odds with industry norms, an ordinary course defense may be successful.

This change may be positive for preference defendants, but potentially reduces recoveries by the estate.

6. Utilities: The Act modifies Bankruptcy Code §366, relating to adequate assurance that must be provided to utilities. Under former §366, debtors were required to provide adequate assurance to utilities to continue uninterrupted utility service. Such adequate assurance generally consisted of an agreement to allow an administrative claim to the extent of post-petition services provided, coupled with the assertion that such utilities had always been and will continue to be timely paid without the need for a security deposit.

Under the Act, unless otherwise agreed to by the utility, the granting of an administrative claim will not be deemed adequate assurance and the fact that no pre-petition security was provided will be irrelevant. Utility providers will have the right to discontinue service if, within 30 days of the commencement of the case, the debtor does not provide cash, a letter of credit, or such other form of security or adequate assurance as may be agreed to by the utility.

Thus, in addition to currently paying utility bills, debtors may be required to post additional collateral which, unlike an administrative claim, is likely to come ahead of both DIP Lender claims and liens and adequate protection obligations to secured lenders. DIP Lenders may need to consider:

- (i) modifying the definition of permitted liens or deposits to include utilities;
- (ii) conducting additional due diligence to determine the magnitude of utility costs;
- (iii) establishing an additional carveout in lieu of a deposit or security, such that the debtors agree to pay obligations in

the ordinary course but, upon the occurrence of an event of default, there is a carveout for utility expenses incurred;

- (iv) reduce availability by the amount of adequate assurance provided.

7. Reclamation: The Act amends Bankruptcy Code §546(c) with respect to a trustee's avoidance powers. The Code provides that a trustee's avoidance powers are subject to the rights of a seller of goods to reclaim such goods under applicable state law, provided that the demand is made in writing within 10 days of delivery of the goods to an insolvent entity. Generally, the Bankruptcy Code is consistent with state law in providing that the reclamation demand must be made within 10 days of the debtor's receipt of such goods (*see, e.g.*, N.Y. U.C.C. §2-702). The Act does not appear to create a substantive right of reclamation under federal law, but permits sellers to make reclamation demands under applicable statutory or common law with respect to goods delivered to an insolvent entity within 45 days before the commencement of a case, provided that the demand is made within 45 days of delivery or not later than 20 days after the commencement of the case if the 45-day period expired after the petition date.

Since there is no substantive reclamation right created under the Act, it is unclear whether this will have any immediate impact on cases. However, to the extent that states modify their reclamation statutes to conform to this 45-day period, the amendment could result in a material increase in reclamation claims that may be afforded administrative expense priority or be granted secured claims. Bankruptcy Code §546(c)(2) provides that a court may deny a valid reclamation demand only if the seller is granted either an administrative priority claim or a secured claim. As a consequence, additional due diligence by the proposed DIP Lender may be appropriate to assess the extent of potential reclamation claims by sellers of goods within 45 days of the commencement of a case.

8. New Administrative Priority Claims: The Act modifies Bankruptcy Code §503(b) by adding a new class of administrative creditor. Trade creditors will receive an administrative claim to the extent of the value of goods delivered to a debtor within 20 days before the date of the commencement of a case (to the extent sold to the debtor in the ordinary course of business). While this may serve to reduce motions for critical vendor payments, it creates a new class of administrative creditors without consideration of the *sine qua non* for allowance of an administrative claim — whether such creditor provided a benefit to the estate. As with utilities, in lieu of immediate payment of such claims, it may be necessary to consider a carveout for these administrative creditors in order to ensure that they continue to provide goods and services post-petition. In addition, as part of due diligence, these newly created priority claims may need to be considered separately from ordinary trade vendor claims.

9. Investment Banker: The Act permits a debtor's pre-petition investment banker and the investment banker's counsel to be retained by the debtor as a "disinterested person." This represents a significant departure from former Bankruptcy Code §§327 and 101(14), which prohibited the estate from retaining and compensating any professional which was not a disinterested person. Under former §101(14), a disinterested person excluded an investment banker for a security of the debtor, or an

attorney for such an investment banker in connection with the offer, sale, or issuance of a security of the debtor within three years before the petition date.

10. Cross-Border Insolvency: The Act deletes former Bankruptcy Code §304 and creates a new Chapter 15 designed to implement the Model Law on Cross-Border Insolvency. Chapter 15 sets forth a two-step process for commencing an ancillary proceeding. The initial step appears similar to the way in which such cases are currently commenced, i.e., with the filing of a petition and request for provisional relief, including injunctions, turnover of assets, etc. The court in which the petition is filed must determine whether or not to “grant recognition” to the foreign proceeding.⁸

The second step follows recognition of a foreign proceeding by a U.S. bankruptcy court. At this phase, the foreign representative (i) may sue and be sued in the United States, (ii) may intervene in any pending case involving the foreign debtor, (iii) becomes a party in interest in any other pending bankruptcy case and (iv) may apply to a court (but not necessarily the court that granted recognition) for additional relief, including an extension or expansion of any provisional relief granted upon the filing of the petition.

