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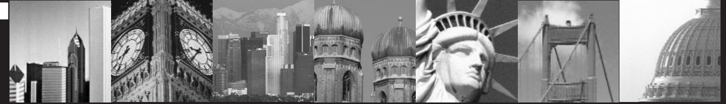
ALERT



July 2005

Bankruptcy Abuse and Consumer Protection Act of 2005

EXECUTIVE SUMMARY

On April 20, 2005 (the "Enactment Date"), President Bush signed the Bankruptcy Abuse and Consumer Protection Act of 2005 (the "Act"). **It has been widely reported as the most substantive change to the bankruptcy laws in 25 years.** We have prepared this alert to summarize some of the major changes in the Act that will affect business bankruptcies, including the provisions that:

- Limit Exclusivity
- Limit the Deadline for Lease Assumption/Rejection Decisions
- Increase the Requirements for Approving Key Employee Retention Plans
- Expand the Grounds for Conversion or Dismissal
- Expand the Rights of Reclamation Creditors
- Allow an Administrative Claim for Goods Delivered Prepetition
- Increase Security Provided to Utility Companies
- Change the Conflicts Rule for Investment Bankers
- Clarify the Types of Allowed Compensation for Professionals
- Create a New Chapter for Cross-Border Cases
- Expand the Rights of Employees
- Relax the Requirements for Prepackaged Plans
- Exempt Certain Securities Actions from the Automatic Stay
- Clarify the Obligation to Cure Non-Monetary Defaults
- Increase the Protections to Preference Actions
- Increase the Scope of Fraudulent Transfers Actions
- Increase the Participation Rights for Creditors
- Expand the Grounds for Appointment of a Trustee
- Provide for the Unwinding of Modifications to Retiree Benefits
- Expand the Information Necessary in Disclosure Statements
- Expand the Rights of Taxing Authorities

As a general rule, the Act becomes effective on October 17, 2005 and applies only to bankruptcy cases filed after that date. While most of the provisions that are immediately effective relate to consumer bankruptcies, there are certain business-related provisions – such as changes to sections governing wage priorities, fraudulent transfers, retiree benefits and the appointment of a trustee – that apply to current cases.

While the Act takes aim primarily at perceived consumer bankruptcy abuses, the new law, which includes a patchwork of special interest provisions, will have a significant effect on numerous aspects of business bankruptcy practice. Some key changes contained in the Act highlight Congressional dissatisfaction with the ways debtors, creditor committees and judges have been operating under the current Bankruptcy Code. The Act, however, does not address some significant issues that have been much debated, such as asbestos liability, venue and pension liability. **While some commentators have suggested that the legislation is anti-company, we believe that it is more appropriate to characterize it as pro-special interest groups.** In this regard, creditors as a whole may be worse off. At a minimum, securing financing will be more challenging because companies will need significantly more cash during a bankruptcy.

KEY CHANGES TO BANKRUPTCY CODE SECTIONS

A. Limit on Exclusivity

Arguably among the most significant changes in the Act are the provisions that limit a bankruptcy judge's discretion to extend a company's exclusive right to file a plan of reorganization. Under the current law, a company has the exclusive right for 120 days from the beginning of the case to file a plan of reorganization. If a plan is filed in such period, exclusivity is extended to 180 days from the beginning of the case for the company to secure the necessary votes from creditors to approve such plan. The Act does not alter the existing (initial) exclusivity periods, and the bankruptcy court still has the ability to extend those deadlines. **Under the Act, a bankruptcy court may not extend a company's exclusive right to file a plan beyond 18 months from the beginning of the case. If a plan is filed in that time frame, a bankruptcy court may not extend the exclusivity period to allow for voting beyond 20 months.**

Congress obviously believed that companies can and should propose and confirm a plan more quickly than they are doing under current law. How all companies are supposed to do this, given the unique facts of each case, is less clear. A difficulty with the solution to the perceived problem of protracted plan negotiations is its "one size fits all" approach. In many complex bankruptcy cases, issues directly affecting the value of the company and its ability to continue operations under any potential plan may take years to resolve. For example, in many cases, changes in collective bargaining agreements and pension plans, estimation or resolution of asbestos and other overwhelming and unliquidated claims, and similar issues cannot be resolved in 20 months. Although Congress may have disagreed with the way bankruptcy courts were using their discretion to extend exclusivity, the complete elimination of that discretion appears to be an imperfect fix.

