

GENERAL COMMERCIAL ISSUES UNDER BAPCPA

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December 2, 2005

1. THE CHAPTER 11 REORGANIZATION PROCESS

One of the main themes of BAPCPA is the tightening of controls on debtors in possession in Chapter 11 cases, with the objective of preventing abuses and speeding up the reorganization process.

- **Status Conferences.**

Prior to BAPCPA, status conferences convened by the Bankruptcy Court under Section 105 were purely discretionary. BAPCPA amends Section 105(d) to provide that the court *shall*, on its own motion or on the request of the party in interest, “hold such status conferences as are necessary to further the expeditious and economical resolution of the case.

- **Securities Self Regulatory Organization Actions Excepted from the Automatic Stay.**

BAPCPA amends Section 362(b) to add a new exception from the automatic stay for investigatory or enforcement actions by “a securities self regulatory organization to enforce such organization’s regulatory power,” including the enforcement of an order or decision (other than for monetary sanctions) and an act to “delist, delete, or refuse to permit quotation of any stock that does not meet applicable regulatory requirements.” A “securities self regulatory organization” is defined in Section 101(48A) as a securities association or national securities exchange registered with the SEC.

- **Limitations on Exclusivity in Cases Other Than Small Debtor Cases.**

BAPCPA amends Section 1121 to limit the extension of the “exclusivity periods” during which only a debtor in possession may file and solicit acceptances of a reorganization plan. The 120 day exclusivity period for filing a plan may not be extended beyond 18 months after the order of relief, and the 180 day period for soliciting acceptances of the plan may not be extended beyond 20 months after the order of relief.

- **Conversion or Dismissal.**

BAPCPA limits the Bankruptcy Court’s discretion to deny a motion to convert or dismiss a Chapter 11 case under Section 1112 if the moving party establishes “cause.” If “cause” is established, the court “shall” convert or dismiss the case unless certain narrowly defined exceptions apply. Those exceptions include (i) a determination that appointment of a trustee or examiner under Section 1104(a)(3) is in the best interests of creditors and the estate, and (ii) other “unusual circumstances specifically identified by the court that establish that [the requested conversion or dismissal] is not in the best interests of creditors and the estate.”

The amendments to Section 1112 also set a tight time table for hearings on motions to convert or dismiss (the hearing must commence no later than 30 days after the filing of the motion and the motion must be decided no later than 15 days thereafter, absent “compelling circumstances” or the creditor’s consent), and expand the open-ended definition of “cause” to include several additional specific acts and omissions, such as “failure to maintain appropriate insurance ..., unauthorized use of cash collateral substantially harmful to 1 or more creditors; and failure to comply with court orders, satisfy filing and reporting requirements, attend meetings, provide information, pay taxes or fees, file a disclosure statement, or file and obtain confirmation of a plan within time periods fixed by the Code or by the order of the court.

- **Appointment of Trustee or Examiner.**

BAPCPA amends Section 1104(a) to add a new clause (3), setting forth new grounds for appointment of a trustee. Under the new clause (3), the court shall order the appointment of a trustee “if grounds exist to convert or dismiss the case under Section 1112, but the court determines that the appointment of a trustee or an examiner is in the best interests of creditors and the estate.” Strictly construed, this language would seem to require the appointment of a trustee even if the court believed that the appointment of an examiner was a preferable remedy. However, it is questionable whether this is what Congress really meant or how the statute will be construed.

The BAPCPA also adds language to Section 1104(b) providing for certification by the United States trustee of any election of a trustee under clause (b)(1), and resolution by the Bankruptcy Court of any dispute arising out of any such election. Finally, BAPCPA has added a new subsection (e) to Section 1104, requiring the United States trustee to move for an appointment of a trustee under subsection (a) “if there are reasonable grounds to suspect ... actual fraud, dishonesty, or criminal conduct in the management of the debtor or the debtor’s public financial reporting” by members of the debtor’s board or its CEO or CFO.

