IMPLICATIONS OF THE BANKRUPTCY LEGISLATION OF 2005 FOR CORPORATE BANKRUPTCIES

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New bankruptcy legislation (the "2005 Amendments") has recently been passed by the United States Congress, and it is expected that the President will sign the new legislation into law today. Among other things, the 2005 Amendments amend title 11 of the United States Code (the "Bankruptcy Code"). Although a clear majority of the 2005 Amendments deal only with consumer bankruptcies or affect small businesses, there are a number of amendments that directly affect general corporate bankruptcies. As a result, we have drafted this memorandum to aid you in understanding what ramifications the 2005 Amendments will have on existing bankruptcy law as applied to large corporate reorganizations. Please note that the 2005 Amendments mentioned in this memo have been analyzed with uncertainty as to how courts will interpret and apply them in the future. Also, the vast majority of the 2005 Amendments will not become effective until 180 days from the time of the enactment and will only affect cases that are filed after such date;[1] however, various amendments will become effective either before or after such date, and such variances of effectiveness are noted herein wherever they are applicable.

ANALYSIS

The 2005 Amendments have implications for various aspects of corporate reorganizations. Consequently, the following nonexhaustive list discusses what aspects of corporate reorganizations have been affected by the 2005 Amendments:

- Exclusivity Period: The 2005 Amendments impose a hard limit on a debtor's exclusive periods. The Bankruptcy Code provides the debtor with a period of 120 days in which only the debtor may file a plan of reorganization. However, if the debtor has failed to file a plan within the requisite 120 days or a plan that was filed was not accepted by each impaired class within 180 days of the filing of the bankruptcy, any creditor or other party in interest would be permitted to file a plan. Courts have routinely granted extensions to the 120-day exclusivity period and 180-day acceptance period without any meaningful restrictions in the Bankruptcy Code on the court's discretion to do so. Pursuant to the 2005 Amendments, a court will

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[1] Certain amendments will affect bankruptcy cases that were filed both before and after the effective date, but none of those amendments affect general corporate bankruptcies and, consequently, have not been mentioned in this memorandum.

now have less discretion to extend a debtor's exclusive periods. Under the 2005 Amendments, extensions on the exclusivity period for filing a plan may not be extended beyond 18 months from the time of filing for bankruptcy and, if a plan is filed, the period for acceptance may not be extended beyond 20 months of the filing of the bankruptcy. Whether these hard outside periods for exclusivity extensions substantially impact plan negotiations remains to be seen.

- Prepackaged Bankruptcies: The Bankruptcy Code mandates that the United States Trustee conduct a meeting of creditors and equity holders within a reasonable time after a debtor files for bankruptcy. Pursuant to the 2005 Amendments, the bankruptcy court may waive the requirement for such a meeting in a prepackaged bankruptcy. The 2005 Amendments also clarify that acceptance or rejection of a plan of reorganization may be solicited before the debtor files for bankruptcy without providing a court approved disclosure statement and a copy of the plan or a summary thereof as long as the solicitation complies with relevant nonbankruptcy law.

- Commercial Leases: Prior to the 2005 Amendments, a commercial lease would be terminated by operation of law and the debtor lessee would be required to immediately surrender the property to the lessor if the debtor did not choose to assume the lease within 60 days of the filing date, which 60-day period could be (and routinely was indefinitely) extended "for cause." The 2005 Amendments modify this provision, in a manner that will almost certainly increase the leverage of commercial landlords. The initial time period for the debtor to assume the lease has been extended to the earlier of 120 days from the time of filing for bankruptcy or upon confirmation of the plan of reorganization. And, an additional 90-day extension may be granted "for cause." However, the court no longer has the discretion to grant extensions beyond 210 days from the time of filing for bankruptcy; such extensions may only be granted upon the consent of the lessor of the property.

  In what is perhaps an effort to mitigate the forced premature assumptions that may be caused by this new seven month deadline, the 2005 Amendments also limit the damage claims a landlord may assert if a commercial lease that was previously assumed is subsequently rejected later in the debtor's case. Under existing law, the damages resulting from the rejection of an assumed executory contract, including a commercial real property lease, would constitute an administrative expense of the bankruptcy and be entitled to payment in full as a condition of confirmation. Pursuant to the 2005 Amendments, the damages qualifying as an administrative expense resulting from the subsequent rejection are capped at the amount of the obligations due under the lease for two years from the later of the date of the rejection or the actual turnover of the premises, excluding any damages arising from the debtor's failure to operate or any penalty provisions, and are subject to reduction or setoff to the extent sums are received from a non-debtor entity (*e.g.*, through mitigation or a guaranty). The remaining sums due for the balance of the lease term

will be treated as unsecured claims and subject to the existing damage cap of Bankruptcy Code § 502(b)(6) (*i.e.*, the greater of either one-year of reserved rent or fifteen-percent of the remaining term of the lease for up to an amount equal to three years of rent).

