

April 15, 2005

Bankruptcy Code Amendments Affecting Business Bankruptcies

As widely reported, Congress has just passed the most significant set of amendments to the Bankruptcy Code since its enactment in 1978. The bill, entitled the “Bankruptcy Abuse Prevention and Consumer Protection Act of 2005” (the “BAPCPA”), is expected to be signed into law by President Bush any day. With some exceptions (noted herein) the bill will become effective 180 days from the date of its enactment and will apply only to cases commenced after the effective date.

Though most press accounts of the bill have focused on provisions affecting consumer bankruptcies – the impetus for the bill – the bill also contains numerous important amendments affecting business bankruptcies. This memorandum provides a brief overview of many of those significant amendments. Given the bill’s numerous amendments, we do not discuss every amendment that might affect business bankruptcies. Also omitted is a discussion of certain narrowly-focused amendments specific to health care company bankruptcies. Finally, although this memorandum briefly describes the significant provisions of the new chapter 15 of the Bankruptcy Code affecting cross-border insolvencies, a detailed discussion of chapter 15 is beyond the scope of this memorandum.

I. The Automatic Stay

In response to the securities fraud scandals of recent years, the BAPCPA will exempt from application of bankruptcy’s automatic stay the following acts that may be taken against a debtor by a securities self-regulatory organization: (i) the commencement of an investigation or action to enforce the organization’s regulations; (ii) the enforcement of an order or decision, other than for monetary sanctions, obtained by such an organization; and (iii) any act taken by such securities self-regulatory organization to delist, delete, or refuse to permit quotation of any stock that does not meet applicable regulatory requirements.

A further narrowing of the scope of the automatic stay will occur through a revision to section 362(a)(8), which applies to proceedings against the debtor before a U.S. Tax Court. Under existing law, section 362(a)(8) broadly stays the commencement or continuation of any proceeding before the U.S. Tax Court “concerning the debtor.” The BAPCPA will limit section 362(a)(8)’s application to a U.S. Tax Court proceeding concerning “a corporate debtor’s tax liability” for a taxable period “the bankruptcy court may determine” Thus, rather than all U.S. Tax Court proceedings “concerning the debtor” being stayed, under the new law, the bankruptcy court will be able to determine the taxable period for which actions to determine the debtor’s tax liability will be stayed.

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Additionally, the BAPCPA will exempt from the automatic stay a setoff by a taxing authority of income tax refunds owed to a debtor taxpayer against the debtor's income tax liabilities, provided that both arise from taxable periods which ended prepetition. In circumstances where the setoff would otherwise be prohibited by nonbankruptcy law due to a pending action to determine the amount or legality of the debtor's tax liability, the BAPCPA will permit the taxing authority to hold the refund pending resolution of the action unless the taxing authority receives adequate protection of its potential setoff right.

II. Employment of Investment Bankers

In a widely publicized and much criticized provision, the BAPCPA amends the Bankruptcy Code to remove the automatic bar against a debtor employing its prepetition investment banker. Under existing law, typically, a debtor's prepetition investment banker cannot qualify as a "disinterested person," as it must to be retained under section 327(a) of the Bankruptcy Code. That is because the definition of "disinterested person" excludes an investment banker for any of the debtor's outstanding securities and an investment banker for any security of the debtor within three years of the debtor's bankruptcy filing. As a result, many of the large investment banks are unable to provide investment banking or financial advisory services to their clients that are in bankruptcy.

The BAPCPA will eliminate these restrictions on the debtor's employment of its prepetition investment bankers. Gone too will be the outright prohibition against retaining someone who within the two years prior to the debtor's bankruptcy filing was a director, officer or employee of such investment banker. Under the new law, the debtor's prepetition investment banker, or a director, officer or employee of such investment banker, may be retained so long as their interests are not materially adverse to the interests of the debtor, its estate or of any class of the debtor's creditors or equity security holders. This is the same standard that applies to other professional persons whom the debtor seeks to employ.

III. Compensation of Professional Persons

The BAPCPA amends section 330 of the Bankruptcy Code – "Compensation of officers" – to include as a factor in determining an award of reasonable compensation to an estate professional "whether the [professional] is board certified or otherwise has demonstrated skill and experience in the bankruptcy field."

The BAPCPA also includes among the examples of permitted terms and conditions of employment of professional persons by a debtor or official committee appointed in a chapter 11 case "a fixed or percentage fee" arrangement. Of course, the fixed or percentage fee arrangement, just like any other compensation arrangement governed by section 328 of the Bankruptcy Code, must be "reasonable."