Moreover, it is far from clear that the change will have its intended effect. The importance of a company's exclusivity is largely untested. Certainly, there have been numerous cases of competing plans and their success has been mixed. They can work, but they can also be expensive. Companies have argued that ending exclusivity will create chaos, while opponents have said it will simply end the company's ability to hold them hostage. Forcing companies to rush and file plans prematurely to avoid competing plans may result more often in flawed restructurings. It is also not self-evident that creditors committees, potential acquirers, unions or employee groups will, if given the right, file their own plans following the termination of exclusivity. **In any event, shorter exclusivity will not necessarily translate into shorter cases.**

B. Limiting the Deadline for Lease Assumption/Rejection Decisions

The Act limits the bankruptcy court's discretion to extend the time for a company to assume or reject leases of non-residential real property. Under the current law, a company is required to assume or reject such leases within the first 60 days of the case. The deadline could be extended without limit by the bankruptcy court, and in many cases companies had years to decide. **Under the Act, a company has until the earlier of (a) 120 days from the beginning of the case and (b) the date of plan confirmation to assume or reject these leases.** The bankruptcy court may grant an extension for up to 90 additional days, but no further extensions are allowed without the written consent of the landlord. Any non-residential real property leases not assumed in that period are deemed rejected. If a company assumes a lease and later developments force the company to reject it, the damages will be afforded administrative priority status, but will be capped at the monetary obligations due during the 2-year period following rejection.

As with extensions to the exclusivity period, it seems that Congress did not approve of decisions by bankruptcy judges to grant multiple extension of the time to assume or reject. Again, a more targeted and refined approval could have been more appropriate. If a company is delaying its decision to

assume or reject a lease as a negotiating tactic or because it is not sufficiently focused on exiting bankruptcy, an extension should not be granted. These decisions could be made on a case-by-case basis. If, however, the company cannot make these decisions to assume or reject because of other factors, the change in law will simply force companies to make early decisions that may turn out to be incorrect. This will, of course, have significant consequences in cases where leased real estate are significant assets of the company.

C. Key Employee Retention Plans

One of the few successful attempts by Democrats to influence the new bankruptcy law can be found in what will become new section 503(c). Senator Kennedy advocated this provision, which places substantial restrictions on a company's use of key employee retention plans ("KERPs"). **It is presumably in response to high-profile cases where historical officers were paid substantial sums to oversee failed enterprises during bankruptcy.**

Under the Act, a company may not pay or agree to pay any amount to an insider for the purpose of inducing such person to remain with the company unless specific requirements are satisfied. *First*, the person proposed to receive the payment must already have a bona fide job offer from another business at the same or greater rate of compensation. *Second*, the services of the person must be "essential to the survival of the business."

Even if these two requirements are met, the amount allowed under KERPs is limited. It cannot exceed ten times the average comparable transfer or obligation paid to non-management employees (for any purpose) during the preceding calendar year. If there were no such transfers or obligations made to non-management employees during the preceding year, the limit is 25 percent of any similar transfers or obligations made to the insider during the preceding calendar year.

The new provision will also limit severance payments to insiders. Such payments will be allowed only if they are part of a program applicable to all full-time employees. The amount paid to an insider may not exceed ten times the average severance pay given to non-management employees during the preceding year.

As stated above, these changes apply only to insiders. The definition of an insider has not been changed. With respect to a corporate debtor, the definition includes, most importantly for this purpose, directors, officers and persons in control. The new changes under the Act may give rise to new court decisions interpreting the meaning of "person in control" and deciding whether the non-exclusive definition of "insider" may actually include other employees.

As a catch-all provision, the new section also prohibits all "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." Payments under KERPs to non-insiders may not change significantly under this provision, since courts typically require such findings already. This change does, however, raise new questions that courts will have to answer, including for example, who will qualify as a "consultant" under this provision.

As a result, retention and severance payments to insiders will be called into greater question under the Act. Yet, insiders often receive large compensation that cannot be fairly characterized as either severance or retention benefits (for instance, success, profit sharing or performance-based compensation). This may become an area of contest in coming years.

