# AMENDMENTS TO THE BANKRUPTCY CODE: A LENDER'S PERSPECTIVE

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This article examines the new amendments to the Bankruptcy Code from a lender's perspective.

When the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 takes effect on Oct. 17, 2005, debtors will have less flexibility in the way they manage their cash and less time to control the reorganization process. A number of the new provisions remove the bankruptcy judge's discretion and impose mandatory payment obligations and deadlines in critical areas such as vendor payments, utility deposits, lease assumptions and management's operating freedom. Debtors and their lenders will need comprehensive planning in advance of a filing to anticipate and to budget properly for these costs.

The act will affect lenders in other ways as well. The commodities and securities markets will benefit from expanded safe harbor provisions that protect a variety of financial instruments in the event of a bankruptcy of a counter-party to swaps, repos and other financial arrangements, and that expressly allow cross-product netting under master netting agreements.

Single asset real estate cases should move more quickly, as the expedited provisions relating to relatively small cases will apply to all borrowers owning properties through a special purpose entity. Lenders involved in multinational transactions should benefit from the changes that bring the U.S. bankruptcy system in line with other international protocols that attempt to harmonize international insolvency laws.

## Changes affecting a debtor's initial budget

Lenders will need to devote attention to utility deposits, reclamation claims, lease cure costs and other items as part of a debtor's initial budgetary process.

Turning first to utilities, the current version of the Bankruptcy Code requires a utility to continue to provide service if the debtor provides "adequate assurance of payment." Although that phrase is not defined in the Bankruptcy Code, it generally has come to mean that the utility must continue to provide service at the same level as before the filing, so long as it receives administrative priority status for its postpetition claims. Revised Section 366 of the Bankruptcy Code now defines what assurance of payment to a utility means. Essentially, the debtor must provide cash or cash equivalent as a deposit, or prepay for services. Prospective DIP budgets will require a line item for every utility serving every location. Adequate assurance payments to utilities will need to be factored into the analysis of the debtor's liquidity requirements.

Reclamation rights of vendors are another cost that must be factored into the prospective debtor's budget. Vendors will have the right to demand the return of goods received by the debtor within 45 days of the bankruptcy filing, or within 20 days of the commencement date of the bankruptcy, if the 45-day period expires after the commencement date. Vendors no longer may be forced to accept an administrative expense claim in lieu of return of the goods. Prepetition payments made for such goods cannot be avoided as a preference.

While trade vendors rarely want their goods returned, the shifting of the bargaining dynamic in favor of vendors with reclamation rights will force debtors to construct their DIP budgets on the assumption that they either will need to obtain court authority to pay these vendors or to obtain replacement product. In either case, this further will strain the debtor's early cash needs.

 

The administrative claim pool also may be affected by the new changes, as administrative expense claims may be asserted under new Section 503(b)(9) for the value of any goods received by the debtor in the 20-day period prior to the bankruptcy filing. This expansion in the administrative claim pool in favor of prepetition trade vendors likely will result in larger exit facilities to accommodate these claims, and in reduced distributions in respect of other unsecured claims in cases involving debtors with large inventories that turn over frequently.

Debtors operating out of a number of leased locations typically defer the decision of whether to assume or reject their leases until plan confirmation. The current version of the Bankruptcy Code gives the court a virtually unlimited right (upon a showing of cause) to extend the period for the debtor to make its assumption/rejection decision. When asked to extend this period, courts generally side in favor of the debtor over a landlord's objection. The act significantly shifts the bargaining dynamic in favor of commercial landlords.

In cases filed after Oct. 17, 2005, the debtor will have a maximum of 210 days (an initial 120 days without a showing and up to 90 additional days for cause) to decide whether to assume or reject a lease. After that period elapses, extensions require the written consent of the landlord. This will have the obvious impact of accelerating the debtor's planning process and could require retail debtors to make assumption decisions without the benefit of the results of a key selling season.

If a change in a debtor's business plan requires it to reject a lease after a postpetition assumption (which requires payment of cure costs), the landlord receives an administrative expense claim for the sum of all obligations owing under the lease for two years following rejection, and a Section 502(b)(6) claim for the remaining sums due for the balance of the lease term. As the impact of these costs ultimately will be borne by creditors and interest holders below the administrative priority level, they are likely to become early participants in the debtor's planning process.

Courts no longer will have the flexibility to allow a debtor to assume a lease by providing adequate assurance that it will cure nonmonetary defaults (as opposed to actually effecting cure) unless it is "impossible" for such breach to be cured in connection with the lease assumption. Any cure tendered as a condition of assumption must include compensation for the pecuniary losses resulting from the default, which is another cost that must be factored into the debtor's planning and budgeting process.