- Investment Bankers: Only disinterested professionals may be retained under the Bankruptcy Code. Prior to the 2005 Amendments, an investment banker could not qualify as a "disinterested person" if it (i) is or was the investment banker for any outstanding security of the debtor or (ii) had been an investment banker for a security of the debtor within three years of the filing of the debtor's bankruptcy. Employees of, and any attorney who in connection with the offer, sale, or issuance of a security of the debtor represented, such a disqualified investment banker, were equally disqualified. The 2005 Amendments eliminate any differentiation of investment bankers from other professionals since an investment banker can now qualify as a "disinterested person", and, therefore, is eligible to be retained by a debtor, unless the investment banker has an interest that is materially adverse to the estate or any class of creditors or equity holders. This is a significant change that will increase the number of available investment banking firms, and, accordingly, will likely change the players advising debtors in large corporate bankruptcy cases.

- KERPs: Debtors have routinely obtained court approval for key employee retention programs ("KERPs") during the early stages of a bankruptcy case. Now, debtors seeking to implement KERPs will face more stringent requirements for court approval. Specifically, the 2005 Amendments require that the court find that (i) the transfer or obligation (*i.e.*, the proposed KERP benefit) is essential to the retention of the person because the individual has a bona fide job offer from another business at the same or greater rate of compensation and (ii) the services provided by the person are essential to the survival of the business and either (1) the transfer or obligation (*i.e.*, the amount of the proposed KERP benefit) is not greater than 10 times the amount of the average 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 (2) if no such transfers had been made to nonmanagement employees, the transfer or obligation is not more than 25% of the amount of any similar transfer or obligation made to or benefiting the insider for any purpose during the previous calendar year. The 2005 Amendments further prohibit (i) a severance payment to an insider unless the payment is part of a program that is generally applicable to all full-time employees and the payment is not greater than 10 times the amount of the average severance payment given to nonmanagement employees during the calendar year in which the payment is made and (ii) 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 or obligations made to, or benefiting, officers, management, or consultants hired after the date of the filing of the bankruptcy.

- Preference Actions: Under the Bankruptcy Code, a transfer of property that was made within a 90-day period[2] before the bankruptcy may be voided as a preferential transfer if the transfer was made on account of a prior debt while the debtor was insolvent (a "Preference Action"). Not all transfers within the preference period are avoidable, however. For example, transfers made for a contemporaneous debt are not avoidable preferences under the Bankruptcy Code. The Bankruptcy Code also provides a variety of safe harbors for certain transfers that occur within the preference period that have been modified by the 2005 Amendments.

  - Perfection of Security Interests: A perfection of a security interest will constitute an avoidable preference if perfection was not contemporaneous with the incurrence of the debt being secured. Prior to the 2005 Amendments, the Bankruptcy Code provided that the perfection of a security interest would be deemed as contemporaneous with the incurrence of the debt that is being secured as long as the security interest was perfected within 10 days of incurring the debt or within 20 days with respect to a purchase money loan. The 2005 Amendments have expanded both windows for perfection to 30 days.

  - Ordinary Course Exception: The Bankruptcy Code provides that a transfer made on account of an antecedent debt will not constitute a preferential transfer if it was (i) payment on account of debt incurred in the ordinary course of business, (ii) the payment was made in the ordinary course of business, and (iii) the payment was made according to ordinary business terms. Pursuant to the 2005 Amendments, a creditor now need only prove that the debt was incurred in the ordinary course of business and that either (i) the payment was made in the ordinary course of business or (ii) the payment was made according to ordinary business terms.