- **Committees.**

BAPCPA gives the Bankruptcy Court the power to “order the United States trustee to change the membership of a committee appointed under [Section 1102], if the court determines that the change is necessary to ensure adequate representation of creditors or equity security holders.” The court may order the inclusion on the committee of a “small business concern (as described in Section (3)(a)(1) of the Small Business Act)” if the creditor’s claims are “disproportionately large” in comparison to its annual gross revenue.

Under new clause (3) of Section 1102(b), a committee must provide “access to information” to, and solicit input from, the creditor constituency that the committee represents.

A retiree committee appointed under Section 1114(d) will be appointed by the United States trustee when so ordered by the Bankruptcy Court, rather than directly by the court.

- **Disclosure Statements.**

“Adequate information” included in a disclosure statement under Section 1125 must now include “a discussion of the potential material Federal tax consequences of the plan to the debtor, any successor to the debtor, and a hypothetical investor typical of the holders of claims or interests in the case.”

In determining whether the disclosure statement provides adequate information, the court “shall 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.”

2. **PREPACKAGED BANKRUPTCIES**

BAPCPA clarifies and streamlines “prepackaged bankruptcy” procedures in two significant respects:

- **Disclosure Statements.**

BAPCPA adds a new subsection (g) to Section 1125, providing that solicitation of plan acceptances or rejections can occur in the absence of an approved disclosure statement “if such solicitation complies with applicable nonbankruptcy law and [takes place] before the commencement of a case in a manner complying with applicable nonbankruptcy law.”

- **Meetings of Creditors.**

Under new subsection (e) of Section 341, “the court, on the request of a party in interest and after notice and a hearing, for cause may order that the United States trustee not convene a meeting of creditors or equity security holders if the debtor has filed a plan as to which the debtor solicited acceptances prior to the commencement of the case.”

3. **SMALL BUSINESS CASES.**

BAPCPA introduces several new provisions regulating in minute detail the conduct of “small business cases,” in which no creditors’ committee is appointed to oversee the debtor’s activities.

- **Definitions.**

BAPCPA adds definitions of “small business case” and “small business debtor.” Under clause (51C) of Section 101 a “small business case” is “a case filed under

Chapter 11 ... in which the debtor is a small business debtor,” which is defined in turn in clause (51D) to mean “a person engaged in commercial or business activities (including any affiliate of such person that is also a debtor [in a case under the Code]” but “excluding a person whose primary activity is the business of owning or operating real property or activities incidental thereto)” having “aggregate non-contingent liquidated secured and unsecured debts ... in an amount not more than \$2,000,000 (excluding debts owed to 1 or more affiliates or insiders)” in a case “in which the United States trustee has not appointed a committee of unsecured creditors or ... the court has determined that the committee of unsecured creditors is not sufficiently active and representative to provide effective oversight of the debtor.” However, a debtor will not qualify as a “small business debtor” if it is a member of a group of affiliated debtors with aggregate debts in excess of the two million dollar threshold.

- **Duties of Debtor-In-Possession or Trustee.**

BAPCPA adds a new Section 1116 to the Bankruptcy Code, listing the duties of a debtor-in-possession or a trustee in a small business case, including the duties to (i) attach to the bankruptcy petition the debtor’s most recent balance sheet, statement of operations, cash flow statement, and federal income tax return (or a statement that such documents have not been prepared or that no such tax return has been filed); (ii) attend meetings scheduled by the court or the United States trustee; (iii) timely file the debtor’s schedules and statement of financial affairs (with extensions that cannot exceed 30 days after the order for relief absent compelling circumstances); (iv) file post-petition reports; (v) maintain customary and appropriate insurance; (vi) timely file tax returns and other government filings, and timely pay all taxes entitled to administrative expense priority; and (vii) allow the United States trustee to inspect the debtor’s business premises, books, and records.

- **Duties of the United States Trustee in Small Business Cases.**

BAPCPA amends 28 U.S.C. § 586 to impose various duties on the United States trustee in small business cases, including conducting an initial debtor interview and monitoring the debtor’s activities. In any case in which the United States trustee finds “material grounds” for any relief under Section 1112, he or she must promptly apply for such relief.