D. Expanded Grounds for Conversion or Dismissal

The Act makes it more difficult for a bankruptcy court to deny a motion to convert or dismiss a bankruptcy case. The law currently provides that a bankruptcy court "may" convert or dismiss a case and lists 10 possible causes. The Act directs that the court "shall" convert or dismiss a case if the movant proves any one of 16 (non-exclusive) enumerated acts or omissions that constitute "cause."[1] There are three exceptions to this mandate:

- If "unusual circumstances specifically identified by the court . . . establish that the conversion or dismissal is not in the best interests of creditors and the estate."
- If (a) the cause for dismissal is an act or omission of the company, (b) there is a reasonable justification for the act or omission, (c) the act or omission will be cured within a reasonable time fixed by the court, and (d) there is a reasonable likeli-

[1] These include "substantial or continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation;" "gross mismanagement;" "failure to maintain appropriate insurance that poses a risk to the estate or to the public;" "unauthorized use of cash collateral substantially harmful to 1 or more creditors;" "failure to comply with an order of the court;" "unexcused failure to satisfy timely any filing or reporting requirement;" "failure to pay postpetition taxes or file tax returns;" and "failure to file a disclosure statement, or to file or confirm a plan," within the time fixed by the Bankruptcy Code or by the court.

hood that a plan will be confirmed within a reasonable period of time.

- If the court determines that appointment of a trustee or examiner, rather than conversion or dismissal, is in the best interests of the estate.

It is not obvious this provision will result in more cases being dismissed and/or converted. Rather, bankruptcy courts may seize on the ability to appoint an examiner (the scope of an examiner's powers and duties are dictated by the bankruptcy court on a case-by-case basis) where dismissal or conversion is inappropriate.

E. Reclamation

The Act creates a right of reclamation in favor of a seller of goods received by the company within 45 days before the beginning of a bankruptcy case. The seller must demand reclamation within 45 days after delivering the goods, or within 20 days after the filing of the case if the 45 day period would have expired subsequent to the filing. The current law simply preserves a seller's more limited state law reclamation rights and requires the reclamation demand to be made within 10 days after delivery (again, with an extension if the period would have expired after a bankruptcy case is commenced).

The Act also deletes the provision that allows the court to deny reclamation if it grants an administrative expense claim to the reclaiming creditor. **As a result, the practical application of these changes is far from clear.** Under the new section, a debtor may have to allow reclamation of the goods or obtain the bankruptcy court's permission to pay for the goods. In many circumstances, sellers may not want the goods to be returned. The effect of this change may be to require more negotiation with vendors early in bankruptcy cases to address an acceptable resolution. The Act does make clear that the reclamation right is subject to the rights of a secured creditor, which may nullify the newly expanded reclamation right in many cases.

F. Administrative Claims for Recently Delivered Goods

The Act provides that the "value" of goods received by the company within 20 days prior to the filing will be given administrative expense priority. Congress apparently has decided that the filing date is an appropriate point for dividing unsecured claims from administrative claims for everyone else, but that sellers of goods should be separated based on where they stood 20 days earlier. This will result in substantially higher administrative claims for some companies. There will also be a substantial amount of litigation over the "value" of goods provided by the seller.

G. Utility Deposits

An amendment to the provision protecting utility companies will require companies to expend more cash early in their bankruptcy case. Under the current section, companies are required to furnish adequate assurance of future payment to utilities, but companies often offer no more than the administrative expense priority to which the utilities are already entitled.

The revised section under the Act appears to require a company to provide adequate assurance of future payment within 30 days in the form of a cash deposit, letter of credit, certificate of deposit, surety bond, prepayment or other form mutually agreed to by the utilities and the company. **An administrative expense priority is no longer sufficient, and the bankruptcy court may not consider the debtor's timely prepetition payments or the availability of an administrative expense claim in setting adequate assurance.** Finally, another change to the section will permit a utility to recover or set-off against a prepetition security deposit without notice or court order.

For industrial companies and others with high utility costs, the need to use cash in this way early in the case could be crippling. The change could make the difference between reorganization and immediate liquidation of some companies.

