

*The Bankruptcy Reform Act of 2001 – Looming  
Business Bankruptcy Amendments*

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**Summaries of H.R. 333 and S. 420 Business  
Provisions**

# I.

## Administrative Issues

### A. Amendments that Affect Non-Residential Real Property Leases

#### 1. Extension of Assumption/Rejection Period

H.R. 333 and S. 420 (collectively, the "Bills") significantly amend Bankruptcy Code section 365(d)(4), making it impossible to extend the time within which a debtor in possession may assume, assume and assign, or reject an unexpired lease of non-residential real property beyond seven months after the commencement of a voluntary chapter 11 case, unless the lessor consents in writing. In short, the debtor-lessee has the earlier of (1) 120 days (about 4 months) after the order for relief is entered or (2) the date the confirmation order is entered, to assume, assume and assign or reject its leases of nonresidential real property. For cause, the court can extend that period by 90 days (about 3 months). After the court grants that first 90-day extension, it cannot further extend the assumption/rejection period without the consent of the lessor.<sup>1</sup>

These amendments will change the course of many chapter 11 cases, where a debtor often seeks to postpone the decision on what to do with its leases until the very end of the case or at least until it determines the size of the reorganized entity. Those debtors will be forced to prematurely assume or reject their leases of nonresidential real property, which could prove disastrous, even taking into account some amendments to Bankruptcy Code section 503(b).

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<sup>1</sup> Revised section 365(d)(4) provides:

4)(A) Subject to subparagraph (B), in any case under any chapter of this title, an unexpired lease of nonresidential real property under which the debtor is the lessee shall be deemed rejected, and the trustee shall immediately surrender that nonresidential real property to the lessor, if the trustee does not assume or reject the unexpired lease by the earlier of—

(i) the date that is 120 days after the date of the order for relief; or

(ii) the date of the entry of an order confirming a plan.

(B)(i) The court may extend the period determined under subparagraph (A), prior to the expiration of the 120-day period, for 90 days upon motion of the trustee or lessor for cause.

(ii) If the court grants an extension under clause (i), the court may grant a subsequent extension only upon prior written consent of the lessor in each instance.

Bills, § 404 (emphasis added).

**2. Administrative Claim Upon Rejection of Lease Previously Assumed by the Debtor**

In Nostas Assoc. v. Costich (In re Klein Sleep Products, Inc.), 78 F.3d 18 (2d Cir. 1996), the debtor in possession assumed a lease of nonresidential real property. A chapter 11 trustee was appointed when the debtor's reorganization efforts failed. The chapter 11 trustee promptly rejected the lease and the lessor sought recovery of future rent under the lease. The trustee argued that the rejection of a previously-assumed lease should be treated as a breach entitling the lessor to a general unsecured claim. The Second Circuit disagreed and held that the lessor's claim for future rent gave rise to an administrative expense claim entitled to priority under Bankruptcy Code section 503(b). Id. at 30. The Second Circuit further held that the section 502(b)(6) cap did not apply to the lessor's claim. Id. at 33.

The Bills overrule that portion of Klein that held that the lessor was entitled to an unlimited administrative expense claim. Under the revised law, a lessor with respect to a lease that was previously assumed and then rejected will have an administrative expense claim for future rent "[f]or the period of 2 years following the later of the rejection date or the date of actual turnover of the premises . . . ." Damages for "going dark" and penalties are expressly excluded from the administrative claim under revised Bankruptcy Code § 503(b)(7). Bills, § 445. Mitigation principles will apply only to the extent that the lessor actually receives rent from a nondebtor.

The Bills also overrule that portion of Klein that held that the 502(b)(6) cap does not apply to these claims, although the cap will apply on a more limited basis. The cap will apply to the lessor's claim for future rent after the first 2 years: "[t]he claim for remaining sums due for the balance of the term of the lease shall be a claim under section 502(b)(6)." Bills, § 445.

These amendments will affect most seriously chapter 11 debtors that operate retail chains. In those cases, a debtor often has many leases that it may want to assume or reject, depending on how the retail stores operate during heavy shopping seasons. Under the new law, many of those debtors will not have the benefit of waiting to decide. Either the debtor assumes its leases and takes the chance that it ultimately will have to reject the leases and be subject to the lessor's administrative claim under revised section 503(b)(7) or the debtor immediately rejects the leases possibly to the detriment of its future business operations.

**B. Amendments that Affect Executory Contracts and Unexpired Leases**

**1. Cure of Nonmonetary Defaults**

In Worthington v. General Motors Corp. (In re Claremont Acquisition Corp., Inc.), 113 F.3d 1029 (9<sup>th</sup> Cir. 1997), the Ninth Circuit would not allow a chapter 11 debtor to assume and assign its franchise agreements due to its inability to cure certain nonmonetary defaults arising from its failure to operate the franchise in accordance with

the agreement's "going dark" clause. *Id.* at 1035. The Ninth Circuit began with the proposition that Bankruptcy Code section 365(b)(1) requires the debtor to cure all monetary and nonmonetary defaults before it can assume or assign an executory contract or unexpired lease. The Ninth Circuit noted that although section 365(b)(2) contains a list of items that need not be cured before assumption and assignment, a nonmonetary default was not one of those items. *Id.* at 1033. The dispute in that case was over the construction of the language of section 365(b)(2)(D):

Paragraph (1) of this section [365(b)] does not apply to a default that is a breach of a provision relating to – . . . (D) the satisfaction of any penalty rate or provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease.

11 U.S.C. § 365(b)(2)(D) (emphasis added).

The debtors and proposed assignees took the position that the phrase "penalty rate or provision" meant "penalty rate or other provision" relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease. *In re Claremont Acquisition Corp., Inc.*, 113 F.3d at 1033. The franchisor took the position that the phrase meant "penalty rate or penalty provision" relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease. *Id.* The Ninth Circuit agreed with the franchisor. *Id.* at 1034. Taking the position that the nonmonetary default was a "historical fact" which could not be cured, the Ninth Circuit would not allow the debtor to assign the franchise agreement. *Id.* at 1033-34.

Under revised section 365(b)(2), the trustee need not cure defaults that relate to a breach of a nonmonetary obligation if it is impossible to do so. However, with respect to real property leases, the trustee must begin performing all nonmonetary obligations under the lease at or after the time of assumption. Moreover, if a lessor of nonresidential real property suffers and pecuniary losses as a result of the debtor's failure to perform its nonmonetary obligations under the lease, those losses must be compensated as part of the cure. H.R. 333, § 328; S. 420, § 327. Revised section 365(b)(1)(A) provides:

(b) (1) If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract or lease, the trustee -

(A) cures, or provides adequate assurance that the trustee will promptly cure, such default; other than a default that is a breach of a provision relating to the satisfaction of any provision (other than a penalty rate or penalty provision) relating to a default arising from any failure to perform nonmonetary obligations under an unexpired lease of real property, if it is impossible for the trustee to cure such default by performing nonmonetary acts at and after

the time of assumption, except that if such default arises from a failure to operate in accordance with a nonresidential real property lease, then 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 provisions of paragraph (b)(1); and

H.R. 333, § 328; S. 420, § 327.

In re Claremont Acquisition is no longer good law with respect to leases of real property. However, to fix the ambiguity under current section 365(b)(2)(D), as pointed out by the Ninth Circuit, the Bills revise section 365(b)(2)(D) to provide that the cure requirement does not apply to the satisfaction of any "penalty rate or penalty provision." H.R. 333, § 328; S. 420, § 327. As a result, Claremont is codified for personal property leases and executory contracts other than unexpired leases of real property. This may create problems for debtors that have defaulted on going dark obligations under franchise agreements. Under revised section 365(b)(2)(D), those debtors may not be permitted to assume and assign their agreements.

## **2. Impairment of Claims or Interests Related to Nonmonetary Defaults**

The Bills amend section 1124(2) to correspond with the amendments to section 365(b)(1) & (2). Revised section 1124(2)(A) & (D) provide:

Except as provided in section 1123(a)(4) of this title, a class of claims or interests is impaired under a plan unless, with respect to each claim or interest of such class, the plan - . . .

(2) notwithstanding any contractual provision or applicable law that entitles the holder of such claim or interest to demand or receive accelerated payment of such claim or interest after the occurrence of a default -

(A) cures any such default that occurred before or after the commencement of the case under this title, other than a default of a kind specified in section 365(b)(2) of this title or of a kind that section 365(b)(2) of this title expressly does not require to be cured . . .

(D) if such claim or such interest arises from any failure to perform a nonmonetary obligation, other than a default arising from failure to operate a non-residential real property lease subject to section 365(b)(1)(A), compensates the holder of such claim or such interest (other than the debtor or an insider) for

**any actual pecuniary loss incurred by such holder as a result of such failure . . . .**

H.R. 333, § 328; S. 420, § 327.

This section appears to prevent "going dark" clauses in loan agreements from preventing reinstatement of the loan as unimpaired. A technical error in the cross reference to section 365(b) however suggests that penalty clauses associated with monetary defaults may be subject to cure as a condition of treating a claim as unimpaired. Compare revised § 1124(2) with In re Southeast Co., 868 F.2d 335 (9<sup>th</sup> Cir. 1989); In re Entz-White Lumber & Supply, 850 F.2d 1338 (9<sup>th</sup> Cir. 1988).

**3. Provisions Affecting Air Carriers**

Current Bankruptcy Code section 365(c)(4) and (d) includes expired provisions that specifically protect and relate to air carriers and lessors of aircraft terminals. The Bills delete all of those provisions.

**C. Utilities**

The Bills practically rewrite Bankruptcy Code section 366. These amendments give a significant amount of power to the utilities, making it possible for a utility to alter, refuse or discontinue utility service without relief from the automatic stay and without court approval.

To begin with, section 366 will include a definition of the term "assurance of payment:"

(A) For purposes of this subsection, the term 'assurance of payment' means --

- (i) a cash deposit;
- (ii) a letter of credit;
- (iii) a certificate of deposit;
- (iv) a surety bond;
- (v) a prepayment of utility consumption; or
- (vi) another form of security that is mutually agreed on between the utility and the debtor or the trustee.

Bills, § 417.

Note that the above list does not include administrative expense priority as an acceptable form of adequate assurance. In fact, revised section 366 provides that administrative expense priority does not constitute adequate assurance. This resolves an ambiguity in the legislative history and conflicting case law.

Turning to a utility's ability to terminate service without court approval and without relief from the automatic stay, it appears that a utility can do so if the form and amount of adequate assurance payment is not "satisfactory" to the utility. Specifically, revised section 366 allows a utility to:

[a]fter, refuse, or discontinue utility service, if during the 30-day period beginning on the date of filing of the petition, the utility does not receive from the debtor or the trustee adequate assurance of payment for utility service that is satisfactory to the utility.

Bills, § 417.

Revised section 366 contains no requirement that the utility seek court approval before terminating service in accordance with the new provision. Although revised section 366 authorizes the court to modify the amount of the proposed adequate assurance payment, there simply is no requirement that the utility seek court approval before terminating service in accordance with the new provision. Moreover, although it might be suggested that a utility would need to seek relief from the automatic stay before terminating service, the provisions of this section that specifically authorize the utility to terminate service probably will control.

Given the utilities' ability to terminate service, debtors that cannot reach agreements with utilities will have to attempt to preempt termination by seeking relief from the bankruptcy court within the first 30 days of the case. It may not be easy for debtors that successfully preempt termination to have the court modify proposed adequate assurance payments, however. The section sets forth certain facts that the court cannot consider when determining whether to modify an adequate assurance payment:

In making a determination . . . whether an assurance of payment is adequate, the court may not consider . . . (i) the absence of security before the date of filing of the petition; (ii) the payment by the debtor of charges for utilities service in a timely manner before the date of filing of the petition; or (iii) the availability of an administrative expense priority.