IV. Sale of Property

The BAPCPA limits the debtor's ability to sell or lease personal information about its customers to an unaffiliated third party. This limitation no doubt reflects Congress's reaction to the litigation spawned by the various internet company bankruptcies where the debtors proposed to transfer customer lists, often their most valuable assets. Under the new law, subject to

certain exceptions described below, such transfers will be prohibited if the debtor, in connection with offering a product or service, discloses to an individual a policy prohibiting the transfer of personally identifiable information about individuals to unaffiliated third parties and such policy is in effect when the bankruptcy case commences. Notwithstanding the foregoing, a transfer of personally identifiable information will be permitted if (i) such transfer is consistent with the debtor's policy, or (ii) the court approves the transfer after the appointment of a "consumer privacy ombudsman"¹ and after notice and hearing at which the court considers "the facts, circumstances and conditions" of such transfer and finds that the transfer would not violate applicable nonbankruptcy law.

V. Claims of Sellers of Goods

The BAPCPA grants two significant new rights to prepetition sellers of goods to the debtor. First, the BAPCPA amends section 503(b) of the Bankruptcy Code to include as an administrative expense the claim of a seller of goods for the value of the goods received by the debtor within the period commencing 20 days before the bankruptcy filing so long as the goods were sold to the debtor in the ordinary course of the debtor's business. This provision essentially elevates to "critical vendor" status those sellers of goods to the debtor within the 20-day period leading up to the debtor's bankruptcy filing by virtually assuring (other than where the debtor is administratively insolvent) payment of their unpaid prepetition invoices for goods sold during such 20-day period.

Second, the BAPCPA expands the reclamation period under section 546(c) of the Bankruptcy Code from 10 to 45 days. If the 45-day period expires after the commencement of the case, then the seller has 20 days after the commencement of the case to provide written demand for reclamation (existing law is 10 days). In addition, the BAPCPA will eliminate the bankruptcy court's authority to satisfy a seller's reclamation claim through the grant of an administrative or secured claim. Nonetheless, under the new law, a reclamation claimant whose goods are not returned to it will be given an administrative expense claim equal to the value of the goods sold during the 20-day period preceding the debtor's bankruptcy filing (*see* immediately preceding paragraph).

VI. Assumption of Real Property Leases

The BAPCPA contains a number of important amendments to section 365 of the Bankruptcy Code dealing with the debtor's assumption and rejection of real property leases. At the outset, the BAPCPA will permit a debtor to assume an unexpired lease of real property even though the debtor cannot cure certain nonmonetary defaults. Specifically, the BAPCPA amends

¹ A "consumer privacy ombudsman" must be "disinterested" and will be appointed by the U.S. Trustee not later than five days prior to the commencement of the hearing to consider the debtor's proposed sale or lease of the personal information. The "consumer privacy ombudsman's" role at the hearing will be to "assist the court in its consideration of the facts, circumstances, and conditions" of the sale or lease of the personal information, including by way of presenting the following: (i) the debtor's privacy policy, (ii) the potential privacy losses or gains to consumers from the proposed sale or lease, (iii) the potential costs or benefits to consumers from the sale or lease, and (iv) the potential available alternatives to mitigate privacy losses or costs to consumers.

section 365 to provide that to assume a real property lease, a debtor must cure all defaults, or provide adequate assurance that it will do so, other than a default arising from the failure to perform one or more nonmonetary obligations under the lease “if it is impossible for the [debtor] to cure such default by performing nonmonetary acts at and after the time of assumption.”² The one exception will be where the default arises from the debtor’s failure to operate in accordance with a nonresidential real property lease. In that case, “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 [other] provisions [of section 365(b)].”

Next, the BAPCPA will significantly hasten the time by which a debtor must assume an unexpired lease of nonresidential real property in which the debtor is the lessee before it is deemed rejected as a matter of law. Under current law, the debtor has 60 days from the commencement of its bankruptcy case to assume an unexpired lease of nonresidential real property. Absent an extension, at the expiration of such 60-day period the lease will be deemed rejected. In practice, particularly in larger chapter 11 cases, the debtor requests and is granted multiple extensions of the 60-day period “for cause” in recognition of the fact that often a debtor is unable to make the assumption/rejection decision until much later in the case.

