

# 2005 Corporate Bankruptcy Law Revisions

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## THE BANKRUPTCY ABUSE PREVENTION AND CONSUMER PROTECTION ACT OF 2005: CORPORATE-RELATED REVISIONS TO THE BANKRUPTCY CODE

On April 20, 2005, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the “2005 Bankruptcy Revisions”) became law. Although largely focused on consumer issues, certain provisions of the 2005 Bankruptcy Revisions involve commercial issues in Chapter 11 cases. The pertinent revisions to the United States Bankruptcy Code (the “Bankruptcy Code”), which become effective on **October 17, 2005** (unless otherwise noted), are discussed below.

### *Exclusive Period for Debtors to File Plan of Reorganization*

The 2005 Bankruptcy Revisions limit the bankruptcy court’s ability to extend the exclusive periods for the debtor to file a plan (initially set at 120 days) and to solicit acceptance of the plan (initially set at 180 days). Historically, bankruptcy judges have almost automatically extended the 120- and 180-day periods “in the best interests of the estate.” Section 1121 of the Bankruptcy Code is amended to provide that the 120-day exclusive period deadline may not be extended beyond a date that is eighteen (18) months after commencement of the case and the 180-day solicitation deadline may not be extended beyond a date that is twenty (20) months after commencement of the case. The bankruptcy judge’s

discretion to extend these dates has been eliminated. Although this amendment may have little effect on smaller Chapter 11 cases, creditors’ committees gain significant leverage in larger cases with their ability to propose their own plans of reorganization or liquidation eighteen (18) months after the commencement of the case.

### *Key Employee Retention and Severance Plans*

The 2005 Bankruptcy Revisions attempt to address what is at least perceived as abuses, both pre- and post-petition, in the executive compensation area in the bankruptcy arena. A new Section 503(c) restricts certain benefits to “insiders,” defined to include a director, officer or person in control of the debtor or a relative of a director, officer or person in control. Transfers to or obligations incurred for the benefit of an insider to induce his or her retention are prohibited absent a finding by the court that (a) it 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,” (b) the services are “essential to the survival of the business,” and (c) the compensation is no greater than “10 times the amount of the mean transfer or obligation of a similar kind given to non-management employees during the calendar year” incurred, or if none, then no greater than

25 percent of any similar transfer to or for the benefit of the insider during the previous calendar year.

Further, a severance payment to an insider must be “part of a program that is generally applicable to all full time employees” and no greater than 10 times the mean severance to nonmanagement employees during the calendar year.

Finally, fraudulent transfer provisions under Section 548 of the Bankruptcy Code have been revised to reach back two years (as opposed to one) for cases filed after April 20, 2006. Further, the provisions were amended, effective as of April 20, 2005 to include pre-petition transfers or the incurrence of obligations “to or for the benefit of an insider under an employment contract” which is “not in the ordinary course of business” and for which the debtor received less than “reasonably equivalent value.”

### ***Unexpired Leases of Nonresidential Real Property***

The treatment of landlords in large Chapter 11 cases, like K-Mart, has been under much scrutiny, and Congress made certain revisions to benefit lessors. Time periods in which the debtor must assume or reject unexpired leases of nonresidential real property have been further restricted by the 2005 Bankruptcy Revisions. Whereas under the pre-amendment Bankruptcy Code, the debtor had 60 days from the date on which the bankruptcy petition was filed, plus such additional time as approved by the court, to assume or reject unexpired leases, Section 365(d)(4) of the Bankruptcy Code now increases the former period to allow the debtor 120 days from the filing of the commencement of the case to assume or reject unexpired leases. More importantly, the revised Bankruptcy Code eliminates unlimited court-approved extensions, instead providing for one ninety-day extension period “for cause,” with no further extensions available unless the lessor consents.

***“. . . creditors’ committees gain significant leverage in larger cases with their ability to propose their own plans of reorganization or liquidation eighteen (18) months after the commencement of the case.”***

Prior to the amendments, debtors and their assignees successfully argued that only monetary defaults must be cured. Section 365(b)(1)(A) of the revised Bankruptcy Code eliminates the obligation of the debtor to cure defaults relating to the failure to perform nonmonetary obligations under an unexpired lease of real property *that are impossible to cure*. If, however, such defaults arise from a failure to operate in accordance with a nonresidential real property lease, then the defaults must be cured by performance at and after assumption of the lease in accordance with the lease; in addition, the debtor must compensate the lessor for monetary losses resulting from such nonmonetary defaults.