Bills, § 417.

In addition to the revisions discussed above, the utility will be permitted to "[r]ecover or set off against a security deposit provided to the utility by the debtor before the date of filing the petition without notice or order of the court." Bills, § 417.

## **D. Preferences**

### **1. The Deprizio Fix**

The Bankruptcy Reform Act of 1994 (the "1994 Reform Act") amended Bankruptcy Code section 550 to overrule Levit v. Ingersoll Rand Fin. Corp. (In re

Deprizio), 874 F.2d 1186, 1187 (7<sup>th</sup> Cir. 1989). Deprizio addressed the issue of the appropriate preference period for payments to third party lenders on account of debts guaranteed by insiders.

Deprizio extended the preference avoidance period from 90 days to 1 year for non-insider creditors that received payments that benefited an insider. Specifically, Deprizio allowed a trustee to recover loan payments that the debtor made to its non-insider lender within 1 year preceding the bankruptcy filing because those payments benefited the debtor's controlling shareholders who guaranteed the loan. The Court in Deprizio reasoned that the payments were made for the benefit of a insider creditors because: (1) the insider guarantors benefited from the payments because their obligations under the guarantees were reduced and (2) the insider guarantors were creditors of the debtor because they had contingent claims against the debtor's estate.

The 1994 Reform Act added subsection (c) to section 550. Subsection (c) provides:

- (c) If a transfer made between 90 days and one year before the filing of the petition -
- (1) is avoided under section 547(b) of this title; and
  - (2) was made for the benefit of a creditor that at the time of such transfer was an insider; the trustee may not recover under subsection (a) from a transferee that is not an insider.

After the 1994 amendment, several decisions held that section 550(c) did not overrule Deprizio in some circumstances. One of the decisions that highlighted the loophole was Roost v. Associates Home Equity Servs., Inc. (In re Williams), 234 B.R. 801 (Bankr. D. Or. 1999). In In re Williams, a chapter 7 debtor and his wife signed a note to finance the purchase of their mobile home. The note was secured by the mobile home and the real property upon which the mobile home was situated. The lender perfected its security interest more than 90 days but less than 1 year before the commencement of the debtor's chapter 7 case. Under the Deprizio rationale, the trustee sought to avoid the security interest, based upon the fact that the transfer benefited the Debtor's wife, who was an insider.

The Debtor did not dispute that the transfer benefited his wife. Rather, the Debtor argued that Bankruptcy Code section 550(c) prohibited any recovery by the trustee. In response, the trustee argued that it was not attempting to "recover" any property because the Debtor's interest in the mobile home became property of the Debtor's estate upon the commencement of the bankruptcy case. The trustee was not seeking to "recover" any property under Bankruptcy Code section 550(a). Rather, the trustee merely sought to avoid the lender's security interest under Bankruptcy Code section 547(b).

Relying upon canons of statutory construction and those decisions that have recognized that the Bankruptcy Code separates the concepts of avoidance and recovery, *see* Congress Credit Corp. v. AJC Int'l (In re Congress), 186 B.R. 555, 558 (D.P.R.

1995), the Court held that the security interest was avoidable under the Deprizio doctrine even though recovery of a payment would be precluded by section 550(c). The Court suggested that had Congress intended to add an exception or defense to section 547 it would have done so.

Congress has done so by adding subsection (i) to Bankruptcy Code section 547:

If the trustee avoids under subsection (b) a transfer made between 90 days and 1 year before the date of filing of the petition, by the debtor to an entity that is not an insider for the benefit of a creditor that is an insider, such transfer shall be considered to be avoided under this section only with respect to the creditor that is an insider.

Bills, § 1213.

Note that this "Deprizio Amendment" applies to any case that is pending or commenced on or after the date of enactment of the 2001 Reform Act. It is unclear whether the fix will apply to adversary proceedings pending on the date of enactment.

## **2. Modification of Ordinary Course Defense Under Section 547(c)(2)**

The Bills modify the ordinary course defense under Bankruptcy Code section 547(c)(2), creating a less rigorous standard for establishing the defense. Bills, § 409. Current law provides that a transfer may not be avoided:

(2) to the extent that such transfer was -

(A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee;

(B) made in the ordinary course of business or financial affairs of the debtor and the transferee; and

(C) made according to ordinary business terms[.]

11 U.S.C. § 547(c)(2) (emphasis added).

As the law currently stands, the requirements of subparagraphs (A),(B), and (C) must be satisfied in order to establish an ordinary course defense. The new law changes that standard by making (2)(B) and (2)(C) disjunctive, as opposed to conjunctive, requirements. Thus, a preference defendant need only establish (2)(A) and either (2)(B) or (2)(C). In general, this will allow defendants to protect payments that though were not made in accordance with ordinary business terms were nevertheless ordinary as between the parties. This largely follows the construction placed on the existing statute by Judge Posner in In re Tolona Pizza Products Corp., 3 F.3d 1029 (7<sup>th</sup> Cir. 1993).

### **3. Monetary Limitation for Corporate Debtors**

Under current law, there is no monetary limit on a business debtor's ability to pursue a preference. Under the new law, a business debtor will not be permitted to avoid transfers of less than \$5,000. Oddly, this "jurisdictional minimum" is made an affirmative defense rather than an element of the trustee's case in chief. Paragraph (9) will be added to subsection 547(c):

(c) The trustee may not avoid under this section a transfer –

(9) if, in a case filed by a debtor whose debts are not primarily consumer debts, the aggregate value of all property that constitutes or is affected by such transfer is less than \$5,000.

Bills, § 409.

### **4. Venue in Preference Proceedings**

The Bills amend 28 U.S.C. § 1409(b) to provide that a preference action for a non-consumer debt of less than \$10,000 can only be commenced in the district in which the non-insider creditor resides. Bills, § 410. Note that business defendants are given more home court protection than consumer defendants.

### **5. Expansion of Time to Perfect a Transfer**

Bankruptcy Code section 547(e)(2) governs when a transfer is made for purposes of Bankruptcy Code section 547(b). Current law provides that a transfer is made at the time the transfer takes effect between the parties, provided the transferee properly perfects its interest within 10 days. If the transferee does not perfect within the 10-day "grace period," the transfer is deemed to have occurred on the date of perfection. Late perfection may make a transfer otherwise outside the preference period, within the period and deny the defendant protection under the contemporaneous exchange for value defense.

The Bills change the 10-day grace period to a 30-day grace period. Bills, § 403. This makes it unlikely that administrative delays in recording financing statements or in obtaining certificates of title will cause preference problems.

### **6. Expansion of Time to Perfect a Purchase Money Security Interest**

The Bills expand the time period within which a creditor can perfect a purchase money security interest. Under current law, a trustee may not avoid a transfer that creates a security interest in property acquired by the debtor "[t]hat is perfected on or before 20 days after the debtor receives possession of such property." 11 U.S.C. § 547(c)(3)(B). The Bills change the 20-day to a 30-day period. A trustee will not be permitted to avoid a transfer that creates a security interest in property acquired by the debtor that is

perfected on or before 30 days after the debtor receives possession of such property. S. 420, § 1222; H.R. 333, § 1223.

**E. Postpetition Transfers**

Bankruptcy Code section 549 empowers the trustee, with certain limitations, to avoid unauthorized postpetition transfers of estate property. Section 549(c) provides one of those limitations. Section 549(c) limits the trustee's ability to avoid postpetition transfers of real property to good faith purchasers for present fair equivalent value and without knowledge of the bankruptcy filing, unless a copy or notice of the petition was properly recorded before the transferee perfects its interest in the property. 11 U.S.C. § 549(c).

The Bills amend Bankruptcy Code section 549(c), overruling Thompson v. Margen (In re McConville), 110 F.3d 47 (9<sup>th</sup> Cir. 1997). Bills, § 1214. In McConville, lenders that did not have any knowledge of the commencement of the debtor's bankruptcy case made a postpetition mortgage loan to the debtor without obtaining a court order. In addition to holding that the lenders violated Bankruptcy Code section 364(c)(2) by making a secured loan without prior bankruptcy court approval, the Ninth Circuit held that Bankruptcy Code section 549(c) was inapplicable because the postpetition creation of the lien on the debtor's real property was not a "transfer of property" within the meaning of section 549(c).

The Bills correct the problem created by In re McConville by replacing the phrase "transfer of real property" with "transfer of an interest in real property." Under the revised law, the creation of a lien will fall under the 549(c) exception.

To accompany the amendments to section 549(c), the Bills amend the definition of the word "transfer" to include the "creation of a lien:"

- (54) The term "transfer" means--
  - (A) the creation of a lien;
  - (B) the retention of title as a security interest;
  - (C) the foreclosure of a debtor's equity of redemption; or
  - (D) each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with--
    - (i) property; or
    - (ii) an interest in property

Bills, § 1201.

In addition to the above-amendments, the House Bill amends section 362(b), precluding the stay "[o]f any transfer that is not avoidable under section 544 and that is not avoidable under section 549." H.R. 333, § 311. The Senate Bill deletes this language.

## F. Reclamation

Bankruptcy Code section 546(c) protects a seller of goods' right to reclamation under state law. Under current law, a seller of goods can seek to reclaim goods that the debtor received while it was insolvent, provided that the seller makes a written reclamation demand "[b]efore 10 days after receipt of such goods by the debtor; or . . . if such 10 day period expires after the commencement of the case, before 20 days after receipt of such goods by the debtor . . . ." 11 U.S.C. § 546(c)(1).

The Bills revise section 546(c) to provide that a seller can seek to reclaim goods if:

- (1) the debtor received the goods while it was insolvent and not later than 45 days before the bankruptcy filing and
- (2) the seller makes a written reclamation demand on the debtor:
  - a. not later than 45 days after the date the debtor received the goods or
  - b. not later than 20 days after the commencement of the case if the 45 day period expires after the commencement of the case.

H.R. 333 § 1228(a); S. 420, § 1227(a) (emphasis added).

As drafted, revised section 546(c) will not accomplish its intended goal. As set forth above, revised section 546(c) provides that in order for the seller to be able to reclaim the goods, the debtor must have received the goods "not later than 45 days" prior to the commencement of the case. Thus, reclamation is not possible if the debtor received the goods between the 44<sup>th</sup> day before the bankruptcy and the petition date. Moreover, since the goods subject to reclamation must be received by the debtor at least 45 days before the bankruptcy, proposed section 546(c)(2)(B) appears to be a nullity since the 45 day period can never expire postpetition.

With respect to a seller's reclamation rights, note the revision to Bankruptcy Code section 503(b). Section 503(b)(10) allows sellers to recover "[t]he value of any goods received by the debtor not later than 20 days prior to the date of commencement of a case under this title in which the goods have been sold to the debtor in the ordinary course of such debtor's business." H.R. 333, § 1229(b); S. 420, § 1227(b). This section may be unworkable for the same reasons discussed above. However, the subparagraph is intended to allow sellers that do not properly seek reclamation in accordance with section 546(c) to have an administrative expense claim for the value of such goods. This is good for sellers if the estate is not administratively insolvent and especially bad for other administrative claimants if it is.

Revised section 546(c) provides that a seller's reclamation rights are limited by Bankruptcy Code section 507(c)<sup>2</sup> and the prior rights of holders of security interests in the goods or the proceeds thereof.

