

New York Law Journal



Web address: <http://www.nylj.com>

VOLUME 233—NO. 88

MONDAY, MAY 9, 2005

ALM

OUTSIDE COUNSEL

BY MADLYN GLEICH PRIMOFF

Commercial Ramifications of the New Bankruptcy Legislation

Both chambers of Congress have passed the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the legislation), which President George W. Bush recently signed into law. It takes effect Oct. 17. Although the press has suggested that the legislation predominantly affects consumers and other individuals filing for bankruptcy protection, the legislation will also have a significant impact on the conduct of chapter 11 and other commercial bankruptcy cases.

This article provides an overview of those provisions of the legislation that will be most relevant in the commercial context—the adoption of chapter 15 to the Bankruptcy Code (concerning ancillary and cross-border cases) and amendments affecting lease assumption/rejection issues, exclusivity, composition of committees, investment banker retentions, conversion and dismissal, financial agreements (such as netting agreements, swaps and other derivatives), preferences and limitations on payments to employees.

This is a general review of the legislation and should not be relied on as legal advice on any particular issue.

Madlyn Gleich Primoff is a partner at Kaye Scholer, specializing in business reorganization and creditors' rights practice and **Richard Smolev**, who co-authored this column, also is a partner in the firm, specializing in the same areas.



Ancillary, Cross-Border Cases

• **Chapter 15: Ancillary and Other Cross-Border Cases.** One of the most sweeping changes to be effectuated by the proposed legislation is the

Upon recognition of a foreign proceeding that is a proceeding pending in a country where the debtor has its main interests, the automatic stay will apply to the debtor/property in the U.S.

introduction of chapter 15 to the Bankruptcy Code, concerning ancillary and other cross-border cases. Chapter 15 replaces former §304. The purpose of the chapter is to incorporate the Model Law on Cross-Border Insolvency.

Upon recognition of a foreign proceeding that is a foreign main proceeding (i.e., a foreign proceeding pending in a country where the debtor has the center

of its main interests), the automatic stay will apply to the debtor and its property within the United States.

This is a significant change from current law where there was no automatic stay in a §304 proceeding. Additional provisions of the Bankruptcy Code will also apply in chapter 15 cases—e.g., §361 regarding adequate protection; §§363, 549 and 552 regarding transfers of property within the United States; unless the court orders otherwise, §§363 and 552 regarding operation of the debtor's business; and §552 regarding the post-petition effect of a security interest. Upon recognition of a foreign proceeding, whether main or nonmain, the court may at the request of the foreign representative grant any appropriate relief.

The order granting recognition will recognize the foreign proceeding as a "foreign main proceeding" or a "foreign nonmain proceeding." The determination of whether a foreign proceeding is a "foreign main proceeding" could be the subject of litigation. For example, the European Regulation on Insolvency Proceedings (the EU [European Union] Regulation) provides that the primary jurisdiction for an insolvency proceeding is the court of the member state where the debtor's center of main interest is located. The EU Regulation allows for the courts in countries other than the home state to open "territorial" insolvency proceedings, but only to administer assets located in that other member state. The EU Regulation has

led to forum shopping by parties that want to establish the debtor's center of main interest in a particular jurisdiction regardless of whether it is truly the debtor's center of main interest. Similar issues may arise under chapter 15.

Assumption, Rejection Issues

• **Commercial Lease Assumption/Rejection Issues.** The landlord community will benefit from the proposed changes to §365(d)(4) of the Bankruptcy Code regarding the assumption and rejection of leases. Section 365(d)(4) is amended to provide that leases will be deemed to be rejected 120 days from the bankruptcy filing, but this period may be extended (a) for 90 days, and (b) thereafter, only with landlord consent.

Section 503(b)(7) is amended to provide that if a lease is assumed and subsequently rejected, the landlord would be entitled to (a) an administrative claim for all monetary obligations under the lease for the two years following the rejection date; and (b) a §502(b)(6) claim for the remaining sums due for the balance of the lease term.

These provisions will have a profound impact on chapter 11 cases for debtors with multiple leased locations. Debtors will no longer be able to extend to confirmation of a plan their time to assume or reject leases. As a result of the deadline for assumption or rejection contained in the legislation, leasehold issues will play a prominent role in the pre-filing considerations of debtors and their creditors. Because the assumption of leases prior to confirmation will require an expenditure for cure costs plus the potential for administrative rejection claims in the event of subsequent rejection following assumption, lenders and creditors' committees will be interested in the assumption/rejection decision-making process. Lenders that provide debtor-in-possession-(DIP)-style financing will be called on to finance cure costs and must plan accordingly. The limited

time frame will also accelerate the process of leasehold marketing efforts.

• **Extensions of Debtor's Exclusive Periods Limited.** The chapter 11 plan process will be affected by changes to the exclusivity provisions of §1121 of the Bankruptcy Code. The proposed legislation amends §1121 to provide that: (a) the 120-day exclusive plan-filing period may not be extended to a date beyond 18 months after the bankruptcy filing, and (b) the 180-day solicitation period may not be extended to a date beyond 20 months after the bankruptcy filing.

Given that the legislation prescribes definitive "outside dates" for the termination of a debtor's exclusive plan-filing period and solicitation period, the legislation could result in an increase in

The legislation puts investment banking firms on equal footing with the debtor's other professionals, such as attorneys and accountants.

the filing of creditor-sponsored plans and competing plans generally. How the courts wrestle with the issues associated with competing plans—timing concerns, keeping a level playing field, cost burdens, etc.—remains to be seen.

Creditor, Equity Committees

• **Formation of Creditor and Equity Committees.** Section 1102(a) is amended to give the courts authority to order the U.S. trustee to change the membership of a committee in order to ensure that there is adequate representation of creditors or equity security holders. Additionally, the court may order the U.S. trustee to increase the membership of a committee of creditors or equity security holders to include a creditor that is a small business concern if the court determines that the creditor holds claims of the kind represented by

the committee that are disproportionately large in comparison to the creditor's annual gross revenue.