  - Transfers to Non-Insider Creditors: In 1994, the Bankruptcy Code was amended in an effort to address the *Deprizio* line of cases, which had held non-insider creditors liable for preferences made for the benefit of insiders more than 90 days but less than one year from the time of the bankruptcy filing. Notwithstanding Congress' expressed intent to overrule this line of cases, courts and commentators had noted that that "fix" - a change to Section 550(c) of the Bankruptcy Code - left open a loophole with respect to the avoidance of non-possessory security interests as preferences (*e.g.*, a lien perfected by filing) granted more than 90 days but within one year of filing if the effect of the grant was (arguably) to benefit an insider of the grantor. The 2005 Amendments clarify that transfers made within the extended reach-back period are avoidable only as to the benefited insider and not as against the non-insider creditor.

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[2] The reach-back period for transfers to "insiders", as defined by the Bankruptcy Code, is one year.

- Fraudulent Conveyances: The Bankruptcy Code allows a transfer of a debtor's interest in property or the incurrence of an obligation by a debtor that was made within a specified period of time to be set aside if such was made (i) with the intent to hinder, delay or defraud a creditor or (ii) such was made for less than reasonably equivalent value and (1) the debtor was insolvent or was so rendered as a result of the transfer or incurrence of the obligation, (2) the debtor had unreasonably small capital remaining after the transfer, or (3) the debtor was incurring, or about to incur, debts beyond the debtor's ability to pay as they mature. Prior to the 2005 Amendments, only a transfer made within one year from the date the debtor filed for bankruptcy could be set aside as a fraudulent conveyance.[3] Now, the period has been expanded to two years.[4]

  The 2005 Amendments also add new provisions directed at transfers to or for the benefit of an insider under an employment contract. More specifically, a transfer that was made under an employment contract outside the ordinary course of business for less than reasonably equivalent value and that was made for the benefit of an insider, or the incurrence of an obligation to or for the benefit of an insider, may be set aside by a court regardless of whether the debtor was insolvent at the time of the transfer or was effectively rendered insolvent by the transfer.

  Except as otherwise noted, all changes concerning fraudulent conveyances are effective immediately.

- Appointment of a Trustee or Examiner: Upon the request of a party in interest or the United States Trustee, the court may order an appointment of an independent trustee to manage the debtor if cause exists, including fraud, dishonesty, or gross mismanagement of the debtor, or if such appointment would be in the best interests of creditors, equity holders, and other interests of the estate. Pursuant to the 2005 Amendments, a trustee may also be appointed if grounds exist to dismiss or convert a case (see below), but the court determines that the appointment of a trustee or an examiner is in the best interests of creditors and the estate. The 2005 Amendments further provide that, effective immediately, the United States Trustee shall move for the appointment of a trustee if there are reasonable grounds to suspect that current members of the debtor's governing body, the CEO or CFO, or members of the governing body who selected the CEO or CFO, participated in "actual fraud,

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[3] The Bankruptcy Code also permits the debtor and creditors to bring such actions under state fraudulent conveyance laws, which typically have a look-back window of at least four years.

[4] Although the 2005 Amendments dealing with fraudulent conveyances are effective immediately, the amended two-year look-back window will only apply to cases commenced more than one year after the enactment.

dishonesty, or criminal conduct in the management of the debtor or the debtor's public financial reporting."

- Self-Regulating Securities Organizations: Upon the filing of a bankruptcy, there is an automatic stay that enjoins all actions against the debtor except for those specifically excepted from the stay by the Bankruptcy Code or permitted by the court. The 2005 Amendments add actions brought by Self-Regulating Securities Organizations that are registered with the Securities and Exchange Commission to the list of actions that are specifically excepted from the automatic stay. In particular, a Self-Regulating Securities Organization, such as the NYSE, may conduct investigations, prosecute actions to enforce its regulatory power, enforce existing regulatory orders (other than monetary sanctions), and delist stock of a debtor notwithstanding the automatic stay.

- Assumption of Contracts and Leases: In order for an executory contract or unexpired lease to be assumed in bankruptcy, the debtor must cure certain defaults that may exist or provide adequate assurances that such defaults will be cured. Prior to the 2005 Amendments, it was unclear whether the Bankruptcy Code required non-monetary defaults in leases to be cured. Since certain non-monetary defaults, such as store operation requirements in a lease, were incapable of being cured retroactively, such leases could not be assumed if the Bankruptcy Code was interpreted as requiring the cure of non-monetary defaults that were, as a result, impossible to cure. Accordingly, a debtor could be barred from assuming leases where such non-monetary defaults existed. Now, the 2005 Amendments have clarified that if it is impossible for the debtor to cure such a default by performing non-monetary acts retroactively, then such non-monetary defaults need only be cured by performance at and after the time of assumption in accordance with such lease. Any pecuniary losses resulting from such non-monetary default must still be cured in order for the contract or lease to be assumed.