## **G. Statutory Liens**

### **1. Purchasers for Adequate and Full Value**

The Bills section 711 add a somewhat obscure "except" clause to section 545(2), the section authorizing the trustee to strong-arm certain statutory liens. Under existing law unrecorded tax liens may be avoided, of course, but even recorded federal tax liens may under some court decisions lose to a trustee because section 6323 of the Internal Revenue Code of 1986, allows (with respect to certain kinds of property listed in 26 U.S.C. § 6323(b)) "[a] person who for adequate and full consideration in money or money's worth, acquires an interest (other than a lien or security interest) in property which is valid under local law against subsequent purchasers without actual notice" 26 U.S.C. § 6323(h)(6), to defeat a recorded tax lien if he is without actual notice of the lien. The intent of the amendment appears to be to prevent the bankruptcy trustee from "stepping into the shoes" of this kind of purchaser under his statutory lien strong-arm power.

It is unclear whether the amendment will accomplish this assumed objective. Revised section 545(2) provides:

The trustee may avoid the fixing of a statutory lien on property of the debtor to the extent that such lien -

(2) is not perfected or enforceable at the time of the commencement of the case against a bona fide purchaser that purchases such property at the time of the commencement of the case, whether or not such a purchaser exists, **except in any case in which a purchaser is a purchaser described in section 6323 of the Internal Revenue Code of 1986, or in any other similar provision of State or local law;**

Bills, § 711 (emphasis added).

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<sup>2</sup> The Bills probably should say section 507(b) instead of 507(c). Section 507(b) provides: (b) If the trustee, under section 362, 363, or 364 of this title, provides adequate protection of the interest of a holder of a claim secured by a lien on property of the debtor and if, notwithstanding such protection, such creditor has a claim allowable under subsection (a)(1) of this section arising from the stay of action against such property under section 362 of this title, from the use, sale, or lease of such property under section 363 of this title, or from the granting of a lien under section 364(d) of this title, then such creditor's claim under such subsection shall have priority over every other claim allowable under such subsection. (Bankruptcy Code section 507(c) provides that "[a] claim of a governmental unit arising from an erroneous refund or credit of a tax has the same priority as a claim for the tax to which such refund or credit relates" 11 U.S.C. § 507(c)).

It is very difficult to parse revised section 545(2). The new "except" clause appears to be referring to an actual purchaser and may be interpreted as creating a kind of safe harbor for such persons. Of course, actual purchasers of property subject to properly recorded federal tax liens and of the type described are few and far between, and would in any event unquestionably defeat both the government and the bankruptcy trustee under current law. On the other hand, certainly there are much clearer ways for the Congress to state that a properly recorded tax lien can not be defeated by a bankruptcy trustee, if indeed that is what is intended.

The amendment would not appear to change current law with respect to a tax lien properly recorded against accounts receivable, inventory and other types of property protected by 26 U.S.C. § 6323(c) (dealing with certain types of commercial financing agreements).

Note that most courts draw a strong distinction between "bona fide purchaser" as the term is understood in the context of current section 545(2) and "purchaser" as it is defined and understood under Internal Revenue Code section 6323. Those courts generally point out that the distinction lies between the meaning of "value" and "adequate and full consideration." *See e.g., Battley v. United States (In re Berg)*, 121 F.3d 535 (9<sup>th</sup> Cir. 1997); *United States v. Hunter (In re Walter)*, 45 F.3d 1023, 1030 (6<sup>th</sup> Cir. 1995).

## **2. Warehouseman's Liens**

Under current law, a trustee's power to avoid statutory liens includes the power to avoid certain warehouseman's liens. 11 U.S.C. § 545(2) and (3). The Bills limit the trustee's ability to avoid a warehouseman's lien for storage, transportation, or other costs incidental to the storage and handling of goods, notwithstanding the provisions of section 545. Bills, § 406. These amendments are contained in section 546, the Bankruptcy Code provision that limits the trustee's avoidance powers.

## **II.**

### **Small Business Provisions**

#### **A. Definitions Relating to Small Business Debtors**

Under current law, "small business" is defined in Bankruptcy Code section 101(51)(C). The Bills delete the definition of small business, replacing it with definitions of "small business case" and "small business debtor:"

(51C) **small business case** means a case filed under chapter 11 of this title in which the debtor is a small business debtor;

(51D) **small business debtor**—

(A) subject to subparagraph (B), means a person engaged in commercial or business activities (including any affiliate of such person that is also a debtor under this title and excluding a person whose primary activity is the business of owning or operating real property or activities incidental thereto) that has aggregate noncontingent, liquidated secured and unsecured debts as of the date of the petition or the order for relief in an amount not more than \$3,000,000 (excluding debts owed to 1 or more affiliates or insiders) for a case in which the United States trustee has not appointed under section 1102(a)(1) a committee of unsecured creditors or where the court has determined that the committee of unsecured creditors is not sufficiently active and representative to provide effective oversight of the debtor; and

(B) does not include any member of a group of affiliated debtors that has aggregate noncontingent liquidated secured and unsecured debts in an amount greater than \$3,000,000 (excluding debt owed to 1 or more affiliates or insiders).

Bills, § 432 (emphasis added).

#### **B. Issues Affecting Plan Confirmation**

##### **1. New Exclusivity Period in Small Business Cases**

Under current law, a small business debtor (of which there are at present virtually none, since the current small businesses provisions are both unattractive and elective) has the exclusive right to file a plan until 100 days after the date of the order for relief. 11 U.S.C. § 1121(e)(1). In small business cases, a plan must be filed in any event, be it by the debtor or another party in interest, within 160 days after the date of the order for relief. 11 U.S.C. § 1121(e)(2). Only the exclusivity deadline can be extended for cause under Bankruptcy Code section 1121(e)(3)(B) if it is demonstrated that "[t]he need for an

increase is caused by circumstances for which the debtor should not be held accountable." 11 U.S.C. § 1121(e)(3)(B).

Under the Bills, the small business provisions are no longer optional. All business debtors with less than \$3 million in debt (other than single asset real estate debtors who are treated separately) must comply with the special small business provision.

The Bills extend the small business debtor's exclusivity period to 180 days and the absolute plan-filing deadline to 300 days after the date of the order for relief. The court will not be permitted to extend those periods unless: (1) it is demonstrated by preponderance of the evidence that it is more likely than not that the court will confirm the plan within a reasonable period of time; (2) a new deadline is imposed at the time the extension is granted; and (3) an order is signed before the existing deadline expires. Bills, § 437.

The new law changes the standard and may make it more difficult for the debtor to successfully extend the exclusivity period. The preponderance of the evidence standard places the burden on the movant (usually the debtor in these instances) to show that it will propose a confirmable plan. The current standard only requires the debtor to establish that it should not be held accountable for its failure to file a plan. Moreover, small business debtors will need to ensure that they move quickly to seek to extensions before the expiration of the statutory periods.

## **2. Deadline for Confirmation of a Plan**

The Bills add a new subsection to 11 U.S.C. § 1129, which specifies a time period within which a small business debtor's plan must be confirmed. The House version requires a small business debtor to confirm a plan within 175 days after the order for relief, unless the period is extended pursuant to 11 U.S.C. § 1121(e)(3). H.R. 333 § 438. This provision appears to be inconsistent with the House Bill's exclusivity provision for small business debtors.

The Senate version, on the other hand, requires a small business debtor to confirm a plan no later than 45 days after it is filed with the court. S. 420, § 438. The Senate version provides for an extension of that period if the debtor can demonstrate that it is more likely than not that the court will confirm a plan within a reasonable period of time. If the period is to be extended, a new deadline must be imposed at the time the period is extended and the order must be signed before the statutory period expires. S. 420, § 438.

## **3. Standard Form of Disclosure Statement and Plan**

The Bills direct the Advisory Committee on Bankruptcy Rules of the Judicial Conference of the United States and to propose a standard form disclosure statement and plan of reorganization for small business debtors. These forms are supposed to strike a

balance between the needs of the courts, creditors, and other parties in interest to receive complete information, and economy and simplicity for debtors. Bills, § 433.

#### **4. More Flexible Rules for Plan and Disclosure Statement**

Under current law, a court can conditionally approve a disclosure statement in a small business case. 11 U.S.C. § 1125(f)(1). Thereafter, the debtor can solicit acceptances or rejections to the plan, provided that holders of claims and interests are mailed a copy of the conditionally approved disclosure statement within 10 days before the confirmation hearing. 11 U.S.C. § 1125(f)(2). Moreover, the court can hold a combined hearing on the disclosure statement and plan. 11 U.S.C. § 1125(f)(3).

The Bills amend section 1125(f) to authorize a court to determine that the plan itself provides adequate information, making it unnecessary to file a separate disclosure statement. Moreover, the section will authorize the court to approve a form disclosure statement. The Bills preserve the court's ability to (1) conditionally approve a disclosure statement and (2) combine the plan and disclosure statement hearing. The small business debtor still can solicit acceptances to a conditionally approved disclosure statement, provided that the disclosure statement is mailed to holders of claims and interests within 20 days before the confirmation hearing. Bills, § 431.

### **C. Duties of Trustee or Debtor in Possession in Small Business Cases**

#### **1. Duties of Debtor in Small Business Cases**

The Bills add a new section to chapter 11. New section 1116 sets forth the duties of a trustee or debtor in possession in small business cases. Bills, § 436. Section 1116 requires a small business debtor to attach additional information to its voluntary petition and requires management to attend meetings and hearings. Section 1116 provides:

In a small business case, a trustee or the debtor in possession, in addition to the duties provided in this title and as otherwise required by law, shall—

(1) append to the voluntary petition or, in an involuntary case, file not later than 7 days after the date of the order for relief--

(A) its most recent balance sheet, statement of operations, cash-flow statement, Federal income tax return; or

(B) a statement made under penalty of perjury that no balance sheet, statement of operations, or cash-flow statement has been prepared and no Federal tax return has been filed;

(2) attend, through its senior management personnel and counsel, meetings scheduled by the court or the United States trustee, including initial debtor interviews, scheduling conferences, and meetings of creditors convened

under section 341 unless the court waives that requirement after notice and hearing, upon a finding of extraordinary and compelling circumstances;

(3) timely file all schedules and statements of financial affairs, unless the court, after notice and a hearing, grants an extension, which shall not extend such time period to a date later than 30 days after the date of the order for relief, absent extraordinary and compelling circumstances;

(4) file all postpetition financial and other reports required by the Federal Rules of Bankruptcy Procedure or by local rule of the district court;

(5) subject to section 363(c)(2), maintain insurance customary and appropriate to the industry;

(6) (A) timely file tax returns and other required government filings; and

(B) subject to section 363(c)(2), timely pay all administrative expense tax claims, except those being contested by appropriate proceedings being diligently prosecuted; and

(7) allow the United States trustee, or a designated representative of the United States trustee, to inspect the debtor's business premises, books, and records at reasonable times, after reasonable prior written notice, unless notice is waived by the debtor.

## **2. Increased Debtor Reporting Requirements**

The Bills add a new section to chapter 3 (section 308) which requires a small business debtor to file periodic financial and other reports containing information with respect to debtor's profitability and the debtor's projected cash receipts and disbursements. In addition to that information, the small business debtor must report whether it is in compliance with the requirements of the Bankruptcy Code and the Federal Rules of Bankruptcy Procedure and whether it has paid its taxes and filed its tax returns. Bills, § 434.

It is unclear whether these periodic reports will take the place of the monthly operating reports that currently are required to be filed and served upon the Office of the United States Trustee.

The effective date of the amendments with respect to the increased debtor reporting requirements is 60 days after the date on which "[r]ules are prescribed under section 2075 of title 28, United States Code, to establish forms to be used to comply with section 308 of title 11, United States Code . . . ."