In a related provision, a newly added paragraph to Section 503(b) grants administrative expense priority, in connection with a nonresidential real property lease that is first assumed and then subsequently rejected, for all monetary obligations due for the two-year period following the later of the rejection date or the turnover date. A claim for any remaining amounts due beyond this two-year period is subject to the cap currently applied to such claims under Section 502(b)(6).

### ***Equipment and Personal Property Leases and Other Executory Contracts***

Generally, a debtor may assume an equipment or personal property lease or executory contract only if it cures or provides adequate assurance that it will promptly cure any defaults. Prior to the 2005 Bankruptcy Revisions an exception under Section 365(b)(2) of the Bankruptcy Code excused the debtor from curing a default that was a breach of a provision relating to “the satisfaction of any penalty rate or provisions relating to a default arising from any failure by the debtor to perform non-monetary obligations.” Some courts interpreted this exception to

excuse performance of all nonmonetary obligations. The Ninth Circuit Court of Appeals in *Worthington v. General Motors Corp. (In re Claremont Acquisition Corp.)*<sup>1</sup>, however concluded that nonmonetary defaults, which were not penalty provisions, were not excluded and must be cured. The 2005 Bankruptcy Revisions merely added “penalty” immediately prior to “provision” in the above-quoted exception, codifying the conclusion in *Claremont*.

*Query: Did Congress create a new issue in its attempt to solve the nonresidential lease penalty rate and penalty provisions issue discussed above? Could an equipment lessor now argue that even nonmonetary obligations that are impossible to cure (other than ipso facto provisions like the commencement of a case, insolvency or financial conditions specifically excepted in Section 365(b)(2) of the Bankruptcy Code) preclude assumption, because Congress only excepted such impossible to cure obligations in Section 365(b)(1) for nonresidential real estate leases?*

### **Section 1110 Aircraft Equipment**

The 2005 Bankruptcy Revisions did not amend Section 1110 relating to certain aircraft equipment and vessels. However, do the amendments to Sections 365(b)(1) and 365(b)(2) (discussed in the two previous sections of this Bulletin) provide a stronger argument for lessors of aircraft that an airline may not effectively make a Section 1110(a) election if it is unable to cure all nonmonetary defaults, *even those that are impossible to cure?* Section 1110(a) excepts only those defaults specified in Section 365(b)(2), typically referred to as *ipso facto* provisions, from an airline’s obligation to cure to retain the aircraft.

***“Time periods in which the debtor must assume or reject unexpired leases of nonresidential real property have been further restricted by the 2005 Bankruptcy Revisions.”***

*Query: Can an aircraft lessor now argue that nonmonetary cross-defaults in other leases and financial covenants that do not fit within the ipso facto exception of Section 365(b)(2) preclude a Section 1110(a) election, even if such nonmonetary provisions are impossible to cure?*

### **Aircraft Terminal and Aircraft Gate Leases**

The 2005 Bankruptcy Revisions also eliminate the restriction on assignments of aircraft terminal and aircraft gate leases, which appeared in Section 365(c)(4) of the pre-amendment Bankruptcy Code.

### **Preference Actions**

Preference defendants received certain benefits from the 2005 Bankruptcy Revisions. The “ordinary course of business” defense set forth in Section 547(c) of the Bankruptcy Code is revised to require the preference defendant to show that, in addition to the *debt* being incurred in the ordinary course of business or financial affairs of the debtor and the transferee, the *transfer* was (a) made in the ordinary course of business or financial affairs of the debtor *or* (rather than *and*) (b) made according to ordinary business terms.

In addition, a new paragraph is added to Section 547(c) which prohibits the

avoidance of transfers that, in the aggregate, total less than \$5,000.

