PROSKAUER ROSE LLP®

Client Alert

A report for clients and friends of the firm

April 2005

The Bankruptcy Abuse Prevention And Consumer Protection Act Of 2005: What's Left Of Chapter 11?

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "2005 Bankruptcy Act"), which adopts the most significant amendments to the bankruptcy laws in more than 25 years, is expected to be signed into law by the President, perhaps as early as this week. The 2005 Bankruptcy Act has an effective date of six months after its enactment, and with certain exceptions, its provisions will apply only to cases commenced after the effective date, which is currently anticipated to be mid-October 2005.

A large portion of the 2005 Bankruptcy Act focuses on issues relating to individual consumer bankruptcies under Chapters 7 and 13, the most significant of which is to introduce a "needs-based" formula which focuses on the amount of debt that an individual consumer can repay in determining whether they are eligible to file for relief under Chapter 7 or must instead file under Chapter 13. However, although less widely publicized in the popular press, the 2005 Bankruptcy Act also makes significant changes to numerous sections of the Bankruptcy Code that could materially impact certain commercial bankruptcies under Chapter 11.

Certain of the changes could result in a major departure from current commercial practice and will likely make it more difficult for certain commercial debtors to reorganize under Chapter 11. These changes include expanding the categories of creditors entitled to administrative expense priority status, assisting creditors in defending preference actions, limiting the time within which debtors must determine whether to assume or reject non-residential real property leases, placing maximum limitations on the length of a debtor's exclusive periods for filing and soliciting votes on a plan of reorganization, severely curtailing employee retention and severance plans and lowering the burden of proof for parties-in-interest seeking conversion of a case from Chapter 11 to Chapter 7.

The overall impact of the 2005 Bankruptcy Act on the dynamics of commercial Chapter 11 practice is uncertain, but two things are apparent: First, *before* filing for Chapter 11 protection, companies and their advisors will need to engage in a greater degree of Chapter 11 planning to ensure that the new claim priorities, plan and lease deadlines and other provisions do not inhibit the company's ability to successfully reorganize. Second, while several of the provisions appear to benefit and provide additional leverage to certain creditor lobbies (in particular, landlords, utilities and certain trade vendors), it remains to be seen whether, in the long run, these provisions will actually result in enhanced recoveries to creditors (including those groups for whose benefit certain of the amendments were designed) or whether the decreased flexibility afforded debtors under the 2005 Bankruptcy Act will actually lead to lower recoveries and a greater chance of failed reorganizations.

The following is a general overview of certain of the most significant of these changes. It is by no means exhaustive or representative of all of the provisions of the 2005 Bankruptcy Act.

I. The 2005 Bankruptcy Act Provides Additional Protections to Creditors in Chapter 11

A. New Priorities for Certain Trade Creditors

Under the Bankruptcy Code, a Chapter 11 plan of reorganization must provide for payment in full of all allowed administrative expense claims. Currently, Section 503(b) of the Bankruptcy Code defines administrative claims to include, among others, the actual and necessary costs and expenses of preserving the estate and claims of professionals retained in the Chapter 11 case. The 2005 Bankruptcy Act adds to this list the value of any goods received by the debtor within 20 days prior to commencement of the case, where the goods have been sold to the debtor in the ordinary course of business. Under current practice, the value of such goods would merely constiue a general unsecured claim. By elevating such claims to administrative expense priority, Congress may be attempting to cool the controversy concerning payment of pre-petition amounts owing to "critical vendors," because critical vendors that made deliveries within the 20-day period will now enjoy a priority and may not press for post-petition payment of pre-petition invoices. Nonetheless, companies that receive large ordinary course shipments (such as retail debtors) will now be burdened with substantial administrative liabilities that will require payment in *full* to successfully exit bankruptcy. Thus, careful pre-petition planning will be required to ensure that these additional liabilities do not doom the reorganization before it starts.

B. Expansion of Reclamation Rights

The 2005 Bankruptcy Act also changes Section 546(c) of the Bankruptcy Code, which protects a seller's right to reclaim goods shipped to the debtor immediately prior to the bankruptcy filing. The 2005 Bankruptcy Act substantially changes current practice by providing that any goods sold in the ordinary course of business and received by the debtor while insolvent may be reclaimed by the seller within 45 days after the debtor receives the goods or within 20 days of the bankruptcy, whichever is later. Sellers that do not send a timely reclamation demand may, under the new amendments, still claim administrative expense priority under Section 503 of the Bankruptcy Code so long as their goods were received within 20 days of the bankruptcy filing. The 2005 Bankruptcy Act also appears to eliminate the option afforded debtors under current law *not* to return goods to a reclaiming creditor and instead provide such creditor an administrative claim or lien. Rather the act appears to suggest that the debtor must now literally return the goods to the reclaiming creditor. Thus, the new amendments could impose a significant burden on debtors who will be required to establish procedures to monitor reclamation demands and, possibly, to segregate and return reclaimed goods.