The Bills also direct the Advisory Committee on Bankruptcy Rules of the Judicial Conference of the United States to propose a corresponding Federal Rule of Bankruptcy Procedure to implement new section 308.

### **3. Increased Supervision by Office of the United States Trustee**

The United States Trustee ("UST") will have increased monitoring responsibilities in small business cases. Bankruptcy Code section 586(a) will set forth the UST's increased monitoring functions in small business cases. In small business cases, the UST will be required to conduct an initial debtor interview "as soon as practicable" after the entry of the order for relief, but before the first meeting of creditors under Bankruptcy Code section 341(a). During the initial debtor interview, the UST will (i) begin to investigate the debtor's viability; (ii) inquire about the debtor's business plan; (iii) explain the debtor's obligations to file monthly operating reports and other required reports; (iv) attempt to develop an agreed scheduling order; and (v) inform the debtor of other obligations. Bills, § 439.

In addition to investigating the debtor's viability during the initial debtor interview and making other inquiries, the UST may visit the debtor's business to "[a]scertain the state of the debtor's books and records and verify that the debtor has filed its tax returns...." Bills, § 439. Moreover, the UST will monitor the debtor's activities to determine "[w]hether the debtor will be unable to confirm a plan . . . ." Bills, §439 (emphasis added). This represents a potentially important shift toward involving the UST in business operations as well as case administration.

It is difficult to determine how the UST's increased monitoring function in small business cases will affect a small business debtor's ability to conduct its normal business operations. However, many contend that requiring the UST to have that much involvement in a small business debtor's business affairs will only hinder the small business debtor's reorganization efforts.

### **D. Automatic Stay Does Not Apply to Serial Filers**

Unless a small business debtor can prove by a preponderance of the evidence that (1) its bankruptcy resulted from circumstances beyond the debtor's control that were not foreseeable at the time the case was filed and that (2) it is more likely than not that the court will confirm a plan of reorganization (as opposed to a liquidating plan), the automatic stay will not apply in a case in which the debtor:

["\(A\) is a debtor in a small business case pending at the time the petition is filed;](#)

[\(B\) was a debtor in a small business case that was dismissed for any reason by an order that became final in the 2-year period ending on the date of the order for relief entered with respect to the petition;](#)

(C) was a debtor in a small business case in which a plan was confirmed in the 2-year period ending on the date of the order for relief entered with respect to the petition; or

(D) is an entity that has succeeded to substantially all of the assets or business of a small business debtor described in subparagraph (A), (B), or (C)."

Bills, § 441.

At first glance, it would appear that the automatic stay does not apply in a small business case. That is incorrect. These provisions were added to prevent serial filing. Note that the serial filer provision will not apply to an involuntary case, provided that there was no collusion by the debtor with creditors. Given the new limitation on the automatic stay, the preferred course of action for a small business debtor that has confirmed a plan or reorganization within the past 2 years and subsequently wishes to liquidate in chapter 11 is to reopen the prior case. It is unclear why Congress appears to prefer a failed reorganization to be followed by another attempt at reorganization than by orderly liquidation under chapter 11.

### **III.**

## **Single Asset Real Estate**

#### **A. Definition**

Single asset real estate ("SARE") cases have been of little significance so far because the \$4 million cap excluded most significant projects, at least in California. The Bills eliminate the \$4 million cap:

(51B) "single asset real estate" means real property constituting a single property or project, other than residential real property with fewer than 4 residential units, which generates substantially all of the gross income of a debtor who is not a family farmer and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental;

Bills, § 1201.

The elimination of the cap means that for the first time the SARE rules will apply in large cases. Note however that the definition will still exclude real estate projects upon which the debtor operates a "real" business — hotels, farms, health care and so forth. Also there will be significant pressure on defining exactly what is a single "project" for purposes of application of the SARE rules as multiple project entities remain excluded.

#### **B. Monthly Payments**

Revised section 362(d)(3) provides:

(d) On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay –

(3) with respect to a stay of an act against single asset real estate under subsection (a), by a creditor whose claim is secured by an interest in such real estate, unless, not later than the date that is 90 days after the entry of the order for relief (or such later date as the court may determine for cause by order entered within that 90-day period) or 30 days after the court determines that the debtor is subject to this paragraph, whichever is later -

(A) the debtor has filed a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time; or

(B) the debtor has commenced monthly payments that –

(i) may, in the debtor's sole discretion, notwithstanding section 363(c)(2), be made from rents or other income generated before or after the commencement of the case by or from the property to

each creditor whose claim is secured by such real estate (other than a claim secured by a judgment lien or by an unmatured statutory lien); and

(ii) are in an amount equal to interest at the then applicable nondefault contract rate of interest on the value of the creditor's interest in the real estate;

Bills, § 444.

To date there is little case law or experience with section 362(d)(3) because of the cap. It remains to be seen how significant the SARE rules will be in practice in light of this limited experience. But at least in theory, the debtor will have to pay to play, that is stay current on monthly payments to secured creditors. Application of those monthly payments will depend on whether the creditor is over or undersecured. If the creditor is undersecured, under United Sav. Ass'n of Texas v. Timbers of Inwood Forest Associates, Ltd., 484 U.S. 365 (1988), the payments should be applied to reduce principal. Bills, § 444. Alternatively, the debtor can avoid foreclosure by getting a confirmable plan on file within 90 days.

As under existing law, revised (d)(3) will allow the debtor (or presumably any party resisting relief from stay) to move to extend the time period for commencement of payments within the 90 days for "cause." The Bills further loosen up the time frame for the commencement of monthly payments by allowing the debtor to contest the applicability of the SARE rules and only requiring payments to commence within 30 days after a determination that SARE is applicable. Bills, § 444. Especially in the larger cases, debtors may well take advantage of these provisions to defer payment.

### **C. Monthly Payments From Pledged Rents**

Current law allows a creditor whose claim is secured by single asset real estate relief from the automatic stay unless (1) the debtor has filed a confirmable plan of reorganization or (2) the debtor is making monthly payments "to each creditor whose claim is secured by such real estate . . . which payments are in an amount equal to interest at a current fair market on the value of the creditor's interest in the real estate." 11 U.S.C. § 362(d)(3).

There is a split of authority under current law on whether rents may be a source of required adequate protection payments. The Bills revise section 362(d)(3)(B), making it possible for debtors to commence making payments to secured creditors from pledged rents. Bills, § 444. Since rents are the only likely source of cash payments in a SARE case, this is a major concession to debtors.

#### **D. Rate of Interest**

Under current law, a single asset real estate debtor can commence making monthly payments "equal to interest at a fair market value of the creditor's interest in real estate." 11 U.S.C. § 362(d)(3)(B) (emphasis added). The Bills change the applicable rate of interest to "[a]n amount equal to interest at the then applicable nondefault contract rate of interest on the value of the creditor's interest in the real estate . . . ." Bills, § 444 (emphasis added). This should simplify administration of the statute and under current market conditions of falling rates probably works to the advantage of lenders.

Note that the payments are measured in the amount of interest; they are not interest payments. Whether they will be attributable to interest or principal probably should depend on whether the property is over or undersecured.

#### **E. Creation or Perfection of Liens for Special Taxes or Assessments on Real Property**

The Second Circuit in Lincoln Sav. Bank, et al v. Suffolk County Treasurer (In re Parr Meadows Racing Ass'n, Inc.), 880 F.2d 1540, 1542 (2d Cir. 1989) held that the automatic stay prohibited "[t]he creation of a local tax lien upon real property unless the county has a prepetition interest in the real property . . . ." The 1994 amendments to the Bankruptcy Code overruled Parr Meadows by creating an additional exception to the automatic stay for "[t]he creation or perfection of a statutory lien for an ad valorem property tax imposed by the District of Columbia or a political subdivision of the State, if such tax comes due after the filing of the petition." 11 U.S.C. § 362(b)(18).

The Bills expand the overruling of Parr Meadows by clarifying that the exception to the stay applies to all special taxes and assessments on real estate, whether or not ad valorem:

(18) under subsection (a) of the creation or perfection of a statutory lien for an ad valorem property tax, or a special tax or special assessment on real property whether or not ad valorem, imposed by a governmental unit, if such tax or assessment comes due after the filing of the petition

H.R. 333, § 1226; S. 420, § 1225 (emphasis added).

## IV. Chapter 11 Plan Issues

### A. Exclusivity

The Bills contain amendments to Bankruptcy Code section 1121(d) that will affect the debtor's ability to seek unlimited extensions of the plan exclusivity and solicitation periods. Current Bankruptcy Code section 1121(d) permits a party in interest to seek to reduce or increase (1) the 120-day period within which the debtor has the exclusive right to submit a plan of reorganization and (2) the 180-day period within which the debtor must obtain acceptances to its proposed plan of reorganization. Currently, section 1121(d) does not limit the debtor's ability to continue to seek extension after extension, provided that the requisite cause is established each time.

The Bills add a new paragraph to section 1121(d), which limits the debtor to a 14-month extension in the case of both the exclusivity and plan solicitation periods:

(2)(A) The 120-day period specified in paragraph (1) may not be extended beyond a date that is 18 months after the date of the order for relief under this chapter.

(B) The 180-day period specified in paragraph (1) may not be extended beyond a date that is 20 months after the date of the order for relief under this chapter.

Bills, § 411.

These revisions will have the most serious impact on the larger and more contentious chapter 11 cases, and may encourage creditors to file more competing plans in such cases.

### B. Revised Definition of "Adequate Information"

The Bills add some additional language to the definition of "Adequate Information" that currently is contained in Bankruptcy Code section 1125(a). The revised definition includes the following language:

"[I]n determining whether a disclosure statement provides adequate information, the court shall consider the complexity of the case, the benefit of additional information to creditors and other parties in interest, and the cost of providing additional information . . . ."

Bills, § 431.

Moreover, adequate information also will include "[a] discussion of the potential material Federal tax consequences of the plan to the debtor, any successor to the debtor,

and a hypothetical investor typical of the holders of claims or interest in the case . . . ." Bills, § 717.

## C. Discharge

### 1. Individual Chapter 11 Debtors – Plan Payments Must be Made Before Discharge is Effective

The Bills add a new paragraph to subsection 1141(d) that requires a chapter 11 individual debtor to complete all payments under a plan before a discharge will become effective. The amendments to section 1141(d) simply clarify that an individual must confirm a plan and complete all of the payments under the plan before a discharge will become effective. The amendment gives the court discretion to grant a discharge to an individual chapter 11 debtor that has not completed all of the payments under a plan if:

- (i) for each unsecured claim, the value, as of the effective date of the plan, of property actually distributed under the plan on account of that claim is not less than the amount that would have been paid on such claim if the estate of the debtor had been liquidated under chapter 7 of this title on such date; and
- (ii) modification of the plan under 1127 of this title is not practicable.

Bills, § 321(d) (emphasis added).

The House Bill revises section 1141(d)(2):

A discharge under this chapter does not discharge a debtor from any debt excepted from discharge under section 523 of this title.

H.R. 333, § 321(d).

The Senate leaves § 1141(d)(2) unchanged. It is unclear whether the House version simply removes a redundancy in the current Bankruptcy Code or whether it is meant to have any substantive effect. It is difficult to discern what possible substantive effect this provision of the House Bill might have since section 523(a) is expressly limited to the debts of individuals.

**2. Corporate Chapter 11 Debtors –  
Limitation on Discharge of Certain Fraud and Tax Claims  
in Chapter 11**

The Bills add a new paragraph (6) to section 1141(d) to circumscribe the scope of the chapter 11 discharge. Bills, § 708. The House Bill subjects corporate debtors to an exception from discharge for certain false and fraudulent taxes and also probably intended to make applicable to corporate debtors the section 523(a)(2) exception to discharge for certain debts incurred by fraud.