Under the BAPCPA, the debtor will now have until the earlier of (i) 120 days after the commencement of its bankruptcy case, or (ii) the date of the entry of an order confirming a plan, to assume its nonresidential real property leases before they are deemed rejected. The court may, prior to the expiration of this initial period, and on motion of either the debtor or the lessor, grant an extension for 90 days for “cause.” Significantly, however, subsequent extension(s) beyond the 90 days may be granted only upon the lessor’s written consent. Thus, although the BAPCPA will double the initial time for the debtor to decide whether to assume a lease, it caps at 210 days, or roughly 7 months, the amount of time the debtor will have to decide absent consent of the lessor. In practice, this timeframe may prove too short for many debtors, particularly large retailers with multiple leased locations, and may result in debtors having to make rushed judgments about certain of their leases or concessions to their lessors solely to obtain their consent to extend the time in which to assume or reject.

Perhaps in recognition of the possibility that the change described above may result in the premature assumption of leases that subsequently must be rejected, the BAPCPA provides for a cap on a lessor’s administrative expense claim arising out of the debtor’s rejection of a previously assumed nonresidential real property lease. Specifically, the administrative expense claim amount will be capped at the sum of all monetary obligations due, excluding those arising from or related to a failure to operate or a penalty provision, for the period two years following the later of the rejection date or the date of actual turnover of the property. The lessor’s damage claim for the remaining sums due for the balance of the lease term will be treated as a

² Notably, the BAPCPA does not contain a similar carve-out from the cure requirement for executory contracts or non-real property leases. In fact, to the contrary, in an apparent attempt to clarify a split in the case law regarding whether nonmonetary defaults under such contracts or leases must be cured prior to assumption, the BAPCPA seemingly codifies the law in the Ninth Circuit that requires such defaults to be cured. *In re Claremont Acquisition Corp., Inc.*, 113 F.3d 1029, 1034-35 (9th Cir. 1997) (debtor-franchisee required to cure all defaults, including nonmonetary defaults, prior to assumption of dealership agreements).

general unsecured claim and capped in accordance with section 502(b)(6) of the Bankruptcy Code.

VII. Utilities

The BAPCPA amends section 366 of the Bankruptcy Code – “Utility service” – to provide utilities with substantial additional protections. Under current law, many times debtors are able to avoid posting additional security in the form of a deposit or letter of credit to procure continued utility service by convincing the bankruptcy court that it has an excellent prepetition payment history and sufficient liquidity to meet its utility obligations postpetition. In addition, debtors argue that in a worst case scenario utility service providers will be administrative claimants and will be paid in full.

Congress has stripped the debtor of these arguments. Specifically, the BAPCPA adds a new subsection (c) to section 366 which provides that “assurance of payment,” as required by subsection (b), means only a cash deposit, a letter of credit, a CD, a surety bond, a prepayment, or another form of security that is mutually agreed upon between the utility and the debtor. Importantly, the revised section 366 expressly provides that “an administrative expense priority shall not constitute an assurance of payment.” The revised section 366 further provides that in determining whether the debtor’s assurance of payment is adequate, the court may not consider the absence of security before the petition date, the debtor’s stellar prepetition payment history or the availability of administrative expense priority. Finally, the revised section 366 provides that “notwithstanding any other provision of law,” including the automatic stay, a utility may recover or setoff against a security deposit provided to it prepetition.

VIII. Avoidance Powers

The BAPCPA contains three significant amendments to the trustee or debtor in possession’s avoidance powers. The first should make it easier for defendants to successfully invoke the “ordinary course of business” defense to a preference action. Under the new law, the preference defendant must only demonstrate that the transfer was made in the ordinary course of business or financial affairs of the debtor and the transferee *or* according to ordinary business terms. A preference defendant no longer will need to satisfy both prongs to prevail on an “ordinary course of business defense,” as it must under existing law.

The second important amendment expands section 548’s “look back” period for the avoidance of fraudulent transfers from one year to two years. The expansion of the “look back” period shall apply only to cases filed one year after the BAPCPA’s enactment.

Additionally, the BAPCPA includes as a new constructive fraudulent transfer a transfer to or for the benefit of an insider under an employment contract, not in the ordinary course of business and for less than reasonably equivalent value. Such insider transfers shall be avoidable immediately upon the BAPCPA’s enactment to cases filed on or after the date of enactment, however, the two year “look back” period for such transfers will not take effect until one year after the BAPCPA’s enactment.