C. Preferences Are More Difficult to Recover

The 2005 Bankruptcy Act may also help protect trade creditors from having to repay monies received pre-filing. First, to aid smaller preference recipients, the 2005 Bankruptcy Act eliminates preference exposure for transfers aggregating less than $5,000 during the 90-day preference period. Second, the 2005 Bankruptcy Act attempts to make it easier for creditors to establish the so-called "ordinary course of business defense" contained in Section 547(c) of the Bankruptcy Code.

Under current law, a creditor receiving payment from an insolvent debtor within 90 days prior to the commencement of a case can defend against recovery of the payment as a preference by showing that (i) the payment was on account of a debt incurred in the ordinary course of business of both parties, (ii) the payment was made in the ordinary course of business of both parties and (iii) the payment was made according to ordinary business terms. This requires a creditor to establish that the payment at issue was both in the ordinary course of business between the parties and made according to ordinary business terms (*i.e.*, was paid within industry terms). The latter test is often difficult or costly for creditors to satisfy as many courts require objective proof from experts or other industry sources and many preference targets, especially those with smaller claims, simply fail or are unable to provide such proof. The 2005 Bankruptcy Act alters Section 547(c) by eliminating the requirement that a transferee show that the payment was *both* in the ordinary course of business of the parties and made according to ordinary business terms; now the creditor need only show one or the other. Although factual disputes will remain over what constitutes "ordinary" payments under either prong, undoubtedly this change will foster greater consensual resolutions and especially aid the smaller or less sophisticated preference recipient.

D. Expansion of "Look-Back" Period for fraudulent Transfers

Two important changes were made to the Bankruptcy Code's fraudulent transfer provisions. With respect to fraudulent transfers under Section 548, the 2005 Bankruptcy Act expands the "look-back" period to two years rather than the one year period under current law. State law fraudulent transfer "look-back" periods are not affected by the amendments. The 2005 Bankruptcy Act also expands the criteria for fraudulent transfers to specifically include transfers made to or for the benefit of an insider, or an obligation incurred, under an employment contract, outside of the debtor's ordinary course of business, where the debtor did not receive reasonably equivalent value in exchange for the payment. Importantly, transfers or obligations meeting such criteria will be deemed fraudulent transfers without regard to the debtor's solvency or financial condition at the time such transfer was made or obligation was incurred. The change with respect to insider employment contracts will be effective immediately upon enactment of the 2005 Bankruptcy Act.

E. Leases of Non-Residential Real Property

Under current law, a debtor/lessee must determine whether to assume or reject an unexpired lease of non-residential real property within 60 days after the commencement of the case. Bankruptcy courts have routinely extended this 60-day period for "cause" to allow the debtor sufficient time to make an informed decision respecting the value of its leases and their importance to the debtor's reorganization. In large or complex cases involving a large number of leases, such as retail cases, it is not unusual for courts to extend this period for many months or even longer.

The 2005 Bankruptcy Act marks a significant departure from current practice by severely limiting the time within which debtors must assume or reject leases. Under the new amendments, a debtor/lessee's unexpired lease of non-residential real property will be deemed rejected *and* must be immediately surrendered to the lessor by the earlier of (i) 120 days after filing or (ii) the date of entry of an order confirming a plan. The Court, for "cause," may extend such 120-day period for an additional 90 days. Subsequent extensions beyond the additional 90 days may only be granted upon the prior written consent of each lessor, which in cases involving large numbers of leases could prove to be an extremely cumbersome process. The 2005 Bankruptcy Act reduces the economic impact resulting from improvident assumption of leases by amending Section 503 of the Bankruptcy Code to cap administrative expenses arising from the rejection of a previously assumed lease. Such administrative expenses are capped at an amount equal to the monetary obligations due for the period of 2 years following the later of the rejection date or the date of actual turnover of the premises (excluding those arising from or relating to a failure to operate or a penalty provision.) Despite this cap, such administrative obligations could be overwhelming in cases involving numerous non-residential real property leases. Accordingly, a much greater degree of advanced analysis respecting the value and importance of a debtor's leases will be required to prevent the debtor from making improvident decisions when considering whether to assume or reject such leases.

F. Increased Protection for Utilities

Another significant amendment made by the 2005 Bankruptcy Act, which will have a substantial impact on retail and other debtors that maintain numerous accounts with utility service providers, is a change to the definition of adequate assurance. Currently, under Section 366 of the Bankruptcy Code, a utility provider may alter, refuse or discontinue service if neither the trustee nor the debtor, within 20 days after commencement of the case, furnishes adequate assurance of payment, in the form of a deposit or other security. Cases interpreting this section in many districts have held that courts must be afforded reasonable discretion in determining what constitutes adequate assurance and that availability of an administrative expense priority can constitute adequate assurance in some cases, with no additional deposit required.

