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It's Not Just Aimed At Consumer Debtors: New Bankruptcy Legislation Changes The Rules For Business Bankruptcies

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In addition to the much-publicized changes to consumer bankruptcy laws, the new bankruptcy legislation contains key changes applicable to corporate chapter 11 cases. Chief among the modifications to existing law are provisions designed to: shorten the length of chapter 11 cases; radically enhance the protections afforded to certain types of creditors such as telephone companies, other utilities, and landlords; provide for a patient ombudsman in health care cases; and strictly limit the sometimes unconscionable retention bonuses paid to management of failed companies. The new law also adds an entirely new chapter to the Bankruptcy Code dealing with international cases. In addition, the law includes substantial changes to small-business bankruptcy cases. With certain exceptions, the amendments to the Bankruptcy Code become effective one hundred eighty (180) days following enactment.

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Limitation On Plan Exclusivity Extensions

Following the commencement of a bankruptcy case, the debtor has a period of one hundred twenty (120) days during which it alone may file a plan. Under the current law, this time period, known as "exclusivity," may be extended upon a showing of "cause." In many large bankruptcy cases, enlargements of exclusivity are common, and some cases have been extended for years. For example, UAL Corp., the parent company of United Airlines filed for bankruptcy law protection in December, 2002 and is still in its exclusive period. The amendments place an absolute limit on exclusivity of eighteen (18) months following the date the case commences. Debtors in large cases may be required to work more quickly if they hope to propose a plan that is likely to be supported by the creditor body and to avoid the prospect of fighting a competing plan. The practical result of this amendment may be that large bankruptcy cases will be resolved much quicker than under current law.

Adequate Assurance Of Payment For Utilities

Section 366 of the Bankruptcy Code allows a utility to alter, refuse or discontinue service if the debtor, within twenty (20) days after the case is filed does not provide "adequate assurance of payment, in the form of a deposit or other security, for service after such date." In recent telecom bankruptcies, some bankruptcy courts have ruled that minimal protections – of little real value – such as those already afforded post-petition cred-

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itors, without much more, suffice to prevent discontinuation of service particularly where the debtor asserts that it has timely paid its utility bills in the past.

The new law defines exactly what qualifies as "assurance of payment." Specifically, cash deposits, letters of credit, pre-payment and surety bonds are listed as forms of adequate assurance of payment, while the availability of the oft times useless administrative expense priority does not suffice. Similarly, the amendment provides that timely pre-bankruptcy payments are not evidence of assurance of post-petition payment. This amendment would have made large telecom bankruptcy cases, such as WorldCom, virtually impossible due to the massive telecommunications obligations incurred in the ordinary course of business.

Assumption And Rejection Of Leases

There are significant amendments in favor of commercial landlords. The Bankruptcy Code currently provides the debtor a period of one hundred twenty (120) days from the filing of a petition to decide whether to assume or reject leases of non-residential real property. However, this time period may be extended upon a showing of cause. Courts commonly have extended the deadline for several months and in some cases, years. The new law will prohibit the bankruptcy court from extending the deadline to a date that is more than two hundred ten (210) days after the order for relief (usually the petition date) without the landlord's consent. In addition, the legislation modifies the bankruptcy code to clarify that use restrictions will be honored when leases are assumed and assigned. For example, under current law, bankruptcy courts commonly will permit a debtor to assign a lease, which requires the tenant to operate a specific type of business, to a new tenant that does not intend to operate that type of business. In recent years, many large retail operations have filed chapter 11, including K-Mart, Ames Department Stores, Trak-Auto, and Winn-Dixie. In many of these cases, the debtors attempted, with differing levels of success to assign leases to new tenants which did not plan on complying with use restrictions in the lease. Retailers in chapter 11 will no longer be able to ignore these important contractual provisions.