- Venue for Adversary Proceedings: Prior to the 2005 Amendments, as a default rule, an adversary proceeding, such as a Preference Action, could be brought against anyone in the district where the debtor's non-consumer bankruptcy case is located regardless of amounts or where the defendant is located. Now, the debt of a non-insider that constitutes less than $10,000 may only be brought in the district where the defendant resides. A proceeding may still be brought against an insider of the debtor in the district where the debtor's bankruptcy is located regardless of the amount.

- Single Asset Real Estate Case: The Bankruptcy Code provides that the debtor must either file a plan that has a reasonable possibility of being confirmed within a reasonable time or has commenced interest payments at the current market rate within 90 days of the time the debtor filed for bankruptcy. Pursuant to the 2005 Amendments, the debtor now has until the later of 30 days from the time a court

determines that the case is a single asset case or 90 days from the date the debtor filed for bankruptcy to file the plan or commence interest payments. The 2005 Amendments also provide that the interest payments are at the applicable nondefault contract rate, not the current fair market rate, and provide that the debtor may make such payments from rents or other income generated before, on, or after the date the debtor filed for bankruptcy.

- Committees: The Bankruptcy Code provides that the United States Trustee appoint a committee of creditors holding unsecured claims and may appoint additional committees of creditors or equity security holders as it may deem appropriate. Upon the request of a party in interest, the court may also direct the United States Trustee to appoint additional committees. Pursuant to the 2005 Amendments, upon the request of a party in interest, the court may now also order that the United States Trustee change the membership of a committee in order to ensure adequate representation of creditors or equity security holders. In particular, the court may order the United States Trustee to increase the number of committee members to include a small business if the court determines that the creditor holds claims in an aggregate amount that is disproportionately large in comparison to the small business's annual gross revenue. The 2005 Amendments also add a requirement that a committee (i) provide access to information to creditors holding claims of the type represented by the committee (ii) solicit and receive comments from such creditors, and (iii) be subject to a court order that compels any additional report or disclosure to be made to such creditors.

- Return of Goods: In 1994, the Bankruptcy Code was amended to allow sellers of goods to reclaim goods shipped to, or to offset the purchase price of prepetition goods returned by, a debtor against the prepetition claims held by the creditor as long as the creditor consents and the court approves of the action within 120 days of the filing of the bankruptcy petition. Consistent with recent case law, the 2005 Amendments have clarified that the debtor's right to return and the creditor's right to offset are subject to the prior rights of holders of any security interests in such prepetition goods or the proceeds thereof. The 2005 Amendments also allow a seller of goods, subject to the prior rights of holders of any security interests in such prepetition goods or the proceeds thereof, to reclaim any goods that the seller provided to the debtor in the ordinary course of business while the debtor was insolvent and within 45 days of the debtor's bankruptcy as long as the seller makes a written demand for such goods within the earlier of (i) 45 days from the date the debtor received the goods or (ii) 20 days from the time of the bankruptcy if the 45-day period will expire after the bankruptcy was filed. In addition, the 2005 Amendments have removed the court's discretion to deny the reclamation demand if the debtor granted the seller an administrative expense priority claim or a lien. Instead, it appears that the court must now grant the reclamation demand if it is timely made. In any case, a seller will be entitled to an administrative expense

priority claim for the value of any goods received by the debtor in the ordinary course of business within 20 days prior to the filing of the bankruptcy and not reclaimed.

- Compensation of Professionals: The 2005 Amendments add a provision that the court should consider whether a professional is board certified or has otherwise demonstrated skill and experience in the bankruptcy field when determining whether the professional's fees are reasonable.

- Utilities: The Bankruptcy Code prohibits a utility from altering, refusing, or discontinuing service to a debtor based solely upon the filing of bankruptcy or that a debt to the utility is outstanding at the time of the filing. However, a utility may alter, refuse, or discontinue service if the debtor does not furnish adequate assurance of payment for future services within 30 days of the debtor's filing for bankruptcy. Courts have interpreted this requirement as permitting an administrative expense priority to constitute an adequate assurance of payment. Pursuant to the 2005 Amendments, an administrative expense priority will no longer constitute adequate assurance. Instead, the debtor must provide (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 (iv) another security that is mutually agreed upon between the utility and the debtor within 30 days from the time the bankruptcy was filed. The 2005 Amendments also prohibit the court from considering the debtor's prior payment history or the lack of any security prior to the bankruptcy when determining the amount of adequate assurances that must be provided. A utility may now also recover or set off against a security deposit prior to the bankruptcy filing without notice or court order.