H.R. 333, § 708. 1141(d)(6), as revised by the House, provides:

(6) Notwithstanding paragraph (1), the confirmation of a plan does not discharge a debtor that is a corporation from any debt described in section 523(a)(2) or for a tax or customs duty with respect to which the debtor –

(A) made a fraudulent return; or

(B) willfully attempted in any manner to evade or defeat that tax or duty

H.R. 333, § 708.

As drafted, the House bill clearly excludes fraudulent tax or customs duty claims from a corporate chapter 11 debtor's discharge if the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat the claim. Less clear, however, is whether the amendment subjects corporate debtors to the section 523(a)(2) exception to discharge for non-tax debts. The ambiguity concerns the absence of a comma after "523(a)(2)." As drafted, the plain language of the amendment limits the 523(a)(2) debts excepted from discharge to those "with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat that tax or duty." On the other hand, it could be argued that the drafters intended to place a comma after "section 523(a)(2)," which would have made section 523(a)(2) applicable to corporate debtors to allow creditors to pursue post-confirmation fraud actions against corporate debtors. The problem with that outcome is that section 523(c) requires the bankruptcy court to exercise exclusive jurisdiction over nondischargeability complaints under section 523(a)(2). Although the bankruptcy judge is not required to determine the amount of the nondischargeable debt, most exercise their power to do so. It is unclear whether bankruptcy courts will exercise exclusive jurisdiction over section 1141 nondischargeability complaints to the extent they involve debts "described" in section 523(a)(2).

Not surprisingly, the House version of new paragraph (6) raised a lot of concern among bankruptcy practitioners by opening the door for any creditor to seek exception to the chapter 11 discharge on grounds of fraud perhaps even after confirmation of the plan. S. 420 fixes one potential problem created by H.R. 333 by making it clear that the provision applies only to the claims of governmental units against corporate debtors under certain limited circumstances:

(6) Notwithstanding paragraph (1), the confirmation of a plan does not discharge a debtor that is a corporation from any debt described in subparagraph (A) or (B) of section 523(a)(2) that is owed to a domestic governmental unit or owed to a person as the result of an action filed under subchapter III of chapter 37 of title 31, United States Code, or any similar statute, or for a tax or customs duty with respect to which the debtor –

(A) made a fraudulent return; or

(B) willfully attempted in any manner to evade or defeat that tax or duty.

S. 420, § 708.

In this section the comma after "similar statute" removes the ambiguity about the scope extending to non-tax fraud debts. But the Senate version creates additional ambiguities. As drafted, the new provision might limit the government to claims under Subchapter III of title 37. Subchapter III of chapter 37 of title 31 is entitled "Claims Against the United States Government." 31 U.S.C. §§ 3721 *et. seq.* Claims arising under chapter 37 can be asserted only against the United States government. The various sections chapter 37 authorize the Attorney General of the heads of various federal governmental agencies to settle claims that are asserted against the United States. Such claims include but are not limited to claims of or relating to government employees, property damage and damages cause by the Federal Bureau of Investigation.

## **B. Tax Provisions**

### **1. Rate of Interest on Tax Claims**

A new section has been added to chapter 5 of the Bankruptcy Code. Bills, § 704. Section 511 relates to the rate of interest on tax claims. Section 511 provides that the rate of interest on a tax claim is determined under applicable nonbankruptcy law:

If any provision of this title requires the payment of interest on a tax claim or on an administrative expense tax, or the payment of interest to enable a creditor to receive the present value of the allowed amount of a tax claim, the rate of interest shall be the rate determined under applicable nonbankruptcy law.

Bills, § 704.

It is unclear whether "the rate determined under applicable nonbankruptcy law" is the default rate. New section 511 further provides that if taxes are to be paid under a plan, "[t]he rate of interest shall be determined as of the calendar month in which the plan is confirmed." Bills, § 704. This revision does not take into account that in some cases, the effective date of the plan is long after confirmation.

## **2. Time and Manner of Payment of Tax Claims Under a Plan.**

Under current law, one of the requirements for confirmation of a plan is that the plan provide that the allowed unsecured claims of governmental units "[r]eceive on account of such claim deferred cash payments, over a period not exceeding six years after the date of assessment of such claim, of a value, as of the effective date of the plan, equal to the allowed amount of such claim." 11 U.S.C. § 1129(a)(9)(C). The Bills significantly revise section 1129(a)(9)(C). Bills, § 710(2).

First, governmental units holding allowed unsecured claims must receive on account of such claim, regular installment payments in cash "[o]f a total value, as of the effective date of the plan, equal to the allowed amount of such claim . . . ."

Second, payments to taxing authorities can no longer be stretched out for a period of six years from the date of the assessment. Under revised section 1129(a)(9)(C), those claims must be paid in full within five years after the date of the entry of the order for relief.

Third, and perhaps most significant, a taxing authority must not receive less favorable treatment than other non-priority unsecured claims provided for in the plan. Thus, if a class (other than a convenience class) is paid on the effective date of the plan, it is arguable that the taxing agency must be paid on the effective date as well. On the other hand, if trade claims are paid at a discount on the effective date, perhaps the payment in full of the tax claim a few years later is not less favorable.

Finally, taxing authorities that hold secured claims which would otherwise meet the description of unsecured priority claims will be entitled to cash payments in the same manner and over the same period as described above.

## **3. Taxes Incurred Before the Commencement of the Case**

Under current law, the unsecured property tax claims of governmental units qualify for priority under Bankruptcy Code section 507(a)(8) if property taxes were assessed before the commencement of the case. 11 U.S.C. § 507(a)(8)(B). The Bills revise section 507(a)(8) to provide that property taxes that have been incurred before the commencement of the case receive priority treatment. Bills, § 706. Accordingly, taxes that are incurred prepetition but assessed postpetition will qualify for priority treatment under Bankruptcy Code section 507(a)(8).

## **4. Determination of Tax Liability**

Under current law, a bankruptcy court may determine the debtor's tax liability unless the matter was already contested and adjudicated before a court of competent jurisdiction. 11 U.S.C. § 505(a). The Bills add a new subparagraph (C) to section 505(a)(2), preventing the bankruptcy court from determining "[t]he amount or legality of any amount arising in connection with an ad valorem tax on real or personal property of

the estate, if the applicable period for contesting or redetermining that amount under any law (other than a bankruptcy law) has expired." Bills, § 701.

Most states have statutes that provide a limited time period within which a party may contest the assessment of an ad valorem tax. Under revised section 505(a), a bankruptcy court is not authorized to adjudicate a dispute over the assessment of an ad valorem tax after the expiration of the applicable period for contesting the assessment.

## **5. Provisions Affecting Subordination of Tax Liens**

Bankruptcy Code section 724(b) provides for the subordination of tax liens to pay among other things, secured claims and administrative expenses. 11 U.S.C. § 724(b). Current section 724(b)(1) grants first priority to holders of allowed claims that are secured by a lien on the property that also is subject to a tax lien. 11 U.S.C. § 724(b)(1). The Bills revise section 724(b)(1) to provide that tax liens arising in connection with ad valorem taxes will not be subordinated to the payment of secured claims. Revised section 724(b)(1) provides:

(b) Property in which the estate has an interest and that is subject to a lien that is not avoidable under this title and that secures an allowed claim for a tax, or proceeds of such property, shall be distributed . . .

(1) first, to any holder of an allowed claim secured by a lien on such property that is not avoidable under this title (**other than to the extent that there is a properly perfected unavoidable tax lien arising in connection with an ad valorem tax on real or personal property of the estate**); and that is senior to such tax lien . . .

Bills, § 701.

Perhaps more problematic is the section that essentially re-orders the priority for the payment of chapter 11 administrative expenses in cases that have been converted to chapter 7. Current section 724(b)(2) grants second priority over tax liens to holders of allowed administrative expense claims under section 507(a)(1). Such claims include chapter 11 administrative expenses incurred during chapter 11 cases that are later converted to chapter 7. The Bills make it clear that chapter 11 administrative expenses, except for certain employee claims, will no longer receive second priority under section 724(b)(2). Revised section 724(b)(2) provides:

(b) Property in which the estate has an interest and that is subject to a lien that is not avoidable under this title and that secures an allowed claim for a tax, or proceeds of such property, shall be distributed . . .

(2) second, to any holder of a claim of a kind specified in section 507(a)(1) (**except that such expenses, other than claims for wages, salaries, or commissions which arise after the filing of a petition, shall be**

limited to expenses incurred under chapter 7 of this title and shall not include expenses incurred under chapter 11 of this title), 507(a)(2), 507(a)(3), 507(a)(4), 507(a)(5), 507(a)(6), or 507(a)(7) of this title, to the extent of the amount of such allowed tax claim that is secured by such tax lien;

Bills, § 701.

Finally, the Bills add a new paragraph (e) to section 724 which provides:

(e) Before subordinating a tax lien on real or personal property of the estate, the trustee shall--

(1) exhaust the unencumbered assets of the estate; and

(2) in a manner consistent with section 506(c), recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving or disposing of that property.

## **6. Setoff of Tax Refunds**

The automatic stay will not preclude a taxing authority from setting off an income tax refund under certain circumstances. According to the Bills, a governmental unit can set off a tax refund with respect to a taxable period that ended before the commencement of the case against an income tax liability for a taxable period that ended before the commencement of the case. Bills, § 718.

However, if applicable nonbankruptcy law would not permit the setoff due to a pending action to determine the amount of legality of tax liability, the government cannot set off the refund, but may hold it pending resolution of the action. The taxing authority can be compelled to release the tax refund, but only if it is granted adequate protection (within the meaning of section 361) for its secured claim under Bankruptcy Code section 506(a).

## **7. Stay of Tax Proceedings Limited to Prepetition Taxes**

Under current law, the automatic stay applies to "[t]he commencement or continuation of a proceeding before the United States Tax Court concerning the debtor." 11 U.S.C. § 362(a)(8). The Bills revise section 362(a)(8), to make the stay applicable to "[t]he commencement or continuation of a proceeding before the United States Tax Court concerning a corporate debtor's tax liability for a taxable period the bankruptcy court may determine . . . ." Bills, § 709. Under the revised law, section 362(a)(8) is restricted to corporations and excludes individuals.

## V. Prepackaged Bankruptcies

### A. Prepetition Solicitation and Acceptance

Under current law, a debtor cannot solicit acceptances or rejections to a plan postpetition until the holders of each claim or interest have received a bankruptcy court-approved disclosure statement. 11 U.S.C. § 1125(b). With respect to a prepackaged plan, the debtor can solicit acceptances under section 1126(b) but apparently that solicitation process cannot continue postpetition without the approval of a disclosure statement. The Bills add subsection (g) to section 1125, making it clear that "an acceptance or rejection of the plan may be solicited from a holder of a claim or interest if such solicitation complies with applicable nonbankruptcy law and if such holder was solicited before the commencement of the case in a manner complying with applicable nonbankruptcy law." Bills, § 408.

### B. No Meeting of Creditors Required in Pre-Packaged Bankruptcy

Under the revised law, a party in interest may request that the UST refrain from convening a meeting of creditors under Bankruptcy Code section 341(a) if the debtor has solicited acceptances to a prepackaged plan. After notice and a hearing, and if there is cause, the court may direct the UST to refrain from convening a 341(a) meeting. Bills, § 402.