The 2005 Bankruptcy Act revises Section 366 to provide a detailed definition of what does and does not constitute adequate assurance. Specifically, the new amendments provide that adequate assurance means: (i) a cash deposit, (ii) a letter of credit, (iii) a certificate of deposit, (iv) a surety bond, (v) a prepayment of utility consumption or (vi) another form of security that is mutually agreed upon between the debtor and the utility. The amendment provides specifically that an administrative expense priority *shall not* constitute adequate assurance of payment. Overall, these amendments will likely impose significantly greater (and, in some cases, potentially prohibitive) cash burdens on a debtor and must be considered in connection with pre-filing planning, particularly in developing and negotiating budgets relating to debtor-in-possession financing.

G. Outside Limitation on a Debtor's Exclusivity Periods

The 2005 Bankruptcy Act imposes new outside limits on a debtor's exclusive periods for filing and soliciting votes on a plan of reorganization. Under current law, a debtor is given an initial 120-day exclusive period to file a plan of reorganization, and an initial 180-day period to solicit votes thereon. However, especially in large or complex cases, such periods are routinely extended for months or sometimes years. Under the 2005 Bankruptcy Act, the 120-day exclusive period to file plan *cannot* be extended beyond 18 months after the petition date and the exclusive period to solicit votes on a plan *cannot* be extended for more than 20 months after the petition date. These provisions will likely only impact large and complex Chapter 11 cases where debtors often require greater time periods to implement operational and financial restructuring strategies, and to attempt to build consensus on a Chapter 11 plan. In such cases, the new time limitations may empower recalcitrant creditors content to hold out until the debtor's exclusive period expires.

II. Other Amendments

A. Key Employee Retention and Severance Plans

Under current practice, Chapter 11 debtors routinely seek court authority for the approval of broad-based key employee retention plans as a means to minimize the loss of critical employees with institutional knowledge and client relationships as a result of the Chapter 11 filing. However, the 2005 Bankruptcy Act includes strict limitations on the payment or allowance of claims for retention bonuses or severance pay to key employees of the debtor. Specifically, the 2005 Bankruptcy Act amends Section 503 of the Bankruptcy Code, the section governing allowance of administrative expense claims, to provide that payments to induce key personnel to remain in the debtor's employ are *not allowed* unless the payment 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." A debtor must also show that the services provided by the person are essential to the survival of the business. Moreover, the amount of the payment cannot exceed ten times the amount of similar payments to non-management employees, or if no such similar payments were made, then not greater than an amount equal to 25% of the amount of any similar payment made to the person for any purpose during the calendar year before the year in which such payment is made.

Severance pay is similarly limited under the 2005 Bankruptcy Act to an amount not to exceed ten times the amount of the mean severance pay given to non-management employees, unless the severance pay is part of a program generally applicable to all employees. The 2005 Bankruptcy Act further prohibits payment or allowance of any other obligations to any officers, managers or consultants hired after the petition date that are outside the ordinary course of business unless they are "justified by the facts and circumstances of the case."

B. Retention of Investment Bankers

Under current law, a professional retained by the estate must be a "disinterested person" as defined in Section 101(14). Further, Sections 101(14)(B) and (C) specifically prevent investment bankers from representing the estate if they (i) were investment bankers for any outstanding security of the debtor or (ii) within three years before the petition date, acted as an investment banker for a security of the debtor. The 2005 Bankruptcy Act removes all such references to, and restrictions on, investment bankers from Section 101(14). Accordingly, an investment bank that acted as an underwriter for an outstanding security of the debtor may now be retained in the Chapter 11 case notwithstanding its prior role with the debtor, as long as the investment banker otherwise qualifies as a "disinterested person."

C. Conversion of a Chapter 11 Case

The 2005 Bankruptcy Act seeks to limit a Court's discretion in converting a reorganization case to a liquidation case and makes it easier for creditors or other parties-in-interest to compel conversion of a Chapter 11 case. Section 1112(b) of the Bankruptcy Code currently provides that a Bankruptcy Court may convert a Chapter 11 case to a case under Chapter 7 or dismiss the case for "cause." The 2005 Bankruptcy Act amends Section 1112 to provide that the Bankruptcy Court shall convert or dismiss the case, or appoint a trustee, for "cause", unless the court finds unusual circumstances that establish that conversion or dismissal is not in the best interests of the creditors and the estate. The 2005 Bankruptcy Act defines "cause" to include, among other things, gross mismanagement, loss to or diminution in value of the estate, failure to comply with a court order, unauthorized use of cash collateral, unexcused failure to timely satisfy any filing or reporting requirement under the Bankruptcy Code, failure to timely pay post-petition taxes, failure to file or confirm a plan within the exclusivity periods provided under the 2005 Bankruptcy Act or inability to substantially consummate a plan.