- **Reporting Requirements.**

BAPCPA adds a new Section 308 to the Bankruptcy Code, requiring small business debtors to file periodic financial and other reports covering the debtor’s profitability, projected cash receipts and cash disbursements, actual cash receipts and disbursements as compared with prior projections, the timely filing of tax returns and payment of taxes, and compliance with other requirements of the Bankruptcy Code and rules, together with a description of any failings in this regard and the steps the debtor intends to take to remedy such failures. These

reporting requirements will become effective 60 days after the promulgation of rules and forms to be used in complying with the requirements of Section 308.

- **Disclosure Statements.**

BAPCPA amends Section 1125 of the Code to provide that, in a small business case, the Bankruptcy Court may (i) “determine that the plan itself provides adequate information and that a separate disclosure statement is not necessary;” (ii) “approve a disclosure statement submitted on standard forms approved by the court or adopted under” 28 U.S.C. § 2075; and (iii) “conditionally approve a disclosure statement subject to final approval after notice and a hearing,” which may be combined with the hearing on confirmation of the plan. Plan acceptances and rejections may be solicited on the basis of such a conditionally approved disclosure statement if it is mailed to creditors not later than 25 days before the confirmation hearing.

- **Exclusivity and Plan Filing and Confirmation Deadlines.**

BAPCPA amends Section 1121(e) to provide that “only the debtor may file a plan until after 180 days after the date of the order for relief [and] the plan and a disclosure statement (if any) shall be filed not later than 300 days after the date of the order for relief” in a small business case.

BAPCPA also adds a new subsection (e) to Section 1129, providing that, in a small business case, if a plan meets the legal requirements for confirmation, it must be confirmed not later than 45 days after it is filed.

The 180 day exclusivity period may be suspended if “the court, for cause, [so] orders.” In addition, the 180 day exclusivity period, the 300 day plan filing deadline, and the confirmation deadline provided in Section 1129(e) may each be extended if “(A) the debtor, after providing notice to parties in interest (including the United States trustee), demonstrates by a preponderance of the evidence that it is more likely than not that the court will confirm a plan within a reasonable period of time; (B) a new deadline is imposed at the time the extension is granted; and (C) the order extending time is signed before the existing deadline has expired.”

- **Automatic Stay Inapplicable to Serial Small Business Filers.**

BAPCPA adds a new subsection (n) to Section 362 to provide that the automatic stay does not apply if the debtor (i) is a debtor in another small business case that is pending when the petition is filed, (ii) was a debtor in a small business case that was dismissed for any reason within the preceding two years, or (iii) was a debtor in a small business case in which a plan was confirmed within the preceding two years.

The automatic stay will also not apply in the bankruptcy case of an entity that acquired substantially all the assets or business of the small business debtor in any of the categories described above, unless the debtor can show that it made the acquisition in good faith and not for the purpose of evading the new serial filer provisions.

The stay will apply if the case is a non-collusive involuntary case or, in a voluntary case, if the debtor can establish that the filing resulted from unforeseeable circumstances beyond the debtor's control, and that it is likely that a feasible plan (other than a plan of liquidation) will be confirmed within a reasonable time.

4. TRADE CREDITOR ISSUES

BAPCPA includes two new provisions favoring creditors who supplied goods to a debtor on credit prior to the commencement of the case.

- **Administrative Expense Priority for Pre-Petition Sale Claims.**

A new clause (9) has been added to Section 503(b), conferring administrative expense priority status on claims for the value of goods received by the debtor within 20 days before the commencement of the case if the goods were sold to the debtor in the ordinary course of the debtor's business. An amendment to Section 546(c) makes it clear that the administrative claim will be allowed even if the creditor fails to make a timely reclamation demand for the goods.