## VI. Creditors' Committees

### A. Reimbursement of Attorneys' Fees

The Third Circuit held that the 1994 amendment to Bankruptcy Code section 503(b)(3)(F), which authorized reimbursement of expenses incurred by creditors' committee members, authorized reimbursement of attorneys' fees incurred by members of a creditors' committee. *See* First Merchants Acceptance Corp. v. J.C. Bradford & Co. (In re First Merchants Acceptance Corp.), 198 F.3d 394 (3d Cir. 1999). *But see* In re Firstplus Financial, 254 B.R. 888 (Bankr. N. D. Tex. 2000) (holding to the contrary); In re County of Orange, 179 B.R. 195 (Bankr. C.D. Cal. 1995) (same).

Overruling In re First Merchants Acceptance Corp., the Bills amend section 503(b)(4), clarifying that committee members cannot be reimbursed for the attorneys' fees that they incur in connection with committee activities. Bills, § 1208.

### B. Expansion of Committees

The Bills revise Bankruptcy Code section 1102(a) to make it clear that the bankruptcy judge may change the composition of creditors' and equity security holders committees that are appointed by the UST on request of a party in interest and after notice and a hearing. Bills, § 405(a). In addition, the court can order the UST to add to the committee a small business concern creditor if that creditor "[h]olds claims (of the kind represented by the committee) the aggregate amount of which, in comparison to the annual gross revenue of that creditor, is disproportionately large." Bills, § 405(a).

The Bills also revise section 1102(b), increasing the committee members' duties to non-member creditors. The committee will be required to provide non-member creditors access to committee information and solicit and receive comments from non-members. Bills, § 405(b). It is unclear how the committee members that have signed confidentiality agreements with the debtor or other parties in interest will be able to carry out these newly-created disclosure duties. It is also unclear whether giving non-member creditors access to committee communications with counsel will waive the committee's attorney/client privilege.

### C. Election of Trustee

The Bills amend Bankruptcy Code section 1104(b) to provide procedural clarification regarding resolution of disputes over the election of a trustee at a meeting of creditors. The Bills also deem the elected trustee "appointed" so that exclusivity will clearly terminate under § 1121(c)(1) of the Bankruptcy Code. Bills, § 416.

## **VII.**

### **Consumer Privacy**

In the Toysmart.com chapter 11 case the question arose whether Toysmart.com could sell its customer list (containing approximately 250,000 names, addresses, billing information, shopping preferences and family profiles) free of its contractual obligation to maintain customer privacy. Toysmart.com, a retailer of educational toys, was 60% owned by Buena Vista Internet Group, a subsidiary of Walt Disney.

Shortly after the commencement of its chapter 11 liquidating case, Toysmart.com filed a motion pursuant to Bankruptcy Code section 363(b) seeking approval to sell substantially all of its assets, including its customer list. Several parties objected to the sale motion, including the Federal Trade Commission (the "FTC"), attorneys' general of 39 states and TRUSTe, an organization that certifies companies that adhere to online privacy guidelines.

Just before the hearing on the sale motion, Toysmart.com and the FTC reached a settlement, which would have allowed Toysmart.com to sell its customer list to a buyer that was willing to purchase Toysmart.com's entire Web site. The bankruptcy court did not approve the FTC settlement. The matter was eventually settled when Buena Vista Internet Group offered Toysmart.com \$50,000 to destroy its customer list.

The Toysmart.com case began the debate over the protection of consumer privacy in the context of Bankruptcy Code section 363 asset sales. The consumer privacy issue raised many questions about how consumer privacy could be protected during the age of Internet bankruptcies, where customer lists often constitute a major portion of the debtor's assets.

The Senate Bill seeks to ensure that debtors sell "personally identifiable information" in accordance with their prepetition privacy policies by revising Bankruptcy Code section 363(b). "Personally identifiable information" is defined in revised Bankruptcy Code section 101 as follows:

"personally identifiable information", if provided by the individual to the debtor in connection with obtaining a product or service from the debtor primarily for personal, family, or household purposes--

(A) means-

- (i) the individual's first name (or initials) and last name, whether given at birth or adoption or legally changed;
- (ii) the physical address for the individual's home;
- (iii) the individual's e-mail address;
- (iv) the individual's home telephone number;

(v) the individual's social security number; or

(vi) the individual's credit card account number; and

(B) means, when identified in connection with one or more of the items of information listed in subparagraph (A)—

(i) an individual's birth date, birth certificate number, or place of birth; or

(ii) any other information concerning an identified individual that, if disclosed, will result in the physical or electronic contacting or identification of that person;

S. 420, § 231.

Revised section 363(b) prohibits a debtor from selling personally identifiable information in a manner that is inconsistent with its prepetition privacy policy (unless the court orders otherwise). In determining whether a debtor can sell personally identifiable information in a manner that is inconsistent with its prepetition privacy policy, the court is required to give due consideration to the facts and circumstances of the sale or lease. S. 420, § 231. Ironically, these nominally privacy protective provisions appear to broaden the authority of the debtor to use, and the court to authorize the sale of, customer lists, in derogation of the debtor's prepetition contractual privacy obligations.

To further protect consumers' privacy in the context of section 363(b) sales, the Senate Bill provides for the appointment of a consumer privacy ombudsman. The UST will appoint a disinterested person to act as an ombudsman when a debtor attempts to sell customer information in violation of its pre-petition nondisclosure policies. The ombudsman will act as a friend of the court to assist the court in its consideration of the facts, circumstances and conditions of the sale or lease. The ombudsman may present information to the court to assist the court in its decision. Such information could include presentation of the debtor's privacy policy, potential losses or gains of privacy to consumers that the sale or lease is approved, potential costs or benefits to consumers if the sale or lease is approved and potential alternatives which mitigate potential privacy losses or potential cost to consumers. S. 420, § 232.

The ombudsman will be compensated under Bankruptcy Code section 330. S. 420, § 232(c).

## VIII. Appellate Jurisdiction

The Bills revise 28 U.S.C. §158(d), making it possible for parties to bypass district court or BAP review and appeal orders and decrees of the bankruptcy court directly to the courts of appeals.

### A. House Bill

The House Bill provides that bankruptcy court orders appealed to the district court will become final orders of the district court unless the district court determines the matter or expressly extends the time within 30 days after the appeal is filed. The parties can appeal directly to the court of appeals as soon as the order becomes a final order of the district court. H.R. 333, § 1234. The House Bill raised concerns among some judges and practitioners that this proposed procedure would unduly further crowd the courts of appeals. Accordingly, the Judicial Conference developed a proposal, which has been incorporated into the Senate Bill, as set forth below. *See generally, Judicial Conference Asks Congress to Address Areas of Concern in Bankruptcy Reform Bill, The Third Branch, March 2001.*

### B. Senate Bill

The Senate Bill sets forth the standard for the direct appeal:

(d)(1) The courts of appeals shall have jurisdiction of appeals from all final decisions, judgments, orders, and decrees entered under subsections [1](a) and [1](b) of this section.

(2)(A) A court of appeals that would have jurisdiction of a subsequent appeal under paragraph (1) or other law may authorize an immediate appeal of an order or decree, not otherwise appealable, that is entered in a case or proceeding pending under section 157 or is entered by the district court or bankruptcy appellate panel exercising jurisdiction under subsection (a) or (b), if the bankruptcy court, district court, bankruptcy appellate panel, or the parties acting jointly certify that –

- (i) the order or decree involves—
  - (I) a substantial question of law;
  - (II) a question of law requiring resolution of conflicting decisions; or
  - (III) a matter of public importance; and

- (ii) an immediate appeal from the order or decree may materially advance the progress of the case or proceeding.

S. 420, § 1233 (emphasis added).

That standard will apply to final and interlocutory orders entered by the bankruptcy court. Final orders of the district court and bankruptcy appellate panel will remain appealable as of right to the courts of appeals as under existing law.

Under current law, as a matter of right, a party can appeal to the district court or the bankruptcy appellate panel final judgments, orders and decrees of the Bankruptcy Court and interlocutory orders increasing or reducing plan exclusivity periods in Bankruptcy Code section 1121. Under the new law, a party would not be permitted to appeal those matters directly to the courts of appeals without meeting the above standard.

With respect to all other interlocutory orders, as the law currently stands, a party must seek "leave of court" before an appeal is allowed. Current section 158(a)(3) does not set forth any standards for determining when leave of court is appropriate. However, several courts have adopted the analogous provision of 28 U.S.C. § 1292(b) as the standard for determining when a party should be granted leave to appeal. An analogous section authorizing certification of interlocutory appeals under the general jurisdictional statutes of the courts of appeals is 28 U.S.C. § 1292(b). It provides:

(b) When a district judge, in making in a civil action an order not otherwise appealable under this section, shall be of the opinion that such order involves a controlling question of law as to which there is substantial ground for difference of opinion and that an immediate appeal from the order may materially advance the ultimate termination of the litigation, he so shall state in writing in such order. The Court of Appeals . . . may thereupon, in its discretion, permit an appeal to be taken from such order . . .

28 U.S.C. § 1292(b).

In general courts have imposed a very high standard for certification of appeals under section 1292(b) and certification is rarely granted. Some courts adopt the section 1292(b) standard for determining when leave of court is appropriate, *see 5 Collier On Bankruptcy*, ¶ 5.07[4] (15th ed. rev.), but most courts appear to apply a less rigorous standard. The ability of the parties or the bankruptcy court (in lieu of the district court) to certify a direct appeal and the absence of section 1292(b)'s controlling question language in the Senate Bill may allow a looser standard than that of section 1292(b) and more analogous to the leave of court standard to develop.

The Senate Bill also includes a set of temporary procedural rules that will apply to direct appeals to the court of appeals until a Federal Rule of Bankruptcy Procedure is promulgated or amended. These procedural rules are summarized as follows:

- The district court, bankruptcy court or bankruptcy appellate panel may enter the required certification;
- Rule 5 of the Federal Rules of Appellate Procedure will govern the procedure for filing the appeal;
- The appeal must be filed within 10 days after the bankruptcy court, district court, or bankruptcy appellate panel issues the certification; and
- A copy of the certification must be attached to the petition.

## **IX.**

### **Transnational**

The Bills create chapter 15, which incorporates the Model Law on Cross-Border Insolvency. Chapter 15 is designed to provide a means for bankruptcy courts to effectively deal with cross-border insolvency cases. Chapter 15 includes several subchapters that govern access of foreign representatives and creditors to the bankruptcy court, recognition of foreign proceedings and relief, cooperation with foreign courts and foreign representatives and concurrent proceedings. Bills, Title VIII.

## **X.**

### **Conversion/Dismissal**

The Bills significantly amend Bankruptcy Code section 1112(b) with respect to how a party in interest can move for conversion or dismissal of a case. Under the revised law, a court must convert or dismiss a case if the movant establishes "cause." The Bills set forth several items that would constitute "cause":

- (A) substantial or continuing loss to or diminution of the estate;
- (B) gross mismanagement of the estate;
- (C) failure to maintain appropriate insurance that poses a risk to the estate or to the public;
- (D) unauthorized use of cash collateral harmful to 1 or more creditors;
- (E) failure to comply with an order of the court;
- (F) repeated failure timely to satisfy any filing or reporting requirement established by this title or by any rule applicable to a case under this chapter;
- (G) 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;
- (H) failure timely to provide information or attend meetings reasonably requested by the United States trustee or the bankruptcy administrator;
- (I) failure timely to pay taxes due after the date of the order for relief or to file tax returns due after the order for relief;
- (J) failure to file a disclosure statement, or to file or confirm a plan, within the time fixed by this title or by order of the court;
- (K) failure to pay any fees or charges required under chapter 123 of title 28;
- (L) revocation of an order of confirmation under section 1144;
- (M) inability to effectuate substantial consummation of a confirmed plan;
- (N) material default by the debtor with respect to a confirmed plan;
- (O) termination of a confirmed plan by reason of the occurrence of a condition specified in the plan; and
- (P) failure of the debtor to pay any domestic support obligation that first becomes payable after the date on which the petition is filed.