Chapter 15 also distinguishes between “foreign main proceedings” and “foreign nonmain proceedings”⁹ This distinction is important for secured creditors. Under new Bankruptcy Code §1520, automatically, upon recognition by a U.S. bankruptcy court of a foreign main proceeding, (i) Code §§361 (adequate protection) and 362 (automatic stay) apply with respect to any property of the debtor located in the U.S., (ii) Code §§363 (sale or use of property), 549 (post-petition transfers) and 552 (liens on after-acquired property and proceeds) apply to transfers of such property, (iii) the foreign representative is automatically empowered to operate the debtor and to take action under Bankruptcy Code §§363 and 552, and (iv) Bankruptcy Code §552 applies to property of the debtor located in the U.S.

Creditors in the U.S. must be mindful of these changes in order to adequately protect their rights. The two-step process for obtaining recognition of the foreign proceeding and then specific relief will provide creditors with at least one additional

⁸ The venue statute relative to ancillary proceedings has also been broadened such that ancillary proceedings may now be commenced in the district where the foreign debtor has assets or a principal place of business, or, if none, in the district where there is an action pending against the foreign debtor, or, if none, in any district “consistent with the interests of justice and the convenience of the parties in connection with the relief sought.” 28 U.S.C. §1410 (as amended).

⁹ A “foreign main proceeding” is defined in new Bankruptcy Code §1502 as “a foreign proceeding pending in the country where the debtor has the center of its main interests.” A debtor’s registered office is presumed to be the “center of its main interests.” A “foreign nonmain proceeding” is defined as “a foreign proceeding, other than a foreign main proceeding, pending in a country where the debtor has an establishment.” The term “establishment” is defined as “any place of operations where the debtor carries out a nontransitory economic activity.”

opportunity to seek protection of their rights. The applicability of §§361, 363, 549 and 552 in cases where the foreign proceeding is a plenary case will likewise afford important protections to creditors by keeping U.S. assets under the jurisdiction of the bankruptcy court as opposed to the almost automatic turnover of assets to the foreign proceeding early in the case. The automatic stay's application is a double-edged sword. It will protect a foreign debtor's U.S. assets from piecemeal attack by creditors, but it also will prevent secured creditors from continuing to exercise any rights with respect to such assets absent relief from the court.

11. Patient Care Ombudsman: The Act adds a new §333 requiring, in cases where the debtor is a health care business, the appointment of an ombudsman to monitor the quality of patient care and to represent the interests of patients, unless the court finds that such appointment is not necessary.

To the extent an ombudsman is appointed, the fees and expenses associated therewith are paid by the estate and subject to court review and approval under Bankruptcy Code §330, dealing with compensation of Chapter 11 professionals. Thus, an ombudsman adds another layer of administrative expense and perhaps the need for a separate or additional carveout.

12. Prepackaged Bankruptcies and §341 Meetings: The Act modifies Bankruptcy Code §341, adding subdivision (e), which grants to the court the discretion, upon request of a party and after notice and a hearing, to direct the U.S. Trustee not to convene a meeting of creditors or equity security holders where the debtor has already solicited acceptance of a plan prior to the commencement of a case.

The exercise of this discretion may reduce costs in the limited number of cases that are true prepackaged bankruptcies, as opposed to prenegotiated bankruptcy cases.

13. KERP Limitations: The Act amends Bankruptcy Code §503, adding subsection (c), to prohibit retention or severance payments to an insider of the debtor. To permit a retention program, the court must find that:

- (A) the transfer or obligation is essential to retention of the person because the individual has a bona fide job offer from another business at the same or greater rate of compensation;
- (B) the services provided by the person are essential to the survival of the business; and
- (C) either—
 - (i) the amount of the transfer made to, or obligation incurred for the benefit of, the person is not greater than an amount equal to 10 times the amount of the mean transfer or obligation of a similar kind given to nonmanagement employees for any purpose

during the calendar year in which the transfer is made or the obligation is incurred; or

- (ii) if no such similar transfers were made to, or obligations were incurred for the benefit of, such nonmanagement employees during such calendar year, the amount of the transfer or obligation is not greater than an amount equal to 25 percent of the amount of any similar transfer or obligation made to or incurred for the benefit of such insider for any purpose during the calendar year before the year in which such transfer is made or obligation is incurred. . . .

Similarly, to permit a severance payment to an insider of the debtor, the court must find that:

- (A) the payment is part of a program that is generally applicable to all full-time employees; and
- (B) the amount of the payment is not greater than 10 times the amount of the mean severance pay given to nonmanagement employees during the calendar year in which the payment is made. . . .

