

Client Alert

Recent Amendments to the Bankruptcy Code Affecting Commercial Entities

On April 20, 2005, President George W. Bush signed the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "Reform Act") into law. The Reform Act will generally become effective on October 17, 2005 with the vast majority of amendments applicable only to cases filed thereafter. While consumer bankruptcy issues are at the heart of the Reform Act, it does contain numerous amendments that will have a significant impact on commercial bankruptcies.

Debtors Will Now be Able to Assume Real Property Leases Notwithstanding the Inability to Cure Non-Monetary Defaults

In general, a non-monetary default is a breach of any obligation in a lease other than a payment obligation. Certain non-monetary defaults are impossible to cure because the offending condition cannot be undone. For example, if a tenant fails to remain open for business in violation of a "going dark provision," the tenant cannot go back in time and reopen the business to repair the breach. Certain courts have refused to allow a debtor to assume a contract if the debtor has breached a non-monetary obligation that cannot be cured. Under the Reform Act, a debtor will now be able to assume a lease of real property notwithstanding the debtor's breach of a non-monetary obligation that cannot be cured.

Debtors Will Generally Have at Most 210 Days to Decide Whether to Assume a Real Property Lease

Current law does not limit the number and length of extensions a court may grant of the time within which a debtor-lessee must decide whether to assume a non-residential real property lease. Under the Reform Act, a debtor-lessee will have until the earlier of 120 days after the date of the order for relief or the confirmation date to assume a lease of non-residential real property. Unless the landlord consents, a court may, for cause, extend the deadline to assume leases once, and only for an additional 90 days. If a lease is not timely assumed, it will be deemed rejected.

A Landlord's Administrative Expense Claim Arising From the Rejection of a Previously Assumed Real Property Lease is Now Capped

Currently, if a lease is assumed and later rejected by a debtor-lessee, the landlord is entitled to an administrative claim in the amount of payments due under the lease for the full remaining term, and the claim is not subject to the section 502(b)(6) cap.¹ Under the Reform Act, only the rent for the two-

¹ Under section 502(b)(6) of the Bankruptcy Code, a landlord's claims for damages resulting from the rejection of a real property lease is limited to the rent reserved by the lease, without acceleration, for the greater of either one year or 15%, not to exceed three years, of the remaining lease term following the earlier of the bankruptcy filing or the date on which the landlord repossessed or the debtor surrendered the property.

year period subsequent to the rejection or the date of actual turnover of the property, whichever is later, will be entitled to administrative priority. A landlord's claim for rent after the two-year period will be capped under section 502(b)(6) and will be treated as a pre-petition claim.

Courts Will Carefully Scrutinize Payments Made to Debtor's Management

The administration of a bankruptcy case means substantially more work under enormous pressure for the debtor's management. A commercial debtor is understandably concerned about losing key employees at a time when the services of those employees may be critical to the debtor's rehabilitation. Under such circumstances, a debtor will often attempt to provide senior management and key employees with retention or incentive compensation (a/k/a "key employee retention plans" or "KERPs") for remaining in its employ through the administration of the bankruptcy case.

Some have questioned whether KERPs are necessary or appropriate in all cases. Creditors and other parties in interest have often been reluctant to object to such plans for fear of alienating key personnel. The Reform Act now imposes substantial restraints on KERPs. Under the Reform Act, a court may not authorize retention or incentive transfers to a senior manager unless the services provided by that individual are essential to the survival of the debtor's business and the individual has a "bona fide" job offer from another business at the same or higher rate of compensation. In addition, the Reform Act imposes caps on the amount of incentive or retention compensation that may be paid to individual members of senior management.

It will be More Difficult for a Trustee to Recover Pre-Bankruptcy Payments

A trustee may recover certain pre-bankruptcy transfers made by a debtor to creditors within 90 days of bankruptcy filing, subject to certain defenses. One such defense, the "ordinary course" defense, prevents a trustee from recovering a transfer if it was (i) a payment of debt incurred by the debtor in the ordinary course of business of the debtor and transferee; (ii) made in the ordinary course of business of the debtor and the transferee; and (iii) made according to ordinary business terms. Some courts have held that each of the foregoing must be shown to establish the ordinary course defense. The Reform Act lowers the hurdle by requiring that a preference defendant demonstrate only that the transfer was in payment of debt incurred by the debtor in the ordinary course of business of the debtor and the transferee and either (i) was made in the ordinary course of the business dealings between the debtor and the transferee, or (ii) was made according to ordinary business terms. Additionally, under the Reform Act, a debtor's pre-bankruptcy payments may not be recovered from a creditor if the aggregate value of the payments is less than \$5,000.

Reclamation Time Periods Will be Expanded

Under current law, a seller has 10 days to reclaim goods received by a debtor, unless the 10-day period ends after the bankruptcy filing, in which case, the seller has 20 days after receipt of the goods to make a reclamation demand. Under the Reform Act, a seller may reclaim goods if the debtor received the goods within the 45-day period prior to the bankruptcy filing. The seller must make a reclamation demand no later than 45 days after the debtor receives the goods, unless the 45-day period ends after the filing of the bankruptcy case, in which case the seller has until 20 days after the bankruptcy filing to make a reclamation demand. A seller that fails to make a reclamation demand may nonetheless assert an administrative expense claim for the value of the goods received by the debtor in the debtor's ordinary course of business within 20 days of the bankruptcy filing.