Bills, § 442.

Note that under revised section 1112(b)(A), the movant need only establish "substantial or continuing loss to or diminution of the estate." This is a change from current law, where the movant must prove both a continuing loss to the estate and the absence of a reasonable likelihood of rehabilitation. *See* 11 U.S.C. § 1112(b)(1).

Any party that opposes a motion to convert or dismiss must establish that there is a reasonable likelihood that a plan will be confirmed. Moreover, the party opposing

conversion or dismissal must show that while there were grounds to convert or dismiss the case, there is reasonable justification for the debtor's act or omission that will be cured within a reasonable period of time. Bills, § 442.

It is important to note that the House and Senate Bills differ with respect to the standard for opposing a motion to convert or dismiss. The House Bill requires that the objecting party establish "[b]y a preponderance of the evidence that ... a plan with a reasonable possibility of being confirmed will be filed." HR. 333, § 442. The Senate Bill, on the other hand, does not require the objecting party to bear the burden of proof. S. 420, § 442.

The revised law contains a requirement that the court hear any motion to convert or dismiss within 30 days after the motion is filed and decide the motion no later than 15 days thereafter. The movant can consent to a continuance of the hearing on the motion.

The Bills also amend section 1104(a) to allow for the appointment of a trustee or examiner if grounds for conversion or dismissal exist. Bills, § 442.

Dismissal or conversion appears to be mandatory under revised section 1112 unless cure is possible, even if the best interests of creditors are not served by dismissal or conversion. This unfortunate result may be forestalled by the court's discretionary appointment of a trustee or an examiner under revised section 1104(a)(3).

## **XI.**

### **Financial Contracts**

The Financial Contract Provisions in Title IX amend the Federal Deposit Insurance Act ("FDIA"), the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"), the Securities Investor Protection Act of 1970 ("SIPA") and the Bankruptcy Code. Senator Gramm stated during the Senate Debate on March 15, 2001, that the financial contract provisions have four principal purposes:

1. To strengthen the provisions of the Bankruptcy Code and the FDIA that protect the enforceability of acceleration, termination, liquidation, close-out netting, collateral foreclosure and related provisions of certain financial agreements and transactions.
2. To harmonize the treatment of these financial agreements and transactions under the Bankruptcy Code and the FDIA.
3. To amend the FDIA and FDICIA to clarify that certain rights of the FDIC acting as conservator or receiver for a failed insured depository institution (and in some situations, rights of SIPC and receivers of certain uninsured institutions) cannot be defeated by operation of the terms of FDICIA.
4. To make other substantive and technical amendments to clarify the enforceability of financial agreements and transactions in bankruptcy or insolvency.

Cong. Rec. S2366 (daily ed. March 15, 2001) (statement of Sen. Gramm).

The Financial Contract provisions concern various types of financial contracts, including forward contracts, repurchase agreements, swap agreements, commodities contracts and securities contracts. The Bills create definitions for the various agreements that fall under the financial contract provisions, some portions of which are controversial. The definitions of financial contracts, including the definitions of "forward contract," "repurchase agreement," "swap agreement" and "securities contract," include guarantees and reimbursement obligations. Bills, § 907. Thus, a debtor-guarantor that has provided collateral under a financial contract will be subject to the netting protections that are afforded to financial institutions under the revised law.

Various provisions of the Bankruptcy Code are amended to reflect the intent of Congress "[t]hat normal business practice in the event of a default of a party based on bankruptcy or insolvency is to terminate, liquidate or accelerate securities contracts, commodity contracts, forward contracts, repurchase agreements, swap agreements and master netting agreements with the bankrupt or insolvent party." Cong. Rec. S2372 (daily ed. March 15, 2001) (statement of Sen. Gramm).

The provisions make the following amendments to the Bankruptcy Code:

- Bankruptcy Code section 362(b) is amended to protect netting provisions in swap agreements, security agreements and master netting agreements. Bills, § 907(d). A corresponding amendment is made to SIPA to provide that a SIPC stay does not operate as a stay against netting provisions. Bills, § 911.
- Bankruptcy Code sections 546 and 548(d) are amended to clarify that the trustee cannot avoid transfers that are made in connection with a master netting agreement, unless the transfer was made to hinder, delay or defraud creditors. Bills, § 907(e) & (f).
- Bankruptcy Code sections 555, 556, 559 and 560 are amended to expand the contractual right to liquidate securities contracts, commodities contracts, forward contracts, repurchase agreements and swap agreements to the right to liquidate, terminate or accelerate those contracts. Bills, § 907(g)-(j).
- Section 561 is added to chapter 5 to protect the "[c]ontractual right to terminate liquidate, accelerate, or offset under a master netting agreement . . . ." Bills, § 907(k).
- A new section is added to chapter 5 to govern the measure of damages in connection with the rejection of a financial contract. Section 562 provides that if the trustee rejects a financial contract or a financial institution liquidates, terminates or accelerates a financial contract the damages are measured as of the date of the rejection, liquidation, termination, or acceleration and treated as though the claim arose prepetition. Bills, § 910.

The principal substantive change in this area is to allow "cross-product" netting pursuant to "master netting agreements" for the first time. Thus a net credit for the debtor on a series of swaps can in effect collateralize the debtor's obligation on otherwise unrelated repurchase obligations with the same financial counterparty under a master netting agreement.

## **XII.**

### **Asset-Backed Securitizations**

According to the Bills, estate property will not include assets that are transferred prepetition to a bankruptcy remote vehicle in connection with an asset-backed securitization. Bills, § 912. In an asset-backed securitization, a company transfers certain of its assets, i.e., usually accounts receivable and other payment rights, to a "bankruptcy remote vehicle," in exchange for a specified purchase price. The primary goal of an asset securitization is to lower borrowing costs by ensuring that the transferred assets securing the financing are not estate property in the bankruptcy of the transferor. There is little case law regarding the ability of the debtor to remove assets from the bankruptcy estate in this way.

The validity of such transfers recently was litigated in the LTV Steel case. Prepetition, LTV's inventory and accounts receivable were transferred to bankruptcy remote vehicles as part of an asset-backed securitization. Shortly after the commencement of its bankruptcy case, LTV sought nonconsensual use of cash collateral. LTV claimed that cash collateral was being generated from collection of accounts receivable and inventory sales. The purchasers of those assets (and securityholders) opposed LTV's efforts, claiming that the accounts receivable and inventory were not estate property and their proceeds were therefore not cash collateral. The court disagreed and entered an order authorizing the interim use of cash collateral. The parties settled the matter before the final hearing perhaps because the purchasers did not want to risk setting a precedent that undermined the legal basis for securitization.

The Bills validate asset-backed securitizations to the extent that they purport to effectuate a prepetition transfer of the debtor's assets. The Bills amend Bankruptcy Code section 541(b), making it clear that property of the estate does not include assets that were transferred prepetition pursuant to an asset-securitization. According to revised section 541(b)(8), property of the estate does not include:

"[a]ny eligible asset (or proceeds thereof), to the extent that such eligible asset was transferred by the debtor, before the date of commencement of the case, to an eligible entity in connection with an asset-backed securitization, except to the extent such asset (or proceeds or value thereof) may be recovered by the trustee under section 550 by virtue of avoidance under section 548(a)."

Bills, § 912.

In order to qualify for the exclusion, a transferred asset must be an "eligible asset" within the meaning of the new definition that is included in revised section 541(f). Interestingly, inventory is not included within that definition. Consumer and trade receivables are, however, included in the definition. Revised section 541(f) provides the definitions of "asset backed securitization," "eligible asset," "eligible entity," "insurer,"

and "transferred" (in the context of an asset-backed securitization). At least one tranche of the securities must be investment grade.

Even under the revised law, asset-backed securitizations can be subject to attack. The bankruptcy remote vehicle itself could be placed into bankruptcy or subject to an order of substantive consolidation. The prohibitions included in most of the agreements governing asset-backed securitizations pose significant barriers to a bankruptcy filings by such entities, but a bankruptcy remote vehicle was placed into an involuntary bankruptcy in at least one instance. *See In re Kingston Square Assoc.*, 214 B.R. 713 (Bankr. S.D.N.Y. 1997).

Note that the amendments relating to asset-backed securitizations are effective on the date of enactment of the legislation. Bills, § 913.

### **XIII.**

#### **S**

##### **A. Disinterestedness**

The Bills amend the definition of "disinterested person" by deleting all references to investment bankers in § 101(14)(B), (C), & (E):

(14) "disinterested person" means person that -

(A) is not a creditor, an equity security holder, or an insider;

(B) is not and was not, within 2 years before the date of the filing of the petition, a director, officer, or employee of the debtor; and

(C) does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor, or for any other reason.

Bills, § 414.

Although this section removes investment bankers their employees and attorneys from per se disqualification, it might cause courts to scrutinize more closely investment banker retentions. Current law draws a 3 year line on per se disqualification for investment bankers of securities that are not outstanding. *See* 11 U.S.C. § 101(14)(C). To the extent some courts might have viewed the 3 year line as a safe harbor for older transactions, the amendment could open the door to more serious scrutiny.

## **B. Compensation of Professionals**

### **1. Amendments to Section 328**

Bankruptcy Code section 328 provides that "[t]he trustee or a committee appointed under Bankruptcy Code section 1102 . . . with the court's approval, may employ . . . a professional person . . . on any reasonable terms and conditions of employment, including on a retainer, on an hourly basis, or on a contingent fee basis." 11 U.S.C. § 328(a).

The Bills confirm that a trustee may employ a professional person on a fixed and percentage fee basis by adding "on a fixed or percentage fee basis" just before "or on a contingent fee basis." Courts use the terms "percentage fee" and "contingent fee" interchangeably. That addition is relatively unremarkable. The fixed fee alternative was added to fix a problem often encountered by chapter 7 trustees. Chapter 7 trustees routinely turn over estate funds to secured creditors on account of their secured claims. Some courts have precluded chapter 7 trustees from receiving their statutorily authorized fee in those circumstances based upon the notion that a trustee should be compensated only out of the proceeds of a sale of an estate asset, and not a mere disbursement to a secured creditor. The fixed fee alternative was added to section 328(a) as an attempt to fix that problem.

### **2. Amendments to Section 330**

The revisions to Bankruptcy Code section 330 are not controversial. However, you should note the following amendment to encourage board certification:

- ***Factors for Compensation of Professional Persons:*** Current section 330(a)(3) provides that "[I]n determining the amount of compensation to be awarded, the court shall consider the nature, the extent, and the value of such services, taking into account . . . " a total of five relevant factors. The Bills add to that list of five factors one additional factor:

[W]ith respect to a professional person, whether the person is board certified or otherwise has demonstrated skill and expertise in the bankruptcy field . . . ."

Bills, § 415.

Moreover, a new paragraph is added to section 330(a), which is designed to ensure that trustees do not receive a recovery from the estate in excess of the fee cap:

(7) In determining the amount of reasonable compensation to be awarded to a trustee, the court shall treat such compensation as a commission, based on section 326 of this title.

Bills, § 407.