Also prohibited are other transfers or obligations that are outside the ordinary course of business and not justified by the facts and circumstances of the case, including transfers made to, or obligations incurred for the benefit of, officers, managers, or consultants hired after the date of the filing of the petition.

There is significant concern among bankruptcy professionals that these restrictions will make it more difficult, if not impossible, to retain key management and employees. It is possible that, as part of the bankruptcy planning process, key management will obtain employment contracts which will then be assumed by the debtor.

14. Wage and Salary Priority: The Act increases the amount allowed as a priority claim for pre-petition wages, salaries and contributions to employee benefit plans under Bankruptcy Code §507(b). Pursuant to the Act, pre-petition wages and salaries earned within the 180 days (up from 90 days) will have a fourth priority claim up to \$10,000 per person (up from \$4,925). Similarly, contributions to employee benefit plans relating to services rendered during the 180 days prior to the commencement of the case (no change) will be afforded a fifth priority to the extent of \$10,000 per employee (up from \$4,925), less amounts otherwise paid as a fourth priority claim and amounts paid on behalf of the employee to other plans.

This doubling of priority wage claims may have a significant impact on the amount requested in routine first-day orders and is certainly a viable area for additional due diligence by potential DIP Lenders.

15. Homestead Exemption: The Act modifies Bankruptcy Code §522 to limit the state homestead exemption to \$125,000 for a residence acquired within 1,215 days prior to the commencement of the case. While it will not be directly relevant in most Chapter 11 cases, where the debtor is privately or closely held, and the principals have provided guarantees, this change may assist lenders in states where an unlimited homestead exemption (e.g., Texas or Florida) may be used to shield substantial assets which were recently acquired. The state homestead exemption is not capped for interests acquired prior to 1,215 days before the commencement of the case, unless:

- (A) the court determines, after notice and a hearing, that the debtor has been convicted of a felony, which under the circumstances, demonstrates that the filing of the case was an abuse of the provision of this title; or
- (B) the debtor owes a debt arising from—
 - (i) any violation of the Federal or state securities laws or regulations;
 - (ii) fraud, deceit, or manipulation in a fiduciary capacity or in connection with the purchase or sale of any registered security;
 - (iii) any RICO civil remedy; or
 - (iv) any criminal act, intentional tort, or willful or reckless misconduct that caused serious physical injury or death to another individual in the preceding 5 years.

16. Fraudulent Transfers: The Act extends a trustee's avoidance powers under Bankruptcy Code §548 to transfers made within two years (rather than one year) of the commencement of the case. As a practical matter, since a trustee can normally bring such actions based upon state law which has a statute of limitations longer than one year, this change is not likely to be material.¹⁰

In addition, the Act adds a cause of action for avoiding a transfer to or for the benefit of an insider under an employment contract outside of the ordinary course of business. This claim appears to permit avoidance without proof of the traditional elements of a fraudulent conveyance claim.

¹⁰ This provision will become effective one year after the enactment of the Act.

17. Trustee Avoidance Powers – Self-Settled Trusts:¹¹ In response to certain states’ creating a creditor avoidance scheme, referred to as a self-settled trust, the Act adds to Bankruptcy Code §548 the power to avoid a transfer of an interest of the debtor in property made within 10 years of the petition date if:

- (A) such transfer was made to a self-settled trust or similar device;
- (B) such transfer was by the debtor;
- (C) the debtor is a beneficiary of such trust or similar device; and
- (D) the debtor made such transfer with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted.

In addition, the Act clarifies that a “transfer” includes a transfer made in anticipation of any money judgment, settlement, civil penalty, equitable order, or criminal fine incurred by, or which the debtor believed would be incurred by—

- (A) any violation of state or federal securities laws and regulations; or
- (B) fraud, deceit, or manipulation in a fiduciary capacity or in connection with the purchase or sale of any registered security.

18. Creditor Committee Information Sharing: The Act modifies Bankruptcy Code §1102(b) to require that an official committee is obligated to provide access to information received by the committee to noncommittee creditors who hold claims of the kind represented by that committee, and to solicit and receive comments from such creditors. This disclosure requirement is enforceable by court order.

This mandatory disclosure may actually have the opposite effect from what was intended. Debtors generally agree to share sensitive information with members of a creditors committee and their professionals conditioned upon the execution of a confidentiality agreement. Such an agreement is meaningless if all creditors represented by the committee are required to receive the information. Thus, it is likely that debtors and committees will need to obtain court orders to permit the committees not to share confidential information.

¹¹ This provision will become effective upon enactment of the Act.