In addition to these amendments, the BAPCPA contains the following additional amendments affecting the trustee or debtor in possession’s avoidance powers:

- an amendment to section 547(c) that prohibits the avoidance as a preference of a transfer involving property with a value of less than \$5,000 in a case in which the debtor's debts are not primarily consumer debts;
- an amendment to section 546 that prevents the trustee or debtor in possession from avoiding a warehouseman's lien for storage, transportation and costs incidental to the storage and handling of goods;
- an amendment to section 547(c)(3)(B) extending the time in which a creditor must perfect its purchase money security interest ("pmsi") in property sold to the debtor from 20 to 30 days after the debtor receives possession of the property in order to successfully invoke the "pmsi" defense to a preference action;
- an amendment to section 547(e)(2) increasing from 10 to 30 days the grace period after the initial transfer by the transferor to the transferee during which the transferee can still perfect its interest and relate it back to the earlier date of the initial transfer; and
- a cleanup amendment to the preference statute to make clear that a transfer made during the period between ninety days and one year prior to the filing date to a non-insider but for the benefit of an insider creditor shall be considered avoided with respect to the insider creditor only. This amendment closes the loophole that permitted the continued application of the *DePrizio* case to avoid transfers to a non-insider that were made to or for the benefit of an insider within one year preceding the debtor's bankruptcy filing. The amendment will take effect immediately and will apply to pending as well as new cases.

IX. Chapter 11 Plans

A. *Pre-packaged Chapter 11 Plans*

Under current law, if a debtor's pre-bankruptcy solicitation of votes for a pre-packaged plan is interrupted by a bankruptcy filing by or against the debtor, then the solicitation begun prepetition must cease and postpetition solicitation must then be accompanied by a court-approved disclosure statement. That will no longer be the case. The BAPCPA will amend section 1125 of the Bankruptcy Code to provide that, notwithstanding the prohibition on postpetition solicitation of plan votes in the absence of a court-approved disclosure statement, acceptances of the plan may be solicited from a claim or interest holder if such solicitation complies with

applicable nonbankruptcy law and if such holder was solicited prior to the commencement of the case also in a manner that complied with applicable nonbankruptcy law.

To further expedite prepackaged bankruptcies, the BAPCPA will amend section 341 to provide that the bankruptcy court may, for cause, order the U.S. Trustee not to convene a meeting of creditors or equity holders if the debtor has filed a plan for which it solicited acceptances prior to the commencement of its chapter 11 case.

B. *Plan Exclusivity*

The BAPCPA will bring an end to the practice common in many jurisdictions of granting a debtor multiple extensions of its plan exclusivity which can sometimes result in the debtor enjoying exclusivity for an extended period of time. The revised section 1121(d) of the Bankruptcy Code will cap at 18 months the debtor's exclusive right to file a plan (a cap of 20 months will apply to the exclusive right to solicit acceptances to the plan). This change is significant and may lead to an increase in filings prior to the BAPCPA's effective date to permit debtors to avoid the 18-month cap on exclusivity.

X. Official Committees

The BAPCPA will amend section 1102(a) – “Creditors’ and equity security holders’ committees” – to allow the bankruptcy court, on request of a party in interest and after notice and a hearing, to order the U.S. Trustee to modify the composition of an official committee to ensure that the committee's constituents are adequately represented. Section 1102(a) will be further amended to allow the bankruptcy court to order the appointment of a small business concern, as defined in section 3(a)(1) of the Small Business Act, to an official committee upon the court's determination that such creditor holds claims of the kind represented by the committee, the aggregate amount of which, in comparison to the creditor's annual gross revenue, is disproportionately large. The BAPCPA further obligates an official committee to provide its non-member constituents with access to information and to solicit and receive comments from such constituents.

Finally, the BAPCPA will close the door on committee members seeking reimbursement of their professional fees incurred in connection with their service on the committee. The BAPCPA specifically excludes as an administrative expense claim compensation for professional services rendered by attorneys or accountants on behalf of an individual member of an official committee.

XI. Appointment of a Trustee

In direct response to the corporate scandals witnessed over the past few years, the BAPCPA contains an amendment to section 1104 of the Bankruptcy Code – “Appointment of trustee or examiner” – that will require the U.S. Trustee to move for the appointment of a trustee if there are “reasonable grounds to suspect” that current members of the debtor's board of directors or other governing body, the debtor's chief executive or chief financial officer, or members of the board or other governing body who selected the debtor's chief executive or chief financial officer, participated in actual fraud, dishonesty or criminal conduct in the management of the debtor or the debtor's public financial reporting. The standards for the court actually appointing a trustee – i.e.,

“for cause” or “if . . . in the interests of creditors, any equity security holders, and other interests of the estate . . .” – remain unchanged. Expect the amendment to engender even greater U.S. Trustee activism and skepticism regarding the debtor’s board and management, particularly during the early stages of a case. This amendment will become effective upon the BAPCPA’s enactment and will apply to cases filed on or after the date of enactment.