- **Expanded Reclamation Rights for Trade Suppliers.**

BAPCPA amends Section 546(c) to expand the reclamation rights of creditors who supplied goods on credit to the debtor during the pre-petition period. Under applicable non-bankruptcy law (codified in Section 2-702 of the UCC) a seller who discovers that its buyer has received goods on credit while insolvent may reclaim the goods upon demand made within a reasonable time after the buyer's receipt of the goods. Former Section 546(c) afforded limited recognition of this right, which trumped the rights and powers of the trustee under Sections 544(a), 545, 547, and 549 only if the reclamation demand was made in writing before 10 days after the date of receipt of the goods by the debtor, or within 20 days after such receipt if the 10 day period expired after the commencement of the case. BAPCPA has expanded Section 546(c) to permit credit sellers to reclaim goods received on credit by an insolvent debtor within 45 days before the commencement of the case, if written demand is made not later than 20 days after the commencement of the case.

The provision that permitted the court to deny reclamation if the court granted the seller an administrative expense claim or a lien for the value of the goods has been eliminated, although it seems likely that most reclamation claims will continue to be settled by payment rather than return of the goods, even if the

seller's claim for the goods does not qualify for the administrative expense priority status described above.

- **Prior Rights of Secured Creditors.**

BAPCPA makes a seller's reclamation rights expressly subject to "the prior rights of a holder of the security interest in such goods or the proceeds thereof." This is consistent with UCC Section 2-702 and case law. The trustee's rights under Section 546(h) to voluntarily return goods received by an insolvent debtor on credit prior to the bankruptcy filing is likewise made subject to the prior rights of holders of security interests in such goods or their proceeds.

5. PREFERENCES

BAPCPA amends Section 547 and the venue rules in 28 U.S.C. § 1409 in ways that will make it easier for creditors to defend preference actions.

- **The Ordinary Course of Business Defense.**

Under prior law, a defendant in a preference case who sought to establish the affirmative defense provided for in Section 547(c)(2) had to demonstrate that the challenged transfer was (i) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee; (ii) made in the ordinary course of business or financial affairs of the debtor and the transferee; and (iii) made according to ordinary business terms. As amended by BAPCPA, subsection (c) now preserves the first requirement, but allows the defendant to establish the defense by proving either the last two requirements. In other words, the defendant must show that the transfer was "made in the ordinary course of business or financial affairs of the debtor and the transferee; *or* ... made according to ordinary business terms." Accordingly, preference defendants can avoid the formidable proof problems associated with demonstrating what "ordinary business terms" are in a particular industry.

- **Expanded Grace Periods for Perfection of Security Interests.**

The affirmative defense provided in Section 547(c)(3) for transfers creating purchase money security interests can now be established if the security interest is perfected on or before 30 days after the debtor receives possession of the property, as opposed to the prior 20 day grace period.

More generally, under Section 547(e) as amended by BAPCPA, a transfer is deemed made "at the time such transfer takes effect between the transferor and the transferee, if the transfer is perfected at, or within 30 days after, such time." Formerly, the grace period was only 10 days.

- **De Minimis Preference Claims.**

BAPCPA amends Section 547(c) to provide a new affirmative defense to a preference claim. Under new clause (9), a transfer may not be avoided in a case filed by a debtor whose debts are not primarily consumer debts if “the aggregate value of all property that constitutes or is affected by such transfer is less than \$5,000.”

- **Deprizio Overruled.**

Yet another stake has been driven into the infamous *Deprizio* decision by new subsection (i) of section 547, which provides that a transfer made between 90 days and one year before the date of the petition, to a non-debtor entity but for the benefit of an insider creditor, can be avoided only with respect to the insider creditor.

- **Venue.**

28 U.S.C. § 1409(b) has been amended to provide that a claim to recover a debt (excluding a consumer debt) against a non-insider of less than \$10,000 can be brought only in the district court for the district in which the defendant resides.

6. FRAUDULENT TRANSFERS AND OBLIGATIONS

- **Expansion of “Look-Back Periods.”**

BAPCPA has amended Section 548(a) to expand the “look-back period” from one to two years. In other words, transfers and obligations “made or incurred on or within 2 years before the date of the filing of the petition” will be subject to avoidance if they meet the other requirements of Section 548.