The Reform Act Limits the Debtor's Plan and Solicitation Exclusivity

With certain exceptions, only a debtor may file a chapter 11 plan during the first 120 days of its bankruptcy case. If the debtor files a plan within this "exclusive" period, no other party may file a competing plan for the next 60 days. Under current law, courts routinely extended these exclusivity periods, particularly in large and complex cases, giving debtors significant leverage in plan negotiations. Congress has now clamped down on debtor exclusivity. Under the Reform Act, a debtor may only have a maximum of 14 additional months of exclusivity, for a total of eighteen months.

Tax Claims are Given Additional Protections

The Reform Act provides additional protections for priority tax claims and mandates that they not be treated any less favorably than non-priority claims. Currently, a plan cannot be confirmed unless it provides holders of priority tax claims with deferred cash payments, over a period not to exceed six years from the date of assessment, with a value, as of the effective date of the plan, equal to the allowed amount of the claim. Under the Reform Act, a plan must provide that the holder of a priority tax claim receive such payments over a period not to exceed five years after the bankruptcy filing. The appropriate interest rate to be applied is the rate under applicable non-bankruptcy law determined as of the month of confirmation. In addition, the Reform Act provides that a plan cannot treat taxing authorities less favorably than the most favored holders of other non-priority unsecured claims. Thus, a class of unsecured creditors may not be paid in full unless and until the taxing authorities' claims have been satisfied.

The Reform Act provides holders of tax claims with additional protections. Under the Reform Act, a bankruptcy court is prevented from determining a debtor's property tax liability if the period for contesting such liability has expired under applicable non-bankruptcy law. Further, bankruptcy courts may not subordinate tax liens for *ad valorem* taxes to secured claims. Moreover, property taxes which accrued pre-petition qualify for priority treatment even though assessed post-petition.

Financial Contracts are Further Protected

The Bankruptcy Code provides non-debtor counterparties to forward contracts, repurchase agreements, swap agreements, commodities contracts and securities contracts with certain protections in order to prevent widespread market disruptions that might otherwise occur upon the debtor-counterparty's bankruptcy. For example, financial contracts are exempted from Bankruptcy Code provisions prohibiting the exercise of termination rights and staying the exercise of setoff rights and the enforcement of security interests. In addition, a trustee may generally not recover the debtor's pre-petition payments made pursuant to a financial contract.

The Reform Act broadens these existing protections and makes them applicable to additional and new financial products through amendments to the definition of the various financial contracts including "securities contract," "commodity contract," "forward contract," "repurchase agreement," and "swap agreement." The new definitions expressly include any combination of the other agreements referenced in the definition and any related master agreement. The new definitions expressly provide that a master agreement may govern financial contracts as well as other transactions and still retain all the protections provided to financial contracts.

Additionally, the Reform Act provides that a non-debtor party may exercise its contractual right to cause the liquidation, acceleration and termination of financial contracts. If a financial contract is

rejected, terminated, liquidated or accelerated, damages will be measured from the earlier of (i) the date of such rejection, or (ii) the date(s) of such liquidation, termination, or acceleration.

The Reform Act also allows “cross product” netting, which permits a creditor to “net out” or reduce the obligation it has to the debtor pursuant to a netting provision in an agreement by the amount of the credit that the debtor has with the creditor under unrelated and multiple agreements. A court or other agency cannot rely on the Bankruptcy Code or the automatic stay to prohibit the exercise of rights under master netting agreements.

The Reform Act Removes Certain Existing Limitations on the Employment of Investment Bankers

Under the current law, a debtor-in-possession may only employ professionals that are “disinterested persons,” as that term is defined in the Bankruptcy Code. The Reform Act maintains the “disinterestedness” requirement, but repeals certain automatic disqualification provisions. Currently, a financial advisor would *not* be disinterested (and therefore disqualified for retention by the debtor) if it was an investment banker for a security of the debtor within three years of the filing of the petition. Additionally, an attorney would not be disinterested if the attorney acted as counsel for such an investment banker in connection with the offer, sale or issuance of a security of the debtor. Under the Reform Act, such prior engagements will no longer disqualify professionals for retention by the trustee or debtor in possession.

The Requirement of “Adequate Assurance” to Utility Providers is Heightened

A utility provider may not alter service or discriminate against the reorganizing debtor-in-possession because of the commencement of a bankruptcy case or nonpayment of pre-petition bills, provided that the debtor-in-possession affords the utility provider “adequate assurance” of payment for future services. Under the current law, courts generally found that a projection of strong post-petition cash flow, a history of timely pre-petition payments, and the assurance of an administrative expense for post-petition services constituted “adequate assurance” and did not require the debtor to make a cash deposit or post additional security.