XII. Conversion or Dismissal of Chapter 11 Case

The BAPCPA will expand the list of examples of “cause” for conversion or dismissal of a chapter 11 case in section 1112, include a provision expressly prohibiting the court from granting such a motion under certain specified circumstances and create an expedited notice and hearing process for determining whether to grant the relief requested in such a motion.

First, the list of examples of “cause” will be expanded to include the following conduct by the debtor:

- gross mismanagement of the estate;
- failure to maintain appropriate insurance that poses a risk to the estate or to the public;
- unauthorized use of cash collateral substantially harmful to one or more creditors;
- failure to comply with an order of the court;
- unexcused failure to satisfy timely any filing or reporting requirement established by the Bankruptcy Code or by any rule applicable to a case under chapter 11;
- failure to attend the meeting of creditors convened under section 341(a) or an examination ordered under Rule 2004 of the Federal Rules of Bankruptcy Procedure without good cause shown by the debtor;
- failure timely to provide information or attend meetings reasonably requested by the U.S. Trustee;
- failure timely to pay taxes owed after the date of the order for relief or to file tax returns due after the date of the order for relief; and
- failure to file a disclosure statement within the time fixed by the Bankruptcy Code or by order of the court.

Notwithstanding the existence of any of the foregoing or any other instance of “cause” listed in section 1112 – other than the existence of “substantial or continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation” – denial of a

dismissal or conversion motion will be mandatory if the debtor or another party in interest objects and establishes that (i) there exists a reasonable likelihood of a plan being confirmed within a reasonable period of time and (ii) the ground(s) for “cause” relied upon by the movant include an act or omission of the debtor that is reasonably justified and capable of being cured by the debtor within a reasonable period of time.

Finally, revised section 1112 will require the bankruptcy court to commence a hearing on a conversion or dismissal motion within 30 days of its having been filed and to decide upon the motion within 15 days of the date the hearing is commenced. Relief from these deadlines is available only upon the movant’s consent or where “compelling circumstances” prevent the court from meeting the deadlines.

XIII. Taxes

The BAPCPA modifies the treatment that must be accorded to priority tax claims under a chapter 11 plan. Under current law, priority tax claims may be satisfied through deferred cash payments over a period not exceeding six years after the date of the assessment of such claim. The BAPCPA alters the payment terms to require that the holders of priority tax claims receive “regular installment payments in cash” (i) of a total value, as of the effective date of the plan, equal to the allowed amount of such claim, (ii) over a period ending not later than *five years after the commencement of the chapter 11 case*, and (iii) importantly, “in a manner not less favorable than the most favored nonpriority unsecured claim provided for by the plan (other than cash payments made to a [convenience] class . . .).”

You should also be aware that the BAPCPA contains other changes affecting the taxation of corporate debtors in bankruptcy cases and provides additional protections for property tax claimants. These changes are beyond the scope of this memorandum.

XIV. Administrative Expense Claims and Wage, Salary & Benefit Claims

A. *Retention and Severance Payments*

The BAPCPA includes certain significant limitations on the allowance and payment of executive retention and severance payments. Specifically, the BAPCPA will amend section 503 of the Bankruptcy Code to prohibit the allowance and/or payment of amounts to or for the benefit of an insider of the debtor “for the purpose of inducing such person to remain with the debtor’s business,” absent a finding by the court supported by evidence in the record that (i) the payment is “essential” to retain the person because he/she has “a bona fide job offer from another business at the same or greater rate of compensation,” (ii) “the services provided by the person are essential to the survival of the business,” and (iii) the amount of the payment does not exceed certain statutory caps.³ The BAPCPA further prohibits the allowance and/or payment of

³ Specifically, the amount of the claim or payment must not exceed (i) an amount equal to 10 times the amount of the mean claims or payments of a similar kind given to nonmanagement employees for any purpose during the calendar year in which the claim is allowed or the payment is made, or (ii) if no such similar claims were allowed or payments made to nonmanagement employees for any purpose during such calendar year, then the claim or payment amount must not exceed an amount equal to 25% of the

severance to an insider of the debtor unless (i) “the payment is part of a program that is generally applicable to all full-time employees,” and (ii) the amount of the claim or payment does not exceed 10 times the amount of the mean severance pay given to nonmanagement employees during the calendar year in which the claim is allowed or the payment is made. Finally, the BAPCPA contains an apparent “catch all” provision that prohibits allowance and/or payment of other amounts “outside of the ordinary course of business and not justified by the facts and circumstances of the case,” including payments made to or for the benefit of officers, managers, or consultants hired postpetition.