BAPCPA has also added a new subsection (e) to Section 548, providing for the avoidance of transfers to “a self-settled trust or similar device” of which the debtor is a beneficiary, made by a debtor with actual intent to hinder, delay or defraud creditors “on or within 10 years before the date of the filing of the petition.” This new subsection is made specifically applicable to “a transfer made in anticipation of any money judgment, settlement, civil penalty, equitable order, or criminal fine incurred by, or which the debtor believed would be incurred by” reason of any violation of state or federal securities laws or regulations or “fraud, deceit, or manipulation in a fiduciary capacity or in connection with the purchase or sale of any [registered] security.”

Note that these “look back period” extensions will not become effective until April 21, 2006, the first day that is more than one year after the enactment of BAPCPA.

- **Insider Transfers under Employment Contracts.**

A transfer made or obligation incurred “to or for the benefit of an insider under an employment contract and not in the ordinary course of business” can be avoided under Section 548 if the debtor received less than a reasonably equivalent value in exchange for such transfer or obligation.

7. COMMERCIAL LEASES

BAPCPA amends Section 365 and Section 503(b) in ways that may radically affect the disposition of commercial leases in Chapter 11 cases.

- **Lease Assumption/Rejection Deadline Extensions.**

Under prior law, there was no statutory limit on the number of times a debtor tenant could get an extension of the period within which its commercial real property leases could be assumed or rejected. BAPCPA amends Section 365(d)(4) to extend the initial deadline for assumption or rejection by a debtor tenant from 60 to 120 days after the order for relief. However, absent the landlord’s consent, a debtor tenant can obtain only one further extension, for 90 days, “for cause.” This provision may force debtor tenants to make decisions on assumption or rejection of their commercial leases far earlier than they would like to.

- **Limitations on Administrative Claims for Rejection Damages.**

The possible adverse effects of a premature decision by a debtor tenant to assume a commercial real property lease is mitigated to some extent by an amendment to Section 503, providing a “cap” on rejection damages claims under leases that are assumed and then subsequently rejected. The portion of the landlord’s damages entitled to administrative expense priority is limited to “a sum equal to all monetary obligations due, excluding those arising from or relating to a failure to operate or a penalty provision, for the period of 2 years following the later of the rejection date or the date of actual turnover of the premises, without reduction or setoff for any reason whatsoever except for sums actually received or to be received from an entity other than the debtor.” The balance of the landlord’s claim “shall be a claim under Section 502(b)(6),” i.e., a general, non-priority prepetition claim subject to the existing provision “capping” a landlord’s allowed claim for rejection damages.

- **Cure Requirements.**

BAPCPA amends Section 365(b)(1)(A) to provide that a debtor tenant’s assumption of a commercial real property lease will not require a cure of “a default that is a breach of a provision relating to the satisfaction of any provision (other than a penalty rate or penalty provision) relating to a default arising from any failure to perform nonmonetary obligations under an unexpired lease of real

property, if it is impossible for the trustee to cure such default by performing nonmonetary acts at and after the time of assumption, except that if such default arises from a failure to operate in accordance with a nonresidential real property lease, then such default shall be cured by performance at and after the time of assumption in accordance with such lease, and pecuniary losses resulting from such default shall be compensated in accordance with the provisions of this paragraph.”

8. SINGLE ASSET REAL ESTATE

- **Automatic Stay Issues.**

BAPCPA clarifies the circumstances under which the Bankruptcy Court may deny relief from the automatic stay for an act against single asset real estate by a creditor who has a secured claim in the real estate. Section 362(d)(3) provides that relief must be granted unless the debtor has filed a plan that is likely to be confirmed, or has commenced monthly payments to the creditor, no later than 90 days after the entry of the order for relief (or such later date as the court may determine for cause by order entered within that 90-day period), or 30 days after the court determines that the debtor is subject to Section 362(d)(3) (whichever is later). BAPCPA gives the debtor discretion to make monthly payments from rents or other income generated from the property before, on, or after the date of the commencement of the case, even if the rents or other income are “cash collateral” under Section 363. BAPCPA also requires these payments to be in “an amount equal to interest at the then applicable nondefault contract rate of interest on the value of the creditor’s interest in the real estate.”

