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The New Bankruptcy Law Amendments and their Impact on Business Bankruptcy Cases

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On April 14, 2005, President Bush signed into law the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "Act"). Subject to certain exceptions, the Act will apply only to bankruptcy cases filed on and after October 17, 2005.

While most of the coverage and discussion regarding the Act has focused on its provisions relating to consumer bankruptcies, the Act will have a significant impact on business bankruptcy cases. In general, the Act's changes to existing law in the business bankruptcy context disadvantage debtors and improve the position of certain creditor groups.

We have prepared the following summary of certain of the Act's business bankruptcy-related provisions, with an emphasis on those having a direct impact on commercial creditors. Due to the complexity and broad scope of the Act, the summary does not include all business bankruptcy-related provisions or all details of the provisions discussed. In addition, the summary does not include any discussion of the Act's amendments to Bankruptcy Code sections dealing with the treatment of financial contracts such as swaps, derivatives, repos, forward contracts and commodity contracts.

<u>Reclamation Rights</u>. The Act provides additional rights to those who sell goods to the debtor prior to its bankruptcy. Under the Act, if goods are shipped in the ordinary course of business, a creditor will have an administrative priority claim for goods received by the debtor within 20 days prior to the date of its petition for bankruptcy relief.

In addition, the Act expands the timeframe within which a vendor can provide the debtor with an effective reclamation demand. Under the Act, a vendor will have the later of 45 days after the debtor's receipt of the goods (expanded from 20 days) or 20 days after the filing of the debtor's bankruptcy petition to deliver a written reclamation demand.

<u>Preferential Transfers</u>. The Act's primary change to the Bankruptcy Code's preference provisions makes it easier for preference defendants to establish the ordinary course of business defense. Under existing law, a defendant can establish the defense by showing that the transfer at issue was (i) in payment of debt incurred in the ordinary course of business of the debtor and creditor, (ii) made in the ordinary course of business of the debtor and the creditor, <u>and</u> (iii) made according to ordinary business terms. Under the Act, the creditor will only have to establish that the transfer (i) was in payment of a debt incurred in the ordinary course of business

of the debtor and creditor and (ii) <u>either</u> was made in the ordinary course of business of the debtor and the creditor <u>or</u> was made according to ordinary business terms.

In addition, the Act expands the protection afforded to secured creditors who delay perfection of their security interests. For preference analysis purposes, a transfer of a security interest occurs at the time it is effective between the debtor and the secured creditor, but only if the security interest is perfected within 10 days after the security interest attached. Under existing law, if perfected more than 10 days after the loan transaction, the security interest may be subject to avoidance as a preferential transfer made in consideration of an antecedent debt. The Act extends the 10-day grace period transfer of a security interest will be deemed made at the time it becomes effective between the parties if the secured creditor perfects its security interest within 30 days after it attaches. A separate provision of the Act similarly extends the protection afforded to a purchase money security interest holders by extending from 20 to 30 days the period within which the purchase money security interest may be perfected after the debtor acquires possession of the collateral.

The Act also requires that all preference avoidance actions seeking to recover less than $10,000 be brought in the defendant's home jurisdiction. This will alleviate the defendant's burden to travel or hire local counsel where the bankruptcy case is pending. The Act further protects recipients of smaller amounts that would otherwise qualify as preferential transfers by providing that transfers of property in the 90 days immediately prior to the bankruptcy will not be subject to avoidance as preferences if the aggregate value of the property transferred is less than $5,000.

<u>Real Property Leases</u>. Under existing law, a debtor tenant must decide whether to assume or reject a commercial real property lease within 60 days from the date of filing for bankruptcy unless the bankruptcy court extends that period for "cause." Such extensions are now common, with the extended period often ultimately lasting well beyond one year. Providing additional leverage to landlords, the Act extends the initial deadline from 60 to 120 days, but limits further non-consensual extensions to only an additional 90 days. Any extension beyond this initial 210-day period (approximately 7 months after the bankruptcy filing) will require the landlord's written consent.

To balance the harm in the event an assumed lease is later rejected, the Act caps the landlord's administrative priority claim for future rent in that circumstance at two years' future rent. Under existing law, all future rent under an assumed lease is entitled to administrative priority treatment.

The Act also provides that the existence of non-monetary lease defaults impossible for a debtor to cure will not prevent the debtor from assuming its lease. Under existing law, a debtor seeking to assume a commercial real property lease must first cure all defaults. Courts currently struggle over whether defaults that are impossible to cure ("going dark" prohibition violations for example) prevent the debtor from assuming the lease. The Act resolves this issue by excusing debtors from cure obligations for non-monetary defaults if cure is impossible, while requiring that any monetary damages arising from such defaults must be cured.

Single Asset Real Estate Debtors. In a "single asset real estate" bankruptcy case, if a motion for relief from the automatic stay is made by a creditor whose claim is secured by an interest in the real estate, the bankruptcy court is required to grant the requested relief unless, within 90 days after the order for relief, the debtor has either filed a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time, or the debtor has started making monthly payments to every mortgagee equal in amount to interest at the market rate on the value of the mortgagee's secured interest. Under existing law, "single asset real estate" cases are defined as cases involving "real property constituting a single property or project…which generates substantially all of the gross income of a debtor…and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental thereto," if the debtor's non-contingent, liquidated secured debts do not exceed $4,000,000. The Act eliminates the $4,000,000 debt limit so that larger properties and projects will now be included. This will make it more difficult for large single asset real estate ventures to reorganize under chapter 11 as many will be required to pay interest to their mortgagees throughout the chapter 11 case.