**C. Jurisdiction**

Current law provides that the district court (or the bankruptcy court if the case has been referred) has exclusive jurisdiction of "[a]ll of the property, wherever located, of the debtor as of the date of commencement of such case, and of property of the estate." 28 U.S.C. § 1334(e). The Bills add to section 1334(e) a provision that grants that district court exclusive jurisdiction "over all claims or causes of action that involve construction of section 327 of title 11, United States Code, or rules relating to the disclosure requirements under section 327." H.R. 333, § 324; S. 420, § 323.

The amendment is a weak remnant of a lobbying effort to prevent malpractice suits against bankruptcy professionals from being tried before a jury in state courts. The current amendment is ineffective to address the problem. It does not mention malpractice suits at all. Moreover, the amendment will likely not affect fee disgorgement suits because it fails to mention sections 101(14) and 328(c). The amendment only affects construction of section 327 or rules relating to disclosure requirements under section 327. Most suits do not involve construction of section 327 or the rules relating to disclosure requirements. They involve determining whether a professional is disinterested under section 101(14) for purposes of fee disgorgement under section 328.

Note that exclusive federal jurisdiction is conferred "[o]ver all claims or causes of action that involve construction of section 327 . . . ." H.R. 333, § 324; S. 420, § 323 (emphasis added). It is unclear whether claims that "involve construction" must "arise under" section 327 or whether the defendant's ability to raise a defense involving construction under section 327 will be a sufficient basis for removal.

## **XIV.**

### **Miscellaneous**

#### **A. More Complete Information Regarding Assets of the Estate**

The Bills direct the Advisory Committee on Bankruptcy Rules of the Judicial Conference of the United States to propose an amendment to the Federal Rules of Bankruptcy Procedure and Official Bankruptcy Forms that would direct a chapter 11 debtor to disclose information regarding the value, operations, and profitability of any closely held corporation, partnership or of any other entity in which the debtor holds a substantial or controlling interest. Pursuant to the new rule, debtors are required to file and serve periodic financial and other reports. The purpose of the proposed amendment to the Federal Rules of Bankruptcy Procedure is to ensure that the debtor's interest in any closely held corporations, partnerships or any other entity can be adequately valued and used to pay allowed claims against the debtor's estate. Bills, § 419. Query whether Congress has the power to direct the Advisory Committee on Bankruptcy Rules to do anything?

## **XV.**

### **Health Care Provisions**

The Bills amend various sections of the Bankruptcy Code to provide for increased duties in health care bankruptcies. The amendments set forth a procedure for disposing of patient records when the estate does not have enough funds to pay to store the records. The Bills add section 351 to chapter 3, requiring the trustee to publish notice of its intent to destroy patient records that are not claimed by either patients or their insurance carriers within 365 days after the notice is published. After the 365 day period has run and if the records have not been claimed, the trustee is required to either shred or burn written documents or, if the records are stored electronically, to destroy the records such that they can never be retrieved. Bills, § 1102.

The Bills further provide for administrative expense priority under a new section 503(b)(8) for the costs associated with closing a health care business. Such costs can include the costs associated with disposing of patient records and moving patients to alternative facilities. Trustees and Federal agencies are entitled to such administrative expense claims. Bills, § 1103.

The Bills provide for the appointment of a disinterested ombudsman to act as a patient advocate. The ombudsman will be appointed within 30 days after the commencement of the case. The role of the ombudsman is to monitor and report to the court on the quality of patient care. The ombudsman is required to keep confidential all information relating to patient records. Bills, § 1104.

The trustee's duties under Bankruptcy Code section 704(a) (as amended by the Bills) are expanded to include the duty to "[u]se all reasonable and best efforts to transfer patients from a health care business that is in the process of being closed . . . ." Bills, § 1105. It is of course unclear what constitutes "reasonable and best efforts" for an administratively insolvent estate.

Many health care cases involve debtors that are not moneyed corporations and these charitable entities are commonly regulated under state law often by the state attorney general. Section 1221 of the Bills requires that any sale of estate assets involving a nonprofit debtor comply with otherwise applicable law. This may significantly complicate disposition of assets in health care cases involving nonprofit debtors. This provision is one of the few provisions of the Act immediately effective on the date of enactment.

The Bills create an exception to the automatic stay, allowing the Secretary of Health and Human Services to exclude the debtor from Medicare. Bills, § 1106.

## **XVI.**

### **Effective Dates and Applicability**

#### **A. Effective Date in General**

The Bills provide for an effective date of 180 days after the enactment of the Bankruptcy Reform Act of 2001 (the "Act"). Except as specifically provided in the Act, the amendments apply to only those cases that are commenced after the effective date. H.R. 333, § 1401; S. 420, § 1501.

#### **B. Effective Date of Specific Sections**

##### **1. Deprizio Amendments**

The Deprizio Amendments apply to cases that are pending or commenced on or after the date of enactment of the Act. Bills, § 1213(b).

##### **2. Financial Contract Provisions**

The financial contract provisions will take effect on the date of enactment of the Act. S. 420, § 913(a). The amendments are applicable to cases commenced on or after the date of enactment of the Act. S. 420, § 913(b).

##### **3. 11 U.S.C. § 308 (Small Business Debtor Reporting Requirements)**

11 U.S.C. § 308 will take effect 60 days after the date upon which the Advisory Committee on Bankruptcy Rules of the Judicial Conference promulgates the rules to establish the forms that will be required under section 308. Bills, § 434(b).

##### **4. Exclusive Jurisdiction Over Matters Involving Professionals**

The section that provides for the District Court (and bankruptcy court's) exclusive jurisdiction over matters relating to disclosure obligations under Bankruptcy Code section 327 applies to cases filed after the date of enactment of the Act. H.R. 333, § 324(b); S. 420, § 323(b)

##### **5. Energy Emergency Response Act of 2001**

The Energy Emergency Response Act of 2001 ("Energy Act") is designed to "[p]rovide assistance to those individuals most affected by high energy prices and to promote and accelerate energy conservation investments in private and Federal Facilities." S. 420, §1402. The Energy Act will constitute Title 14 of the United States Code. The Energy Act takes effect that date of enactment of Title 14.

**6. Transfers Made By Nonprofit Charitable Corporations**

The amendments made with respect to transfers made by nonprofit charitable corporations apply to cases pending on the date of enactment of the Act or filed on or after the date of enactment of the Act. H.R. 333, § 1222; S. 420, § 1221.

**7. Bankruptcy Judges**

The authorization of 27 new bankruptcy judgeships and the extension of certain existing temporary judgeships will be effective upon enactment.

# **APPENDICES\***

## **Blackline to Current Law**

<b>APPENDIX A</b>	<b>Administrative Provisions</b>
<b>APPENDIX B</b>	<b>Small Business Provisions</b>
<b>APPENDIX C</b>	<b>Chapter 11 Plan Issues</b>
<b>APPENDIX D</b>	<b>Miscellaneous</b>
<b>APPENDIX E</b>	<b>Cross-Border</b>
<b>APPENDIX F</b>	<b>Conversion/Dismissal</b>
<b>APPENDIX G</b>	<b>Financial Contract Provisions</b>
<b>APPENDIX H</b>	<b>Asset-Backed Securitizations</b>
<b>APPENDIX I</b>	<b>Conflicts and Compensation</b>

**\*The Appendices can be downloaded free of charge from the Klee, Tuchin, Bogdanoff & Stern, LLP Internet web page:**

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# TABLE OF CONTENTS

	<u>Page</u>
I. Administrative Issues .....	1
A. Amendments that Affect Non-Residential Real Property Leases.....	1
1. Extension of Assumption/Rejection Period.....	1
2. Administrative Claim Upon Rejection of Lease Previously Assumed by the Debtor .....	2
B. Amendments that Affect Executory Contracts and Unexpired Leases.....	2
1. Cure of Nonmonetary Defaults.....	2
2. Impairment of Claims or Interests Related to Nonmonetary Defaults .....	4
3. Provisions Affecting Air Carriers .....	5
C. Utilities.....	5
D. Preferences.....	6
1. The Deprizio Fix.....	6
2. Modification of Ordinary Course Defense Under Section 547(c)(2) .....	8
3. Monetary Limitation for Corporate Debtors.....	9
4. Venue in Preference Proceedings .....	9
5. Expansion of Time to Perfect a Transfer .....	9
6. Expansion of Time to Perfect a Purchase Money Security Interest.....	9
E. Postpetition Transfers .....	10
F. Reclamation .....	11
G. Statutory Liens .....	12
1. Purchasers for Adequate and Full Value .....	12
2. Warehouseman's Liens .....	13
II. Small Business Provisions .....	14
A. Definitions Relating to Small Business Debtors.....	14
B. Issues Affecting Plan Confirmation.....	14
1. New Exclusivity Period in Small Business Cases .....	14
2. Deadline for Confirmation of a Plan.....	15
3. Standard Form of Disclosure Statement and Plan .....	15
4. More Flexible Rules for Plan and Disclosure Statement .....	16
C. Duties of Trustee or Debtor in Possession in Small Business Cases.....	16
1. Duties of Debtor in Small Business Cases.....	16
2. Increased Debtor Reporting Requirements.....	17
3. Increased Supervision by Office of the United States Trustee .....	18
III. Single Asset Real Estate .....	20
A. Definition .....	20
B. Monthly Payments .....	20
C. Monthly Payments From Pledged Rents .....	21
D. Rate of Interest.....	22
E. Creation or Perfection of Liens for Special Taxes or Assessments on Real Property.....	22
IV. Chapter 11 Plan Issues.....	23
A. Exclusivity .....	23
B. Revised Definition of "Adequate Information" .....	23
C. Discharge .....	24

1. Individual Chapter 11 Debtors –	24
Plan Payments Must be Made Before Discharge is Effective	24
2. Corporate Chapter 11 Debtors –	25
Limitation on Discharge of Certain Fraud and Tax Claims in Chapter 11	25
B. Tax Provisions	26
1. Rate of Interest on Tax Claims	26
2. Time and Manner of Payment of Tax Claims Under a Plan	27
3. Taxes Incurred Before the Commencement of the Case	27
4. Determination of Tax Liability	27
5. Provisions Affecting Subordination of Tax Liens	28
6. Setoff of Tax Refunds	29
7. Stay of Tax Proceedings Limited to Prepetition Taxes	29
V. Prepackaged Bankruptcies	30
A. Prepetition Solicitation and Acceptance	30
B. No Meeting of Creditors Required in Pre-Packaged Bankruptcy	30
VI. Creditors' Committees	31
A. Reimbursement of Attorneys' Fees	31
B. Expansion of Committees	31
C. Election of Trustee	31
VII. Consumer Privacy	32
VIII. Appellate Jurisdiction	34
A. House Bill	34
B. Senate Bill	34
IX. Transnational	37
X. Conversion/Dismissal	38
XI. Financial Contracts	40
XII. Asset-Backed Securitizations	42
XIII. Conflicts and Compensation	<b>Error! Bookmark not defined.</b>
A. Disinterestedness	44
B. Compensation of Professionals	45
1. Amendments to Section 328	45
2. Amendments to Section 330	45
C. Jurisdiction	46
XIV. Miscellaneous	47
A. More Complete Information Regarding Assets of the Estate	47
XV. Health Care Provisions	48
XVI. Effective Dates and Applicability	49
A. Effective Date in General	49
B. Effective Date of Specific Sections	49
1. Deprizio Amendments	49
2. Financial Contract Provisions	49
3. 11 U.S.C. § 308 (Small Business Debtor Reporting Requirements)	49
4. Exclusive Jurisdiction Over Matters Involving Professionals	49
5. Energy Emergency Response Act of 2001	49
6. Transfers Made By Nonprofit Charitable Corporations	50
7. Bankruptcy Judges	50
APPENDICES	51