Debtors will have less flexibility budgeting for the recovery of tax refunds, as taxing authorities will be permitted to set off refunds for prepetition periods against prepetition tax liabilities.

## Changes affecting a debtor's control of the bankruptcy process

Under the act, Congress sought to curb what it saw as insider abuse in at least three ways. First, it capped the debtor's exclusivity (the right to control the plan process) at 20 months. Second, it expanded the grounds for the ouster of management and its replacement with a trustee. Third, it limited the debtor's flexibility to create incentive packages to induce its highest-ranking employees to remain with the company throughout its bankruptcy.

The current version of the Bankruptcy Code has been criticized for giving judges too much discretion to continue the debtor's exclusive right to propose a plan. After Oct. 17, the debtor's exclusive right to propose a plan may not be extended beyond 18 months after the bankruptcy filing, and its exclusive right to solicit votes with respect to such plan may not be extended beyond 20 months. This can be a daunting task for debtors that require financial and operating repairs, face mass tort claims, need to renegotiate a large number of labor contracts or benefit obligations, or have operations that cross many borders. Time will become an important element of negotiations.

 

While these changes are designed to shorten the time and to reduce the costs of Chapter 11 cases, they could have the opposite effect if debtors file plans that have not been fully negotiated with all constituencies as a means of protecting exclusivity (or if creditor groups align their interest with outside buyers), resulting in litigation over both the disclosure statement and plan confirmation.

Management has been made more accountable for the administration of a case. While the current version of the Bankruptcy Code allows creditors or the U.S. trustee to seek the appointment of a Chapter 11 trustee for "cause," parties often are reluctant to exercise the remedy except in extreme cases because of the potential harm to the debtor's business and the disruption caused by the need to replace management.

The act requires the U.S. Trustee to seek appointment of a Chapter 11 trustee where there are reasonable grounds to suspect fraud on the part of the debtor's current management, although the act does not require the U.S. Trustee to investigate actively whether such grounds exist. Further, the act details specific grounds for the conversion or dismissal of a case or for the appointment of a trustee, including substantial loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation, failure to maintain appropriate insurance, and the unauthorized use of cash collateral substantially harmful to one or more creditors. These provisions are likely to result in increased litigation over the appointment of a trustee, which often is an effective bargaining tool in the plan negotiation process.

Congress also sought to curb what it saw as abuse in the way that high-level officers are induced to remain with the debtor during the period of its restructuring. Amendments to Section 503 place limits on retention plans, severance payments and other transfers to management and postpetition advisors.

Incentive payments must be "essential to retention" because the insider "has a bona fide job offer from another business at the same or greater rate of compensation" and must be in proportion to both prior years' compensation and to amounts paid to nonmanagement employees. Severance packages must be made available to all employees, with caps on the amounts paid to high-level employees in relation to what is offered nonmanagement employees. Depending upon market conditions, these changes could make it difficult to retain managers at the time when they are most needed and could increase the cost of a debtor's exit from bankruptcy. Turnaround advisors who are not subject to these restrictions might be the beneficiaries of any management exodus, so lenders may find themselves negotiating the terms of their packages as part of the budget process.

Lenders might expect to see debtors introduce success fees, performance bonuses and milestone awards, which are not expressly excluded by the act, into management compensation packages as a means of circumventing the employee retention provisions of the act. This no doubt will spawn litigation by creditors' committees and other holders over the appropriateness of key management compensation plans.

## Changes affecting exit financing

While the provisions discussed above increase the cost of administration of a case and thus the size of exit facilities, the act's treatment of a debtor's tax obligations will increase the cash required at exit. The current version of the Bankruptcy Code allows debtors to repay priority tax claims within six years from the date of assessment. The act amends Section 1129(a)(9)(C) to require payment of priority taxes under "regular installment payments in cash" in not less than five years from the petition date and in the same manner as the most favored nonpriority unsecured class other than a "convenience class." Interest on deferred tax claims must be paid at the applicable nonbankruptcy rate.

These changes will affect a debtor's post-emergence liquidity in all cases with significant priority tax claims. These changes also will drive up the immediate cost of prepackaged or pre-arranged cases, as debtors no longer will be able to pay their unsecured creditors in full on the effective date and to stretch their tax claims. The act gives no guidance on how tax claims must be treated under the most-favored-nations obligations when creditors receive equity.