H. Change in Conflicts Rule for Investment Bankers

As a general rule, a professional must be "disinterested," as that term is defined by the Bankruptcy Code, to be employed by the company. Under the current definition, investment bankers who performed certain services for the debtor prior to the bankruptcy case could not be "disinterested," thereby precluding them from being retained during the bankruptcy cases. The Act amends the definition of "disinterested" to provide that investment bankers who performed services for a company prior to bankruptcy are not automatically disqualified from being retained during the bankruptcy proceedings. **As a result, companies will have more flexibility in choosing investment bankers during the bankruptcy, including any investment bankers utilized before the bankruptcy.**

I. Compensation for Professionals

The Act amends the section governing compensation of professionals to clarify that professionals may be retained on a fixed or percentage fee basis, in addition to on a retainer, an hourly or a contingency fee basis. This is particularly applicable for investment bankers who are often paid a success fee in bankruptcy cases.

J. New Chapter for Cross-Border Cases

The Act replaces the existing provision addressing cross-border insolvencies with an entirely new chapter based on the United Nations model law. It details a mechanism for coordination between U.S. and foreign insolvency proceedings. Specifically, Chapter 15 will apply where foreign representatives seek relief in U.S. courts or companies in bankruptcy seek relief in foreign courts. The new chapter also prohibits discrimination against foreign creditors, who are generally given the same rights under the Bankruptcy Code as domestic creditors. **The new chapter will provide a greater framework for international insolvencies, which may increase cross-border cases in the U.S. and ease administration and disposition of foreign assets for U.S. debtors.**

K. Requirements Relaxed for Prepackaged Plans

The Act amends two sections that could encourage the use of prepackaged plans. *First*, under the current law, the United States Trustee must convene a meeting of creditors in all cases under the Bankruptcy Code. The Act amends that section to allow the bankruptcy court to dispense with the first meeting of creditors if the company has filed a prepackaged plan.

Second, the current law allows acceptances and rejections to a reorganization plan to be solicited prior to filing a bankruptcy case in compliance with applicable non-bankruptcy law, but any such solicitation must stop when a bankruptcy case is filed unless the bankruptcy court so authorizes. Under the Act, a company that solicited votes prior to the bankruptcy filing may solicit the same parties during the bankruptcy if both solicitations comply with applicable non-bankruptcy law.

L. Exceptions to the Automatic Stay Relating to Securities Actions

The Act adds many new exceptions to the automatic stay, including for securities investigations and enforcement actions. Specifically, the Act will permit (a) a "securities self regulatory organization" to commence or continue an investigation or action against the company to enforce such organization's regulatory power, (b) the enforcement of orders (other than monetary sanctions) obtained by such organization, and (c) the delisting of a company's stock. As a result, it does not appear that companies will be able to stop these types of proceedings by filing for bankruptcy.

M. Curing Non-Monetary Defaults

The current law provides that the obligation to cure defaults under an assumed contract does not apply to a default of any penalty rate or provision arising from any failure by the company to perform non-monetary obligations. Some courts have interpreted this provision to mean that a company is not required to cure any non-monetary defaults under executory contracts and unexpired leases. Others have held that the provision relieves companies only of the obligation to pay a penalty rate or to satisfy a penalty provision relating to a non-monetary default.

The Act clarifies the current law by providing that companies who seek to assume agreements do not need to cure non-monetary defaults (a) that relate to a penalty rate or penalty provision, or (b) when such a cure would be impossible. The non-debtor party to such executory contract or unexpired lease will need to be compensated under the Act, however, for any pecuniary loss resulting from such impossible-to-cure historical default and if the default relates to the operation of the facility, the company will also need to cure the default by performance after assumption in accordance with such lease.

N. Amendments to Preference Actions

The Act relaxes the elements of the ordinary course defense in a manner favorable to preference defendants. The Act allows a party to use the ordinary course of business defense if (a) the debt was incurred in the ordinary course of business of the debtor and defendant; and (b) (i) the transfer was made in the ordinary course of business between the parties *or* (ii) the transfer was made according to ordinary business terms. Under the current law, a defendant needs to satisfy *all* three elements.

Further, the Act prohibits preference actions for transfers less than $5,000 where debts are not primarily consumer-related and protects security interests perfected within 30 days (as opposed to the existing 10 days). Also, actions to recover a debt of less than $10,000 from a non-insider will need to be filed in the defendant's district of residence. **As a result, companies will face increased difficulties in avoiding preferential transfers.**

O. Amendments to Fraudulent Transfers

The Act extends the look-back period for the avoidance of fraudulent transfers from one to two years prior to the beginning of the bankruptcy case. This change will apply only to a case that is filed more than one year after the Enactment Date. The Act also provides that transfers to an insider under an employment contract not in the ordinary course of business can be avoided regardless of whether the company was insolvent at the time of the transfer. **These**

changes will apply to any case filed on or after the Enactment Date and will make it easier to avoid transfers to insiders.