- Employee Wages: The Bankruptcy Code mandates that certain unsecured claims be paid before other unsecured claims. As a result, certain employee wages are to be satisfied before other unsecured claims are paid. Prior to the 2005 Amendments, up to $4,925 for each employee of the debtor who had unpaid wages outstanding within the earlier of 90 days prior to the debtor's bankruptcy or the date the debtor ceased its business constitutes such a priority claim. Effective immediately, up to $10,000 for each employee must be paid, to the extent funds are available, for wages outstanding within the earlier of 180 days prior to the debtor's bankruptcy or the date the debtor ceased its businesses.

- Retirement Benefits: In an effort to avoid bankruptcy, a debtor will often seek to modify the retirement benefits of its employees. Effective immediately, pursuant to the 2005 Amendments, a court may undo any modifications that were made to the benefits within 180 days of the debtor's filing for bankruptcy if the debtor was insolvent at the time the modifications were made, unless the court finds that the balance of the equities favors such modifications.

- Fraud: Certain debts are non-dischargeable in a bankruptcy, and, accordingly, a debtor will still be required to pay them in full regardless of the bankruptcy. Until now, non-dischargeability was only applicable to individual debtors. The 2005 Amendments now make non-dischargeable a corporate debtor's obligations (i) arising from fraud and owing to a governmental entity or (ii) resulting from tax or customs fraud.

- Conversion from Chapter 11 to Chapter 7: The Bankruptcy Code permits a chapter 11 reorganization to be converted to a chapter 7 liquidation upon the request of the debtor or upon the request of a party in interest upon a showing of "cause". The Bankruptcy Code further provides a nonexclusive list of what would constitute sufficient cause. The 2005 Amendments have added the following circumstances to the nonexclusive list: (i) substantial or continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation, (ii) gross mismanagement of the estate, (iii) failure to maintain appropriate insurance that poses a risk to the estate or to the public, (iv) unauthorized use of cash collateral substantially harmful to one or more creditors, (v) failure to comply with an order of the court, (vi) failure to satisfy timely any filing or reporting requirement, (v) failure to attend the meeting of creditors or a Rule 2004 examination without good cause, (vi) failure to timely pay taxes owed or file tax returns after the date the debtor filed for bankruptcy, and (vii) failure to file a disclosure statement, or to file or confirm a plan, within the time fixed by the Bankruptcy Code (see "Exclusivity Period" above) or an order of the court. In addition, if the court finds that "cause" exists, conversion is now mandatory unless (i) the court instead appoints a trustee or examiner (discussed above), (ii) there exists unusual circumstances that conversion is not in the best interests of creditors and the estate, or (iii) the debtor demonstrates there is reasonable likelihood of confirmation within a reasonable period of time and the grounds for granting conversion are reasonably justified and will be cured within a reasonable period of time.

- Cross-Border Insolvencies: Section 304 of the Bankruptcy Code, dealing with cross-border insolvencies, has been deleted in its entirety pursuant to the 2005 Amendments. In its place an entirely new chapter 15 has been added. The new chapter 15 incorporates the Model Law on Cross-Border Insolvency as promulgated by the United Nations Commission on International Trade. Among other things, the 2005 Amendments provide (i) that a foreign representative may commence an involuntary or voluntary case, (ii) that foreign creditors have the same rights as domestic creditors, including the right to notice, (iii) for recognition of foreign proceedings, (iv) for cooperation between a United States court and a foreign court or a foreign representative, and (v) for the coordination of concurrent proceedings.

- Commodities Agreements: The 2005 Amendments expand and clarify the definitions of forward contract, repurchase agreement and swap agreement and also

add master netting agreements to the list of agreements that are not subject to the bankruptcy stay. The 2005 Amendments also clarify provisions permitting counterparties to liquidate, terminate, accelerate or offset (in the case of a master netting agreement) outstanding securities contracts, commodity contracts, forward contracts, repurchase agreements, swap agreements, and master netting agreements notwithstanding the imposition of the automatic stay.

If you have questions concerning the implications of the 2005 Amendments, please contact one of the partners in our bankruptcy practice:

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