

## What Bondholders and Lenders Need to Know about the New Revisions to the Bankruptcy Code

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "Act") has now been passed by Congress and signed into law by President Bush. While the consumer provisions have received the most press, there are also significant changes that will affect business reorganizations. The business changes will apply to bankruptcy cases filed after October 16, 2005. The deals you are doing now will be governed by the changes set forth in the Act.

### New Chapter 11 Priorities Benefitting Trade Vendors, Landlords and Employees Reduce the Pie Available for Unsecured and Undersecured Bondholders and Lenders

The Act adds to the administrative expense and other priority claims which are required to be paid in full before any payments can be made on general unsecured or undersecured claims. These changes, by increasing the number and amount of claims entitled to priority payment, will reduce recoveries for non-priority unsecured or undersecured bondholders and lenders.

**Trade Vendors.** Trade vendors are granted a new administrative expense claim for goods received by the debtor within the 20 days *before* the debtor's chapter 11 case is filed. In addition, trade vendors will be entitled to assert reclamation claims to recover goods received by an insolvent debtor within 45 days *before* the debtor's chapter 11 case is filed. The net effect of these two provisions is that the debtor will be required (i) to pay in full for all goods that it received during the 20 day period preceding the bankruptcy filing and (ii) (if there is excess collateral after considering claims secured by goods) either to pay for or to return all goods the debtor received between 21 and 45 days preceding the bankruptcy filing which are identifiable and still in the debtor's possession.

**Landlords.** There is a hard outside date of 210 days after the bankruptcy filing date by which the debtor must either assume or reject leases of non-residential real property. If the debtor elects to assume the lease but subsequently rejects it, the Act imposes a quasi-liquidated damages administrative expense claim of two years rent, without mitigation except for sums the landlord actually receives or is to receive from a third party.

**Employees.** The prepetition employee wage and benefit priority is increased to \$10,000 per employee, and the period within which such amounts are required to have accrued is extended from 90 days to 180 days of the petition date. The primary effect of this change will be to potentially increase the amount of vacation pay that employees will be able to recover as a priority claim in a liquidating case.

**KERP and Severance Plans.** In what can be seen as a pro-lender development, the changes impose severe limitations on key employee retention plans (KERPs) and severance payments to insiders. KERP payments are prohibited unless the insider has a bona fide competing job offer at the same or greater rate of compensation, the insider's services are essential to survival of the business, and the amount of the KERP payment is not greater than 10 times the mean retention or similar payment given to non-management employees during the same calendar year or, if there are no such payments to non-management employees, 25% of any similar transfer or obligation to such insider during the preceding

year. Severance payments to insiders are also prohibited unless part of a program that is generally applicable to all full time employees and the amount of the payment is not greater than 10 times the mean severance pay given to non-management employees during the same calendar year. As a result of these changes, debtors may seek to compensate insiders based on success criteria or other non-retention based benchmarks.

**Payment of Priority Tax Claims.** Installment payment of priority taxes under a plan must be completed not later than 5 years from the date of the order for relief, which is usually the bankruptcy filing date. Secured taxes of the same type as priority unsecured taxes now benefit from the same requirements. Previously, the Bankruptcy Code permitted priority taxes to be paid over the six years from the date of assessment and did not prescribe a time period for the payment of secured tax claims. The interest rate on the unpaid taxes will be the applicable rate under non-bankruptcy law and not a market or judgment rate. The changes also prohibit tax claims from being treated in a manner less favorable than the treatment of non-priority unsecured claims.

## Reduction in the Value of Assets

The Act also reduces the value of certain classes of assets of the debtor.

**Reduction in Value of Leases.** In a change helpful to landlords but an obstacle to debtors and their creditors, any commercial real estate leases that have not been assumed by 120 days after the filing are deemed rejected, and the property must be immediately surrendered. The 120 days can be extended to 210 days for cause, but no further without the landlord's written consent. The Act enhances a landlord's ability to enforce use limitations in real estate leases in shopping centers, perhaps even in circumstances where a use limitation would effectively prevent any assignment. In conjunction, the changes impose greater obstacles to market and less time to market commercial real estate leases. This may diminish the value of leases to the bankruptcy estate.

**Reduction in Value of Preferences.** The "ordinary course" defense to preference liability is now easier to establish. Previously, a transferee had to prove that the alleged preferential payment was made in accordance with industry standards and on terms customary between the debtor and such transferee. Now the defense is available if either test is satisfied. This change will reduce preference recoveries -- often the only asset free from liens of prepetition secured lenders (and available to provide a distribution to unsecured bondholders).

## Changes that will Affect Case Administration

**Exclusivity.** The debtor may no longer seek indefinite extensions of the period during which the debtor has the exclusive right to propose a plan of reorganization. There is now a hard outside date of 18 months after the petition date for the debtor to propose a plan, and 20 months to confirm a plan, after which any party may propose a plan.

**Dismissal or Conversion.** The debtor's case is now subject to mandatory dismissal or conversion if the debtor fails to file a plan within a deadline set by the court, makes unauthorized use of cash collateral resulting in harm to any creditors, engages in gross mismanagement, fails to maintain appropriate insurance, file tax returns or pay taxes, or fails to comply with reporting or court filing requirements.

**Appointment of a Trustee.** The U.S. Trustee must move for appointment of a trustee where there are reasonable grounds to suspect the CEO, CFO or board have engaged in actual fraud, dishonesty or criminal conduct in the management of the debtor or in public financial reporting.

**Prepackaged Bankruptcies.** Prepackaged bankruptcy cases, where acceptances to a plan of reorganization are solicited

before a case is filed, are made easier to use. Acceptances of a prepetition proposed plan of reorganization may be solicited in a manner complying with applicable non-bankruptcy law, dispensing with the requirement of a Bankruptcy Court approved disclosure statement. Where the debtor has solicited acceptances of a plan of reorganization before commencement of a case, the Bankruptcy Court may order the U.S. Trustee not to convene a meeting of creditors or equity security holders, and accordingly not to appoint a creditors' committee or equity committee. Jurisdictions which have been viewed as friendly to effecting chapter 11 transactions can be anticipated to be friendly to and to favor prepackaged bankruptcies.

### The Bottom Line

The changes in the Act in combination operate to favor asset sales, or balance sheet restructuring, as opposed to more extended chapter 11 reorganizations. The new priorities afforded to trade vendors, landlords and employees make it more expensive to confirm a plan, since such administrative and priority claims are required to be paid in full on confirmation. The hard outside dates for the assumption and rejection of leases, and for extensions of exclusivity, favor expedited proceedings. Prepackaged bankruptcies are the most expedited and the most favorably treated proceeding. Look for an increase in (i) exchange offers, and (ii) asset sales, which are implemented through a preplanned or prepackaged chapter 11 case.

### Contact Information

If you would like to learn more about these changes and other business-related amendments in the new Bankruptcy Code provisions, please contact any member of the Bankruptcy & Business Restructuring Department.