The Reform Act makes a significant change in this area by defining the term “assurance of payment” to mandate a cash deposit, letter of credit, certificate of deposit, or surety bond, specifically stating that the court may not consider payment history or the availability of an administrative expense claim in this regard. The Reform Act further provides that a utility may alter or discontinue service if such adequate assurance is not provided within 30 days of the filing of the petition.

The Composition of Official Committees and the Rights of Creditors

The Reform Act expands the courts’ powers to change the membership of an official committee. Courts are granted express authority to order the United States trustee to alter the membership of a committee if the change “is necessary to ensure adequate representation of creditors or equity security holders.” The Reform Act also grants courts the authority to order the United States trustee to appoint to a creditors’ committee a “small business concern” (as defined in the Small Business Act), if that business’s claim (of the kind represented by the committee) is disproportionately large in comparison to its annual gross revenue.

Additionally, the Reform Act expands the rights of creditors who are not members of a committee to certain information. Committees will now be required to (i) grant access to information to the creditors that the committee represents; (ii) solicit and receive comments from the creditors that it represents; and (iii) obey court orders that compel any additional disclosures to be made to such creditors.

Appointment of a Trustee

The Reform Act has not altered the general standards to be applied by a court in appointing a chapter 11 trustee. These standards still require that (i) the court must find cause for the appointment (including, but not limited to, fraud, dishonesty, incompetence, or gross mismanagement), or (ii) the court must find that the appointment is in the interests of creditors, stockholders, and other interests of the estate.

Significantly, the Reform Act now *requires* the United States trustee to move for the appointment of a trustee if there are “reasonable grounds to suspect” that the debtor’s current board members, chief executive or chief financial officer, or members of the governing body that selected the chief executive or chief financial officer, took part in actual fraud, dishonesty, or criminal conduct in the management of the debtor or the debtor’s public financial reporting.

Restoration of Retiree Benefits

Section 1114 governs the modification of retiree benefits. Although changes to this section are not substantial, the Reform Act provides some additional rights to retirees. Under the Reform Act, a court will be required to unwind any modification made to retiree benefits during the 180-day period before the filing of the petition if the debtor was insolvent on the date of modification *unless* the court finds that the balance of equities clearly favors the modification.

Plan Solicitation Issues

The Reform Act implements changes regarding the solicitation of acceptance or rejection of a plan.

Adequate Information. For a court to approve a disclosure statement, which is required before any solicitations regarding a plan may be made, the court must make a determination that the disclosure statement contains “adequate information” such that a hypothetical investor could make an informed judgment as to whether to accept or reject the plan.

The Reform Act has expanded the definition of “adequate information.” In making the determination, the court is now required under the Reform Act to consider “the complexity of the case, the benefit of additional information to creditors and other parties in interest, and the cost of providing additional information.” The Reform Act also requires that “adequate information” include a discussion of the material federal tax consequences of the plan.

Prepackaged Chapter 11 Cases. Under current law, if a debtor had commenced solicitation of acceptances of a prepackaged plan but a petition was filed before the end of the solicitation period, the solicitation must cease until a disclosure statement is approved. The Reform Act, however, allows solicitation to continue after the filing of a petition provided that the solicitation began before the filing and complies with applicable non-bankruptcy law.

Foreign Proceedings

Section 304 of the Bankruptcy Code authorizes United States bankruptcy courts to assist in the administration of insolvency, bankruptcy, or debt restructuring proceedings pending in foreign courts. The Reform Act adds a new Chapter 15 to the Bankruptcy Code that will replace section 304 of the Bankruptcy Code. Chapter 15 is based upon the model law on cross-border insolvencies proposed by the United Nations Commission on International Trade Law. With the adoption of Chapter 15, other countries may follow the lead of the United States and adopt a version of the Model Law.

Under Chapter 15, a debtor's foreign proceeding will generally be automatically recognized. If the foreign proceeding is pending in the debtor's home country, recognition will have certain immediate and automatic effects. For example, the automatic stay generally applicable to U.S. bankruptcy cases will apply with respect to the debtor and its property located in the United States upon recognition. A foreign proceeding that is pending someplace other than the debtor's home country will also be recognized, however, recognition will not have the same immediate effect.

Upon recognition of a debtor's foreign proceeding, irrespective of location, a court may grant "any appropriate relief." Appropriate relief includes (i) injunctions broader than the automatic stay; (ii) discovery concerning the debtor's assets, liabilities, and affairs; and (iii) additional relief available to a trustee. A court, however, cannot authorize the use of U.S. bankruptcy law to permit the recovery of pre-bankruptcy transfers under Chapter 15. Furthermore, a court may provide immediate relief upon the filing of a chapter 15 case, such as a temporary restraining order, if it is urgently needed to protect the debtor's assets or creditors' interests.

In addition to replacing section 304, Chapter 15 expressly authorizes U.S. courts, trustees and other persons authorized by a U.S. court to cooperate and communicate directly with foreign courts. Such cooperation can be accomplished by, *inter alia*, (i) coordinating the administration and supervision of the debtor's assets and affairs; (ii) implementing agreements relating to the coordination of proceeding; and (iii) coordinating concurrent proceedings.

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May 20, 2005

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