Clearly, these amendments are designed to reign in what has been viewed in recent years as overly generous retention, severance and other compensation-related arrangements given to members of the debtor’s existing management to incentivize them to remain with the debtor during the chapter 11 case. Often these arrangements are approved on a scant evidentiary record. That will no longer be the case. Going forward, the debtor will need to make a strong factual showing to justify its retention and severance program. In addition, the amounts proposed to be paid will be determined according to objective guidelines that not only limit the amount of such payments, but also require that they be tied to similar amounts paid to the debtor’s rank and file employees.

B. *Back Pay Awards*

The BAPCPA will further amend section 503(b) of the Bankruptcy Code to allow as administrative expense claims, wages and benefits awarded pursuant to a judicial proceeding or a proceeding of the National Labor Relations Board as back pay attributable to any period of time occurring after the commencement of a bankruptcy case as a result of the debtor’s violation of law, regardless of when the unlawful conduct occurred or whether any services were rendered, provided that the bankruptcy court determines that the award will not substantially increase the probability of layoff or termination of current employees.

C. *Wage Claims*

The BAPCPA will lengthen the look-back period (from 90 to 180 days prior to the petition date) and increase the cap (from \$4,925 to \$10,000) under section 507 for calculating priority wage and salary claims. This amendment becomes effective as of the date of the BAPCPA’s enactment but will only apply to cases commenced after that date.

XV. Retiree Benefits

The BAPCPA will amend section 1114 of the Bankruptcy Code – “Payment of insurance benefits to retired employees” – to direct the bankruptcy court, upon the motion of a party in interest, and after notice and a hearing, to reinstate retiree benefits to the extent the debtor modified them in the 180-day period prior to the commencement of the debtor’s bankruptcy case while the debtor was insolvent, unless the court finds that the “balance of the equities” clearly

amount of any similar claim or payment made to or incurred for the benefit of such insider for any purpose during the calendar year before the year in which such claim was allowed or payment was made.

favors such modification. This amendment becomes effective upon the BAPCPA's enactment and will apply to cases filed on or after that date.

Financial Contracts

The BAPCPA contains a number of amendments affecting financial contracts, such as swaps, commodity contracts, forward contracts, repurchase agreements and the like. The changes primarily affect the non-debtor's rights to liquidate, terminate or accelerate amounts owing under such contracts in the event of a bankruptcy.

At the outset, the BAPCPA clarifies that a stockbroker, financial institution or securities clearing agency may, upon the bankruptcy or insolvency of the debtor, and notwithstanding the automatic stay, exercise a contractual right to liquidate, terminate or accelerate a securities contract, commodities contract, forward contract, repurchase agreement or swap agreement. (The existing statutes permitted liquidation, but were silent as to termination and acceleration.) The BAPCPA also extends these rights of liquidation, termination and acceleration to "financial participants," which is defined to mean entities that have one or more securities contracts, commodity contracts, forward contracts, repurchase agreements, swap agreements or master netting agreements (discussed below) with the debtor or any other unaffiliated entity of a total gross dollar value of at least \$1 billion in notional or actual principal amount outstanding, or has gross mark-to-market positions of not less than \$100 million. This latter amendment recognizes that changes in the financial markets necessitate that these "financial participants" be given the same termination, liquidation and acceleration rights previously afforded to stockbrokers, financial institutions or securities clearing agencies to further limit any ripple effect through the financial markets in the event of a debtor's bankruptcy.

The BAPCPA also introduces two new Bankruptcy Code sections affecting financial contracts – new sections 561 and 562. Section 561 provides that the exercise by the non-debtor party to a financial contract of a contractual right to terminate, liquidate, accelerate or offset or net amounts payable under so-called "master netting agreements" and across financial contracts due to the debtor's bankruptcy or insolvency will not be stayed, avoided or otherwise limited. The non-debtor's exercise of any such rights under a "master netting agreement" will require that the non-debtor party could exercise the same right under each financial contract covered by the "master netting agreement" viewed individually. The term "master netting agreement" means "an agreement providing for the exercise of rights, including rights of netting, setoff, liquidation, termination, acceleration, or close out, under or in connection with one or more [securities contracts, commodity contracts, forward contracts, repurchase agreements or swap agreements], or any security agreement or arrangement or other credit enhancement related to one or more of the foregoing, including any guarantee or reimbursement obligation related to [one] or more of the foregoing."