Under current law, conversion to Chapter 7 or appointment of a trustee is the exception and a debtor generally could remain a debtor-in-possession under Chapter 11 as long as it could demonstrate a reasonable likelihood of rehabilitation. The 2005 Bankruptcy Act may change this presumption. The 2005 Bankruptcy Act provides further that the Court *shall not* convert or dismiss a Chapter 11 case if (i) the debtor or another party-in-interest objects and demonstrates that (a) there is a reasonable likelihood that a plan will be confirmed within the exclusivity periods or a reasonable time and (b) the grounds for granting dismissal or conversion include an act or omission on the part of the debtor for which there is reasonable justification and that can timely be cured and (ii) the court finds unusual circumstances that establish that conversion or dismissal is not in the best interests of the creditors and the estate.

The 2005 Bankruptcy Act also requires a Bankruptcy Court to move swiftly in dealing with motions to convert or dismiss. The Bankruptcy Court must now hold a hearing on a conversion or dismissal motion no later than 30 days after the filing of the motion and must render a decision no later than 15 days after such hearing.

D. Creation of Chapter 15 – New Provisions Governing Foreign Insolvency Proceedings

Under the 2005 Bankruptcy Act, Congress has created Chapter 15 of the Bankruptcy Code, a new chapter governing the ability of foreign debtors to obtain the assistance of U.S. Federal Courts in administering foreign insolvency proceedings. The new Chapter 15 replaces former Section 304 of the Bankruptcy Code and will serve as the statutory framework for international cooperation in cross-border insolvency proceedings that impact U.S. assets or interests of a foreign debtor.[1]

One of the most significant changes under Chapter 15 is that once a valid "petition for recognition" is filed by a foreign representative, it is given automatic and mandatory recognition in the United States, subject only to a Court's discretion to refuse to approve of actions that are manifestly contrary to public policy. This represents a major departure from prior practice which required a court to determine whether a particular foreign proceeding merited relief under Section 304 *before* granting deference to such proceeding. By

[1] Chapter 15 codifies the Model Law on Cross-Border Insolvency, which has already been enacted in some form by several nations, in substantially the same form as it was drafted by the United Nations Commission on International Trade law.

making relief under Chapter 15 automatic, Congress is attempting to curtail the litigation that exists in Section 304 matters, thereby providing greater certainty for foreign debtors who seek the assistance of U.S. Courts. It remains to be seen, however, whether Chapter 15 will reduce or merely shift the focus of such litigation.

Another change from prior practice concerns whether the Chapter 15 case involves a foreign main proceeding (*i.e.*, whether the foreign proceeding is being administered in a country where the debtor has its main interests) or a foreign nonmain proceeding (*i.e.*, whether the foreign proceeding is being administered in a country where the debtor only maintains an establishment). If the matter involves a foreign main proceeding, certain provisions of the Bankruptcy Code (such as the automatic stay, provisions regarding adequate protection of secured claims, the use, sale or lease of property and others) are automatically applicable. Finally, Congress has retained in Chapter 15 the equitable discretion that bankruptcy judges exercised under Section 304, and the case law developed thereunder, to fashion additional relief to a foreign representative utilizing substantially the same criteria as was applicable in Section 304 cases.

NEW YORK • LOS ANGELES • WASHINGTON

BOSTON • BOCA RATON • NEWARK

NEW ORLEANS • PARIS

Client Alert

Proskauer Rose LLP has a nationally recognized Bankruptcy and Reorganization Practice Group that advises clients on the full spectrum of insolvency-related matters. The Group currently consists of six partners, numerous associates and paralegals, all of whom are involved in representing a wide variety of debtors, creditors' committees, individual creditors and entities interested in acquiring or investing in troubled companies. The Group is augmented by a team of attorneys who have extensive experience in bankruptcy litigation and transactional matters.

Our bankruptcy practice has a particularly large amount of experience in dealing with the numerous problems faced by large corporate debtors. We have represented a number of

Alan B. Hyman
212.969.3275 – ahyman@proskauer.com

Sheldon I. Hirshon
212.969.3270 – shirshon@proskauer.com

Jeffrey W. Levitan
212.969.3239 – jlevitan@proskauer.com

Michael E. Foreman
212.969.3218 – mforeman@proskauer.com

Scott K. Rutsky
212.969.3983 – srutsky@proskauer.com

Martin S. Zohn
310.284.5648 – mzohn@proskauer.com

Proskauer Rose is an international law firm that handles a full spectrum of legal issues worldwide.