19. Mandatory Appointment of Trustee: The Act modifies Bankruptcy Code §1104, requiring the U.S. Trustee to seek appointment of a trustee if there are reasonable grounds to suspect that current members of the governing body of the debtor, the debtor's chief executive or chief financial officer, or members of the governing body who selected the debtor's chief executive or chief financial officer, participated in actual fraud, dishonesty, or criminal conduct in the management of the debtor or the debtor's public financial reporting.

It is likely that the Office of the U.S. Trustee will embrace this change as an opportunity to more readily move for the appointment of a trustee. In the past, the U.S. Trustee's Office has, where it deemed it appropriate, sought the appointment of a trustee. (See, e.g., *American Business Financial Services*, where the U.S. Trustee initially moved for the appointment of a trustee, but ultimately agreed to the appointment of an examiner and a chief restructuring officer. Interestingly, promptly following the appointment of the CRO, it was determined that the business could not be restructured and would be liquidated in Chapter 11).

The Act appears to require the U.S. Trustee to act even in a situation where, pre-petition, management (perhaps even at the request of its lenders) engaged an independent turnaround person to fill the role of CEO or CFO. The presence of this independent person should eliminate the cost and expense of a dispute over the appointment of a trustee; however, if post-petition management is the same as pre-petition management, the U.S. Trustee is arguably still required to seek appointment of a trustee if management which selected the CEO or CFO is suspected of the requisite predicate conduct.

20. Plan Confirmation/Tax Authority Treatment: The Act modifies Bankruptcy Code §1129(a)(9)(C) by providing that priority tax claims under Bankruptcy Code §507(a)(8) must not be treated any worse than the most favored non-priority claim and, if not paid in full upon the effective date of the plan, must be paid over a period not to exceed five years from the petition date, rather than the current treatment of six years from the date of assessment.

Since it was common for reorganizing debtors to provide in the plan that such pre-petition tax claims would be paid over a six-year period from confirmation (because the date of assessment is typically delayed during the case), the statutory change effectively reduces the time which the debtor has to repay (*i.e.*, five years, less the time in bankruptcy, versus six years from confirmation).

21. Retiree Benefits: The Act modifies Bankruptcy Code §1114; however, as discussed below, the modifications appear to grant retirees extraordinary rights to avoid otherwise binding pre-petition agreements.

Former Bankruptcy Code §1114 permitted a debtor in possession to seek an order of the Bankruptcy Court authorizing the debtor to modify or terminate retiree benefits if the court found that the debtor had satisfied all required procedural steps, including (i) negotiating with the retiree representatives (as outlined in §1114(f)), (ii) the retiree representative having refused to accept the debtor's proposal without good cause, and (iii) the modification or termination is necessary to permit the reorganization of the

debtor. Former §1114(g) did permit the retiree representatives to apply to the court for an order increasing the benefits upon an appropriate showing (*i.e.*, the modification process was not followed or the debtors could reasonably afford to increase the benefits).

The Act provides that, in the event the retiree plan was modified within the 180 days prior to the bankruptcy case, and at a time when the debtor was insolvent, upon motion of any party in interest, the benefit plan will be reinstated as it was prior to the modifications, unless the “court finds the balance of the equities clearly favors such modification.”

It is clear that the purpose of the amendment is to permit retirees to seek to unwind pre-petition negotiated modifications (to wit, reductions) before the commencement of the §1114 process.¹² As a technical matter, the Act accomplishes this, but it may not ultimately enhance the position of the retirees since the court may deny the relief requested upon finding that the “balance of the equities clearly favors the pre-petition modifications.” Even if the benefit plan is reinstated, the debtor, under §1114 can achieve an even more onerous result upon an appropriate showing. Further, the amendment may actually place retirees and management at a disadvantage in reaching a consensual arrangement since it gives any party in interest in a bankruptcy case, not just the parties to the benefit plan, the right to revisit and undo otherwise lawful pre-petition contract agreements.

22. Property of the Estate: In a Chapter 11 case where the debtor is an individual, the Act adds Bankruptcy Code §1115, which provides that, in addition to property of the estate as defined in Bankruptcy Code §541, property and earnings acquired by the debtor after the commencement of the case but before the case is closed, dismissed or converted to a case under Chapter 7, 12 or 13 will constitute property of the estate. This is a material change from the former Bankruptcy Code definition of property of the estate for individual Chapter 11 debtors which excluded a debtor’s post-petition property and earnings from the property available to satisfy claims of pre-petition creditors.

23. Additional Judges: The Act authorizes the appointment of additional bankruptcy judges in, among other jurisdictions, Delaware (4) and the Southern District of New York (1).

¹² Although it is admittedly extremely unlikely, in the event the retirees were able to extract concessions from management as part of the pre-petition modifications, the Act permits a creditors committee or debtor to ask the court to unwind such modifications before beginning the §1114 process.

For more information on these developments, contact your primary Morgan Lewis attorney or one of the following:

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