9. EMPLOYEE COMPENSATION AND BENEFITS

- **Claims Allowed as Expenses of Administration.**

BAPCPA amends Section 503(b)(1) to provide for two categories of wages and benefits that may be allowed as an administrative expense: (i) wages, salaries and commissions for services rendered after the commencement of the case, and (ii) wages and benefits awarded as back pay attributable to any period of time after the petition was filed, pursuant to a judicial or NLRB proceeding resulting from the debtor’s violation of federal or state law. With respect to the latter category, the time of the violation is immaterial, as is whether the recipient rendered any services. However, the court must determine that the payment of wages and benefits will not substantially increase the probability of nonpayment of domestic support obligations or that current employees will be laid off or terminated while the case is pending.

10. LIMITATIONS ON RETENTION PAYMENTS AND SEVERANCE PAYMENTS AS ADMINISTRATIVE EXPENSES

- **Key Employee Retention Plans (“KERP”).**

BAPCPA adds a new subsection (c) to Section 503, disallowing administrative expense claims for certain payments to insiders of the debtor, including some retention payments, severance payments, and other transfers outside the ordinary course of business.

The court will not permit retention payments to be claimed as administrative expenses unless (i) 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,” and (ii) the person’s services are essential to the business’ survival. In addition, if similar payments were made to non-management employees for any purpose during the same calendar year in which the retention payment is made, the retention payment must not be greater than “an amount equal to 10 times the mean” of those similar payments. If no other similar payments were made to non-management employees during the same year, the retention payment must not be greater than 25% of the amount of any similar payment made to the insider for any purpose during the calendar year *before* the year in which the retention payment is made.

- **Severance Payments.**

If the payment is a severance payment, it will be allowed only if it is part of a program generally available to all full-time employees and if it is not greater than 10 times the mean severance pay given to non-management employees during the year in which it is made.

- **Other Payments.**

Other payments, not in the ordinary course of business and not “justified by the facts and circumstances of the case,” are disallowed as administrative expenses, including payments to officers, managers or consultants hired after the petition is filed.

11. ADMINISTRATION OF EMPLOYEE BENEFIT PLANS

BAPCPA adds a new subsection (b) to Section 521, requiring a debtor who served as an administrator of an employee benefit plan prior to the commencement of the case to continue to perform its administrative obligations after the case has been filed.

12. UTILITY SERVICES

BAPCPA adds a new subsection (c) to Section 366, clarifying when a utility may alter, refuse or discontinue utility service for failure by the debtor to provide “assurance of

payment.” For purposes of Section 366(c), “assurance of payment” may include a cash deposit, letter of credit, certificate of deposit, surety bond, prepayment of utility consumption, or another form of security mutually agreed on between the utility and the debtor or trustee, and specifically does *not* include administrative expense priority. In a chapter 11 case, if the utility does not receive such assurance of payment within 30 days beginning on the date the petition was filed, it may alter, refuse, or discontinue utility service. The court may, upon request and after notice and a hearing, modify the amount of an assurance of payment, but in doing so it may *not* consider the absence of pre-petition security, any timely pre-petition payments, and the availability of administrative expense priority. BAPCPA also allows the utility to setoff or recover against the debtor’s pre-petition security deposit without notice or an order of the court.

13. RETENTION OF PROFESSIONALS

- **Investment Bankers.**

BAPCPA amends the definition of a “disinterested person” in Section 101(14) by removing references to investment bankers for securities of the debtor. Prior to the amendments, a person serving as an investment banker for a security of the debtor within 3 years prior to the filing of the bankruptcy petition was per se excluded from being a “disinterested person,” and therefore could not be employed to represent or assist the trustee under Section 327. BAPCPA now allows investments bankers to be “disinterested,” provided that they meet the other requirements of Section 101(14).

- **Compensation.**

BAPCPA revises Section 328 to permit professionals to be employed on a fixed or percentage fee basis, in addition to the existing retainer, hourly basis, and contingent fee basis options.