Employee claims also must be factored into the emergence planning process. The period under which employees have priority wage claims will increase from 90 to 180 days and the ceiling for priority of their wage and benefit plan claims will more than double, to $10,000. Debtors who modify retiree benefits within 180 days prior to filing while insolvent may (upon motion of a party in interest) have those benefits reinstated unless the court finds that the modification was equitable. Potential exit lenders (as well as creditors and equity holders debating a debtor's enterprise valuation) will need to analyze the risk and cost of any potential reinstatement of retiree benefits.

The act contains consumer protection provisions regarding a debtor's ability to sell or lease customer or client lists that could impair a debtor's ability to monetize those assets. If the debtor has a policy in effect at the time of its filing that prohibits the transfer of "personally identifiable information" (i.e., name, addresses, phone, Social Security number and credit card information), any sale must be consistent with that policy or approved by the court after the appointment of a consumer privacy ombudsman. Lenders financing those types of assets must understand the implications of these changes on their ability to realize on that collateral.

## Changes affecting single asset real estate borrowers

The current version of the Bankruptcy Code contains procedures that require relatively small real estate cases (i.e., $4 million of debt) essentially involving only two parties (a borrower and its mortgagee) to move to plan confirmation quickly as a condition of the automatic stay remaining in place. The act eliminates the $4 million cap in the definition of what is a single asset real estate case, meaning that these expedited provisions will apply to all transactions where the asset is owned in a special purpose vehicle. New provisions also tilt in favor of lenders where there is a demonstrable pattern of abusive filings.

The effect of these provisions likely will be to make real property lenders less likely to be held hostage to a debtor's plan process, although the mortgagee will not be able to lift the automatic stay if after 90 days the debtor pays current interest at the contract rate, thus eliminating battles over whether it can pay market rate of interest, and what that payment should be. If the properties generate sufficient cash to make such payments, the debtor may use that cash collateral without court approval or the mortgagee's consent, to make such payments.

## Changes affecting financial instruments

The act respects both the growth in the market and in the type of financial products and the need to protect the stability in the financial and commodity markets by expanding the safe harbor provisions (that allow counter parties to various instruments to liquidate their positions and to exercise rights of setoff notwithstanding the automatic stay) to a variety of products.

The act recognizes the market practice of cross-product netting by adding a definition of "master netting agreement," which enables parties to these agreements, such as those promulgated by the ISDA, to close out their positions across the instruments covered by those agreements. Parties should take care that their financial contracts fall within these new defined terms. The act also allows the offset of claims and obligations if required by rules or bylaws of a derivatives clearing organization, multilateral clearing organization, national securities exchange, contract market or board of trade, as those terms are defined in the relevant federal statutes, under common law or by reason of normal business practice.

The protections of terminations and setoff rights apply to pledged collateral that is controlled by a creditor, but not literally “held” by it, such as receivables or book-entry securities.

Damage claims arising from the liquidation, termination or acceleration of financial instruments are measured from the earlier of the contract rejection date or the date of the liquidation, termination or acceleration.

## Changes affecting cross-border transactions

The act adds a new Chapter 15 regarding cross-border insolvency that essentially adopts the provisions of the Model Law on Cross-Border Insolvency promulgated by the United Nations Commission for International Trade Law, which are designed to facilitate cooperation between courts in cases where a debtor conducts business and has assets in a number of jurisdictions.

Under the current version of the Bankruptcy Code, when an entity that is subject to a proceeding under the insolvency laws of a non-U.S. jurisdiction seeks recognition of that proceeding in the United States, the bankruptcy judge has the discretion to consider a number of factors in deciding whether to do so. Under the act, the standards for recognition have been eased somewhat.

Chapter 15 applies where: a) assistance is sought in the United States by a “foreign representative” in connection with a “foreign proceeding;” b) assistance is sought outside the United States in connection with a U.S. bankruptcy case; c) a non-U.S. proceeding and a U.S. bankruptcy proceeding are pending concurrently; or d) creditors or other interested persons outside the United States have an interest in requesting commencement of, or participation in, a U.S. bankruptcy case or proceeding.

If the foreign proceeding 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 applies to the debtor and its property within the United States. Additional provisions of the Bankruptcy Code such as those relating to adequate protection, sales and uses of property, the operation of the debtor’s business, transfers of property, and the postpetition effect of security interests also apply. The foreign representative also may sue and be sued in the United States.

New Chapter 15 also contains provisions to facilitate communication between and the cooperation of courts in the different jurisdictions where the debtor’s assets are being administered.

The effect of this chapter should be to increase the number of ancillary cases filed in the United States, with increased opportunities for DIP, exit and acquisition financing.

There are a number of other changes that will affect the administration of a bankruptcy case by expanding the membership of creditor and equity committees, allowing a debtor’s prepetition investment bankers to be retained after the filing and expanding the ability of creditors to defend preference claims.

## Endnotes

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