### **Fraudulent Transfers**

Section 548 of the Bankruptcy Code has been amended to allow the trustee or Chapter 11 debtor to avoid fraudulent transfers that were made or incurred on or

<sup>1</sup> 113 F.3d 1029 (9th Cir. 1997).

within two years (up from one year) of the date on which the bankruptcy petition was filed (effective only for cases filed after April 20, 2006).

### ***Wage and Salary Priority***

The amount allowed as a priority claim for pre-petition wages, salaries, commissions and contributions to employee benefit plans will more than double under the 2005 Bankruptcy Revisions. Section 507(a) of the Bankruptcy Code is amended to grant a fourth priority unsecured claim for up to \$10,000 (increased from \$4,925) for wages, salaries and commissions earned within 180 days (increased from 90 days) before the filing of the bankruptcy petition. The Revisions also provide for a fifth priority unsecured claim for contributions to an employee benefit plan arising from services rendered within 180 days before the filing of the bankruptcy petition to the extent of \$10,000 per employee.

### ***Reclamation***

Although reclamation claimants have increased periods to assert their claims, it is now clear that prior perfected secured creditors prime their claims. Revisions to Section 546(c) of the Bankruptcy Code allow a seller of goods to reclaim the goods received by an insolvent debtor within forty-five (45) days before the commencement of the bankruptcy case (formerly 10 days). The seller must make a written reclamation demand no later than forty-five (45) days after the receipt of such goods, or no later than twenty (20) days after the commencement of the case if the forty-five-day period expires after the commencement of the case. The revisions also make clear, however, that the reclamation right is subject to the prior rights of a secured party in such goods (or the proceeds thereof).

A new paragraph is added to Section 503(b) that grants administrative expense priority for the value of goods received by the debtor within twenty days prior to the commencement of the bankruptcy case where the goods were sold to the debtor in the ordinary course of the debtor's business.

### ***Utility Deposits***

Pursuant to Section 366 of the Bankruptcy Code, a debtor must provide adequate assurance of payment to a utility within twenty days after the commencement of the bankruptcy case, or the utility may discontinue service. The 2005 Bankruptcy Revisions restrict what constitutes "assurance of payment" to include a cash deposit, a letter of credit, a certificate of deposit, a surety bond, a prepayment, or some other form of security that is agreed to by the utility. The utility may alter, refuse or discontinue service if such assurance of payment is not received from the debtor within thirty days after the filing of the bankruptcy petition.

***"A new Chapter 15 has been added to the Bankruptcy Code which governs cross-border insolvency cases."***

### ***Forward Contracts, Repurchase Agreements, Etc.***

The Bankruptcy Code currently offers protections for parties to securities contracts, commodities contracts, forward contracts, repurchase agreements, and swap agreements in the event that the other party to such contracts files for bankruptcy protection. The 2005 Bankruptcy Revisions add a new Section 561 to the Bankruptcy Code that offers similar protections for parties to master netting agreements and cross margining contracts.

### ***Cross-Border Insolvency Cases***

A new Chapter 15 has been added to the Bankruptcy Code that governs cross-border insolvency cases. These

provisions seek to provide a more effective mechanism for dealing with cross-border insolvency cases by facilitating cooperation between U.S. courts, trustees and debtors, on one hand, and non-U.S. courts and other competent authorities, on the other hand.

### ***Homestead Exemption***

The Act amends Section 522 of the Bankruptcy Code to add a new subsection (p) that limits a state homestead exemption to \$125,000 for a residence acquired by the debtor within 1,215 days prior to the filing of the bankruptcy petition.

### ***Access to Official Creditors' Committee***

The 2005 Bankruptcy Revisions require a Creditors' Committee to "provide access to information" to creditors that are not members of the Committee and authorizes the bankruptcy court to compel additional reporting and disclosures to such creditors.

### ***Single Asset Real Estate Cases***

The original \$4,000,000 of aggregate noncontingent, liquidated secured debts requirement to qualify for special provisions for single-asset real estate debtors has been eliminated. Further, amended Section 362(d)(3) now requires a single-asset real estate debtor to make monthly payments of contract rate interest to its secured creditors, if the debtor has not filed a plan that has a reasonable possibility of being confirmed in a reasonable time.

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