Section 1102(c) is new. It requires a committee of creditors or equity security holders to provide access to information to creditors who are not committee members but hold claims of the kind represented by the committee. This provision could prove useful to agents for syndicated credit facilities if the agent sits on an official committee. Section 1102(c) does not address confidential information. A creditor seeking confidential information will, presumably, be required to enter into an appropriate confidentiality agreement as a condition to obtaining the information sought. The possession of such confidential information may also restrict the creditor from trading its claim, at least for a period of time.

• **Investment Bankers May Qualify Under 'Disinterested' Standard.** Any professional person that is to be retained by the debtor pursuant to §327(a) must be a "disinterested person" within the meaning of §101 of the Bankruptcy Code. The definition of "disinterested person" previously excluded an investment banker for (a) any outstanding security of the debtor or (b) a security of the debtor within three years of the filing. The legislation amends §101(14) to eliminate the automatic disqualification of the debtor's investment banking firm from representing the company in chapter 11. The legislation puts investment banking firms on equal footing with the debtor's other professionals, such as attorneys and accountants. Their retention will now be evaluated under the same standard of disinterestedness as these professionals.

• **Expanded Grounds for Conversion, Dismissal and Appointment of a Trustee.** Section 1112(b) requires the court to convert or dismiss the case if the movant establishes "cause." Section 1112(b)(4), as amended, contains an extensive (but, not exclusive) definition of "cause" for conversion or dismissal, including items such as: (a) substantial or

continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation; (b) gross mismanagement; (c) unauthorized use of cash collateral substantially harmful to one or more creditors; and (d) failure to comply with an order of the court.

Conversion or dismissal for cause is not required in three situations:

1. If there are unusual circumstances specifically identified by the court that establish that conversion or dismissal is not in the best interests of creditors and the estate.
2. If the debtor or another party in interest objects and establishes that (A) there is a reasonable likelihood that a plan will be confirmed within a reasonable period of time, and (B) the grounds for granting conversion or dismissal are other than substantial or continuing loss to or diminution of the estate and will be cured within a reasonable amount of time fixed by the court.
3. If the court determines to appoint a trustee pursuant to new §1104(a)(3).

As a result of the amendments to §1112(b), creditors may be more aggressive in seeking conversion or dismissal. Courts may be more inclined to appoint a trustee in order to avert conversion or dismissal.

Netting Agreements

Netting Agreements, Swap Agreements and Other Financial Agreements.

- Generally, the Bankruptcy Code does not enforce ipso facto provisions—i.e., a contractual right of a party to terminate a contract as a consequence of the counterparty's chapter 11 filing. The automatic stay also usually prohibits parties from exercising set-off rights absent court approval.

- Contrary to these generally applicable constraints, the Bankruptcy Code affords special protections to parties to securities contracts, swap agreements,

commodity contracts, forward contracts and repurchase agreements (collectively, financial agreements) in order to minimize disruption to the commodities and securities markets in the event of a major bankruptcy filing.

For example, the Bankruptcy Code permits certain specified parties to terminate, close-out and setoff mutual debts and claims under Financial Agreements to the extent that the applicable termination, close-out or setoff right arises as a consequence of a debtor's chapter 11 filing. The Bankruptcy Code also limits a trustee's avoidance powers with respect to payments received by specified parties to Financial Agreements.

Absent these special protections, a debtor, by virtue of its assumption and rejection power, would have the ability to leverage market pricing fluctuations to its benefit (because the debtor could assume or reject the Financial Agreement at a point in time when the debtor has the benefit of knowing the market price of the security or commodity after the original scheduled purchase or sale date) and to the detriment of the nondebtor contract party (which will be unable to hedge its position because of the uncertainty relating to whether the debtor will assume or reject its Financial Agreement).

- The legislation expands the scope of these special protections in several different ways:

- (1) The types of Financial Agreements entitled to protection are broadened.
- (2) Through a broad definition of "financial participants," the legislation expands the universe of parties that may invoke these special protections.
- (3) The legislation provides that "master netting agreements" are also entitled to the special protections afforded to Financial Agreements.

- *Protecting Security Interests.* Amended

§547(e)(2) extends the time in which a security interest may be perfected without being preferential from 10 to 30 days after the security interest is granted. Amended §547(c)(3) extends the time in which a purchase money security interest may be perfected without being preferential from 20 to 30 days after a debtor receives possession of property.

- *Insulating Payments Made in Ordinary Course of Business.* In order to defend a preference action on ordinary course of business grounds, a defendant previously had to show that the transfer satisfied the following three tests. It was:

- (a) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the defendant,
- (b) made in the ordinary course of business or financial affairs of the debtor and the transferee, and
- (c) made according to ordinary business terms.

Provided that the defendant can meet the first test (i.e., that the debtor incurred the debt in the ordinary course of business or financial affairs of the debtor and the defendant), amended §547(c) will require the defendant to prove only that it satisfies one of the other two tests.

Retention Bonuses

- *Limitation on Retention Bonuses, Severance Pay and Certain Other Payments.* The legislation adds to §503 new subsection (c), which limits employee retention bonuses, severance pay and certain other payments.

Effective Date of Legislation. The legislation will not apply to cases commenced under the Bankruptcy Code before the effective date.

This article is reprinted with permission from the May 9, 2005 edition of the NEW YORK LAW JOURNAL. © 2005 ALM Properties, Inc. All rights reserved. Further duplication without permission is prohibited. For information contact, American Lawyer Media, Reprint Department at 800-888-8300 x6111. #070-05-05-0014