The new section 562 of the Bankruptcy Code will govern the timing for measuring damages in connection with the non-debtor party's liquidation, termination or acceleration of a financial contract or the debtor's rejection of a financial contract. Specifically, it will provide that damages shall be measured as of the earlier of the date of such liquidation, termination or acceleration or the date of rejection. If there are not any "commercially reasonable determinants of value" as of such damage measurement date, then damages will be measured as of the earliest subsequent date(s) on which there are commercially reasonable determinants of value.

Two other important changes are these: (i) the exercise of the liquidation, termination and setoff rights described above, in addition to not being automatically stayed, shall not be stayed by any order of a court or administrative agency in any bankruptcy proceeding; and (ii) the provisions relating to financial contracts shall apply in cases under the new chapter 15 of the Bankruptcy Code involving cross-border insolvencies (see discussion of chapter 15 below).

Judicial, Jurisdictional and Procedural Amendments

A. *Bankruptcy Judges*

The BAPCPA includes the Bankruptcy Judgeship Act of 2005 which provides for the appointment of 28 additional bankruptcy judges located in fifteen states and in Puerto Rico, including four new judges in Delaware and one in the Southern District of New York. The additional judgeships appear only to be temporary because the BAPCPA provides that vacancies occurring five years or more after a judge is appointed under the Bankruptcy Judgeship Act of 2005 shall not be filled. This provision will be effective on the date of the BAPCPA's enactment.

B. *Bankruptcy Appeals*

The BAPCPA will amend the United States Judicial Code to provide for direct appeals of bankruptcy court decisions to the Circuit Court of Appeals under certain specified circumstances. Specifically, if the bankruptcy court (or district court or bankruptcy appellate panel, as applicable) or the parties to the appeal certify (i) that the order appealed from involves a question of law as to which there is no controlling decision of the circuit court of appeals or the U.S. Supreme Court, or involves a matter of public importance, (ii) the order involves a question of law requiring resolution of conflicting decisions, or (iii) an immediate appeal may materially advance the progress of the case, then the circuit court of appeals may authorize a direct appeal of a bankruptcy court's order.

C. *Bankruptcy Rules*

The BAPCPA will direct the Judicial Conference of the United States to propose amended Federal Rules of Bankruptcy Procedure and official bankruptcy forms which instruct chapter 11 debtors to disclose the value, operations, and profitability of any entities in which the debtor holds a substantial or controlling interest. The purpose of the amendments is to assist parties in interest in taking steps to ensure that any interest the debtor has in such entities will be used to pay allowed claims against the debtor.

XVI. Chapter 15: Ancillary and Other Cross-Border Cases

Amongst the most sweeping changes affecting business bankruptcies stem from the BAPCPA's repeal of section 304 of the Bankruptcy Code – "Cases ancillary to foreign proceedings" – and adoption in its place a new chapter 15, captioned "Ancillary and Other Cross-Border Cases," which incorporates the Model Law on Cross-Border Insolvency drafted and recommended for adoption by the United Nations Commission on International Trade and Law

(“UNCITRAL”).⁴ The new chapter 15 has as its stated objectives: (i) cooperation between the U.S. court and the courts and other competent authorities of foreign countries; (2) greater legal certainty for trade and investment; (3) fair and efficient administration of cross-border insolvencies that protects the interests of all creditors, other interested parties and the foreign debtor; (4) preserving and maximizing the value of the foreign debtor’s assets; and (5) facilitating the rescue of a financially troubled business, thereby protecting investment and preserving employment. Though a comprehensive discussion of the new chapter 15 does not lend itself to this brief overview of the BAPCPA, the significant provisions of chapter 15 are summarized below.