Plan of Reorganization Filing Deadlines. Under existing law, debtors have the "exclusive" right to file a plan for the 120 days immediately following the filing of the bankruptcy petition (the "Plan Exclusivity Period") and 180 days to solicit votes on such plan. It is common for debtors to receive numerous extensions to these deadlines. Under the Act, the bankruptcy court cannot extend the Plan Exclusivity Period beyond 18 months from the filing of the bankruptcy petition and cannot extend the solicitation period with respect to the plan beyond 20 months. As discussed immediately below, the revised deadlines are subject to certain exceptions in "small business cases."

Small Business Cases. The Act contains several provisions that will make it more difficult for small businesses to reorganize under chapter 11. These provisions will apply to "small business cases," defined as chapter 11 cases in which the debtor is a "small business debtor." In general, a debtor is a "small business debtor" if (i) it is engaged in commercial or business activities, including an affiliate of the debtor that is also in bankruptcy, but excluding any debtor whose primary activity is the business of operating or owning real estate, (ii) it has non-contingent, liquidated, secured and unsecured debts that do not exceed $2 million in the aggregate on the date of the petition or order for relief, excluding debts owed to affiliates or insiders of the debtor, and (iii) the United States trustee has not appointed a committee of unsecured creditors or the bankruptcy court has determined that the appointed committee is not sufficiently active and representative of unsecured creditor interests.

For small business cases, the Act provides that only the debtor may file a plan within the first 180 days of the bankruptcy case and a plan and disclosure statement must be filed within the first 300 days, regardless of who files them. The Act seeks to penalize "serial filers" by depriving a small business debtor of the benefits of automatic stay if the debtor files a subsequent bankruptcy petition within two years of either confirming a plan in a prior chapter 11 case or having a prior chapter 11 case dismissed. The Act also subjects all small business debtors to stringent reporting requirements including periodic reports on profitability and projected cash receipts and disbursements.

Privacy Issues. The Act provides that an independent "consumer privacy ombudsman" must be appointed in all cases in which the debtor has a policy prohibiting the transfer of "personally identifiable" consumer data and the debtor seeks to sell such information. The ombudsman, who will be compensated from the bankruptcy estate, will be responsible for assisting the bankruptcy court in its consideration of the facts and circumstances surrounding the proposed sale or lease of the personally identifiable information.

Key Employee Retention Programs; Severance Pay. Currently, larger debtors often seek and obtain bankruptcy court approval of key employee retention programs ("KERPs") or targeted bonus packages to induce management to remain with the company in bankruptcy. In response to criticism of the generous KERPs now being granted, the Act places strict limitations on the payment or allowance of claims for retention bonuses or allowance of claims for retention bonuses or severance pay to key personnel of the debtor. Such payments are prohibited under the Act unless, among other requirements, the debtor establishes that the particular employee to be benefited is "essential to the survival of the [debtor's] business," that the employee has an actual offer from another company for greater compensation and, absent approval of the KERP at issue, the employee intends to accept the competing offer. The Act contains similar restrictions with respect to severance payments made during a bankruptcy case. While new standards will likely significantly reduce the number of KERPs and severance arrangements sought to be approved in bankruptcy, it is equally likely that there will be a resulting increase in the number of KERPs implemented shortly prior to companies' bankruptcy filings. The implementation of such programs pre-bankruptcy is likely to lead to questions regarding whether the benefits conferred are avoidable as fraudulent conveyances.

Relevant to this inquiry, the Act provides that a transfer made or obligation incurred within two years prior to a debtor's bankruptcy filing will be avoidable as a fraudulent conveyance if the debtor received less than a reasonably equivalent value in exchange for the transfer or obligation and it was made or incurred for the benefit of an insider under an employment contract and not in the ordinary course of business.

Official Committees. The Act authorizes the bankruptcy court to order the United States trustee to change the membership of an official committee if the court determines the change is required to assure adequate representation. The result of this change is that disputes regarding the make-up of official equity and creditor committees will shift from the United States trustee to the bankruptcy court. This shift to the bankruptcy court will likely result in these issues being more time consuming and expensive to resolve.

The Act also attempts to provide a voice to small business creditors who, due to the small size of their claims, are now excluded from creditors' committees. Under the Act, the bankruptcy court is authorized to order the United States trustee to appoint to a creditors' committee a "small business concern" (as defined in the Small Business Act") if the concern's claim is disproportionately large compared to the concern's annual revenue. The claim's size in proportion to other claims represented on the committee should not be relevant to the Court's determination. Note that the Act does not require, but rather merely authorizes, the Court to direct the appointment of small business concerns.

The Act does requires committees to provide their non-member constituents with access to information and allows for court orders requiring committee reports or disclosures to constituents. The Act also requires committees to solicit and receive comments from their non-member constituents.

Cross-Border Insolvency Cases. The Act adds a new chapter 15 to the Bankruptcy Code which incorporates the Model Law on Cross-Border Insolvency developed by the United Nations Commission on International Trade Law. The new chapter contemplates a high degree of cooperation between the United States and foreign countries with respect to cross-border cases. Cases brought under chapter 15 will be ancillary to the cases brought in the debtor's home country unless a bankruptcy case for the debtor is commenced in the United States under another chapter of the Bankruptcy Code.

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If you would like to discuss these provisions or any issues relating to bankruptcy or creditors' rights generally, please contact Wayne Davis at 212-508-6705 or at davis@tanhelp.com.

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