P. Increased Participation for Creditors

The Act includes several amendments to the current law relating to official committees. First, the Act allows for increased participation and access to information for non-institutional creditors. Specifically, committees will need to (a) provide creditors with access to information if such creditors hold claims of the kind represented by the committee and are not appointed to the committee and (b) solicit and receive comments from these creditors. Additionally, the Act authorizes the bankruptcy court to order the United States Trustee to change the membership of the committee, including the placement of a small business on the committee if it holds a claim that is large in comparison with its own annual gross revenues.

Q. Appointment of a Trustee

Under the current law, a bankruptcy court appoints a trustee upon the request of a party for cause, including fraud and dishonesty. The Act now requires that the United States Trustee *shall* move for the appointment of a trustee if there are grounds to suspect fraud, dishonesty or criminal conduct in the current management of the company or its public financial reporting. This change will apply to any case filed on or after the Enactment Date. Additionally, as stated above, the Act allows the bankruptcy court to appoint a trustee if grounds exist to convert or dismiss the bankruptcy case, but the court determines that the appointment of a trustee or an examiner is in the best interests of the creditors and the estate.

R. Modification of Retiree Benefits

The Act provides that, upon the motion of a party in interest, a bankruptcy court may unwind any modification made to retiree benefits during the 180 days prior to the filing if the company was insolvent at the time of the modification unless the court finds that the balance of the equities clearly favors such modification. This change will apply to any case filed on or after the Enactment Date. Additionally, whereas, the court appoints a retiree committee under the current law, the Act provides that the bankruptcy court order the appointment of a retiree committee, but the United States Trustee actually appoints the committee.

S. Adequacy of Information in Disclosure Statements

When determining whether adequate information has been provided, the Act requires a bankruptcy court 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 Act also specifically requires as part of the adequate information required within a disclosure statement a discussion of the potential material federal tax consequences of the plan. **These changes confirm what is fairly typical procedure, so their impact should not be material.**

T. Bankruptcy Tax Modifications

Companies with large priority tax liabilities have sought to stretch out payment of such liabilities as long as possible under their plans. Under the current law, these claims are required to be paid in full no later than 6 years from the date of assessment. Companies have sometimes provided little or no payments on these claims immediately after confirmation, providing for payment only at the last allowable time. In addition, some courts have allowed companies to pay “market” interest rates on these claims rather than the higher rates demanded by the taxing authorities. Finally, because the tax claims are given priority only if they are unsecured, companies have provided even less favorable treatment to secured tax claims.

The Act makes significant changes to the existing law. A plan must now (a) provide for payment of priority tax claims in regular installments, (b) pay these claims in full within 5 years from the start of the bankruptcy case and (c) pay them on terms no less favorable than those given to the most favored general unsecured claims. In addition, the plan must provide similar treatment to secured claims that, were they unsecured, would have been priority tax claims. The Act provides that the interest rate applicable to these claims shall be the rate specified in applicable non-bankruptcy law in effect as of the month the plan is confirmed. Finally, the government is not stayed from setting-off refunds against liabilities, and there is no discharge for tax debt based on a fraudulent return or evasion of a tax.

U. New Wages and Benefits Claims

The Act amends the current law to increase the cap on priority wage claims to $10,000 (from $4,925) and to extend the time of accrual to 180 days (from 90 days) before the filing. A corresponding change raises the cap on employee benefit claims to $10,000 per covered employee. These increased priority claims are also likely to be required to be paid in cash when a company exits bankruptcy.

CONCLUSION

This alert outlines many important changes but is not an exhaustive discussion of every change under the Act. The actual legislation is very long, often convoluted, and not well-drafted. What is apparent is that the changes attempt to elevate the interests of a few special interests, such as taxing authorities and landlords, over the interests of the general creditor body. We are happy to discuss any questions you have. We are also available to meet with you to discuss the Act and its consequences.

Should you have any questions about the matters addressed in this Alert,
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