In addition, the amendments clarify the need to cure existing non-monetary defaults at the time of assumption. Where the non-monetary default is impossible to cure based upon failure to comply with a lease, the default shall be cured by performing under the lease going forward and the landlord will be compensated for losses suffered as a result of the tenant's failure to operate in accordance with the lease. A split of authority existed under current law with respect to whether non-monetary defaults need to be cured or even could be cured. Finally, the amendments clarify the treatment of a landlord's claim where a lease is assumed but then later breached during the course of a bankruptcy case. In such a scenario, the landlord will have an administrative claim for two (2) years following the rejection except to the extent the landlord re-lets the premises.

Health Care Cases

In recent years, several operators of nursing homes and other health care providers have been debtors in bankruptcy cases. Oftentimes, the nursing home patients were effectively left without a voice in the bankruptcy proceedings. To attempt to remedy this injustice, the amendments add a new section to the Bankruptcy Code requiring the appointment of a "Patient Care Ombudsman" within thirty (30) days after a health care business files a bankruptcy petition. The section specifically provides that in a case where the debtor provides long term care; the court may appoint the State Long-Term Care Ombudsman appointed under the Older Americans Act of 1965 to this position. The ombudsman will be required to report to the court at least every sixty days regarding the quality of patient care being provided by the debtor.

In addition to the appointment of an ombudsman, the new law creates a duty on a debtor to use its "reasonable and best efforts" to transfer patients to an appropriate entity in the same vicinity that provides substantially similar services at a reasonable level of care once a health care business has closed.

Limitation On Executive Bonuses

Chapter 11 debtors often seek court approval of "retention bonuses" for executives. Generally, the debtors argue that absent such economic incentive, the executives will find employment elsewhere rather than continue working for a distressed entity. These types of bonuses have been criticized as giveaways to management. The new law will limit these bonus payments to situations where the person has a "bona fide job offer from another business at the same or greater rate of compensation." Even in circumstances where the person does have such an offer, the bonus may not exceed ten times the average amount of similar payments to non-management employees, or where no such payments were made, twenty-five percent (25%) of the amount of any similar payment to the executive during the prior year. Likewise, severance pay is limited to payments made as part of a program generally applicable to all full time employees and to ten times the amount of the average severance pay given to non-management employees in the prior year.

Cross-Border Bankruptcy Cases

Section 304 of the Bankruptcy Code currently governs so-called "ancillary proceedings." These cases are filed where another insolvency proceeding is already ongoing in a foreign country so as to, among other things, obtain U.S. Court supervision over assets in the United States. The new law replaces § 304 with Chapter 15. Chapter 15 is designed to incorporate the United Nations Commission on International Trade Law's Model Law on Cross-Border Insolvency to the extent it comports with the goals of the Bankruptcy Code. Upon recognition of a foreign bankruptcy proceeding, the representative of that estate may, among other things, intervene in litigation pending in the United States. Further, Chapter 15 provides for coordination and cooperation between the U.S. and foreign courts.

Preference Cases.

The amendments will also affect lawsuits brought by a debtor or trustee to avoid allegedly preferential payments or transfers. These actions typically target payments made to creditors within ninety (90) days of the filing of the bankruptcy case. It is not uncommon in large cases for hundreds if not thousands of these lawsuits to be brought. One common defense to a preference case is the assertion that the relevant transaction occurred in the ordinary course of business. However, under the current law, proving the ordinary course defense is often difficult due to a complex three-prong test that may require expensive expert testimony. The amendments change the law so that if the creditor can meet any two of the three prongs (as opposed to all three), the payment will not be avoided. In addition, the venue requirements will be changed so that cases where the debtor seeks to recover less than $10,000 must be brought in the defendant's home district, rather than the district in which the bankruptcy case is pending.

Conclusion

Businesses should keep these important changes in mind when dealing with the bankruptcy filing of a customer, supplier or other commercial partner. However, the full impact of the business bankruptcy amendments may not be known until bankruptcy cases are filed under the new law and courts apply these new provisions.

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