At the outset, it is important to note that chapter 15 should apply more broadly than section 304. That is due, in large part, to Congress’ expansion of the definition of “foreign proceedings” that will qualify for recognition under chapter 15. Unlike under section 304, “foreign proceedings” no longer will be limited to insolvency proceedings in a foreign country where the debtor is domiciled, has its principal place of business or where its principal assets are located. Rather, the new chapter 15 will permit recognition in the United States of both a “foreign main proceeding” – which is a foreign proceeding pending in the country where the debtor has the “center of its main interests”⁵ – and a “foreign nonmain proceeding” – which is a foreign proceeding, other than a foreign main proceeding, pending in a country where the debtor merely has an “establishment.”⁶ In addition, the revised definition includes within its scope “interim proceedings.” Though it is unclear what is meant by an “interim proceeding,” it could very well mean a proceeding that has been commenced abroad but in which a formal order of relief has not been entered by the foreign tribunal. In the past, courts struggled over whether to qualify such proceedings as “foreign proceedings” for purposes of section 304.

An important substantive distinction between a “foreign main proceeding” and “foreign nonmain proceeding” is that upon recognition of a “foreign main proceeding” only, the automatic stay will apply with respect to the debtor and its property that is located within the United States and the debtor may operate the debtor’s business in the United States in accordance with section 363 of the Bankruptcy Code. In addition, in view of the application of sections 362 and 363, the Bankruptcy Code’s “adequate protection” requirements also will apply. These sections will not apply upon recognition of a “foreign nonmain proceeding;” nor do they currently apply in a section 304 proceeding.

It also bears mentioning that chapter 15 contains an entire subchapter entitled “Concurrent Proceedings” that addresses the coordination of multiple proceedings here and abroad. These provisions are intended to enhance the coordination and cooperation among courts and parties in situations where there is an ancillary proceeding and a separate case commenced

⁴ To date, we are aware of only a handful of countries that have adopted UNCITRAL’s Model Law, including Japan, Mexico and South Africa. We understand that adoption is expected soon in some other countries, including England.

⁵ Under the new law, in the absence of evidence to the contrary, the debtor’s registered office will be presumed to be the center of the debtor’s main interests.

⁶ The BAPCPA defines “establishment” to mean “any place of operations where the debtor carries out a nontransitory economic activity.”

against the debtor under another chapter of the Bankruptcy Code or where there are multiple foreign proceedings – *i.e.* a foreign main proceeding and one or more foreign nonmain proceedings – and an ancillary or other bankruptcy case pending in the United States. In substance, these coordination provisions require that any relief granted in the ancillary proceeding not be inconsistent with the other bankruptcy case pending in the United States, or any relief granted in connection with a foreign nonmain proceeding not be inconsistent with a foreign main proceeding.

In addition, the coordination subchapter contains the following important general rule of payment:

a creditor who has received payment with respect to its claim in a foreign proceeding pursuant to a law relating to insolvency may not receive a payment for the same claim in a case under any other chapter of the Bankruptcy Code regarding the debtor, so long as the payment to other creditors of the same class is proportionately less than the payment the creditor has already received.

Other provisions of chapter 15 worth mentioning include the following:

- express statutory recognition for the first time that the foreign representative has the capacity to “sue and be sued in a court of the United States”;
- foreign creditors are given the same rights to commence or participate in a case under the Bankruptcy Code as domestic creditors;
- during the period between the filing of a chapter 15 petition and until the court rules on the petition, the court may, where appropriate, grant provisional relief, including injunctive or other “additional relief” that, subject to certain prescribed limitations, may be available to a trustee or debtor in bankruptcy;
- “police and regulatory” acts may not be enjoined provisionally or permanently;
- the taking of discovery by the foreign representative is expressly included among the forms of relief available upon recognition of the foreign proceeding (this codifies the trend in the case law permitting such discovery);
- the court may condition the relief granted under chapter 15, or the foreign representative’s operation of the debtor’s business, as appropriate, including by requiring “the giving of security or the filing of a bond”;

- upon recognition of a foreign proceeding, the foreign representative has standing in a case concerning the debtor under another chapter of the Bankruptcy Code to initiate avoidance and setoff actions; and
- to foster cooperation, the bankruptcy court is entitled to communicate directly with, or to request information or assistance directly from, a foreign court and to approve “protocols” concerning the coordination of the proceedings.

Though many of these provisions merely reflect the existing practice under section 304 as it has been developed through case law, their inclusion in chapter 15 dispels any doubt about their validity and ensures greater uniformity throughout the United States.

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We hope that this overview of the BAPCPA is helpful. Please do not hesitate to contact any one of us with questions or to request additional information regarding the BAPCPA.

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This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Questions concerning issues addressed in this memorandum should be directed to any member of the Bankruptcy & Corporate Reorganization Department.

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