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PLENARY SESSION: BUSINESS BANKRUPTCY UPDATE

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I. The Housing Market and Bankruptcy Filings¹

A. Timeline of the Housing Market Situation

1. **2001** – interest rates lowered to a low of 1.75%
2. **2002** – annual appreciation in excess of 10% in Florida, California and the Northeast
3. **2002-2003** – mortgage denial rates drop to 14%
4. **2004-2005** – record appreciation levels in excess of 25% in the West and Florida
5. **2005** – the housing market boom ended in late summer in many parts of the US
6. **2006** – due to flat prices and falling home sales, inventory builds up, US Home Construction Index down 40% by mid-August
7. **2007**
 - a. home sales continue to fall, in the first quarter, the S&P reports the first year-over-year decline in housing prices since 1991
 - b. subprime mortgage market collapses beginning in February; throughout the year, more than 25 subprime lenders file bankruptcy (New Century Financial, American Home Mortgage, Neumann Homes, Levitt & Sons), put themselves up for sale (Countrywide), or close their doors (Ameriquest)
 - c. interest rates lowered from 6.25% to 5.75% in August to 4.75% in September; the federal funds rate is lowered to 4.25% and the discount window rate is lowered to 4.75% in December
 - d. the House and the Senate propose similar bills seeking to modify § 1322(b)(2)² to provide bankruptcy judges with additional discretion to cram down the value on mortgage loans on a debtor's primary residence
 - e. the federal reserve injects \$41B in November and \$40B in December of low rate funds into the money supply

B. Impact on Bankruptcy Practice

1. Continued filings by mortgage lenders and increasing numbers of filings by residential real estate developers
2. Increasing individual filings with possibly a future ability to cram down mortgages

C. Two Versions of Proposed Legislation³

1. Helping Families Save Their Homes in Bankruptcy Act of 2008, Title IV of the Foreclosure Prevention Act of 2008, S. 2636, 110th Cong. (2008) (introduced by Sen. Reid on Feb. 13, 2008, debated April 3, 2008)

¹ Appreciation is expressed to Paul Singerman of Berger Singerman, LLP in Miami for allowing me to borrow topics shamelessly in preparing these materials from his paper "Recent Developments in Chapter 11 Cases" which he presented at the 2008 SBLI Conference in Atlanta. Any errors are, of course, mine.

² Unless otherwise stated, all Code citations are to the Bankruptcy Code, found in Title 11 of the United States Code.

³ In early April, both Bills were put before the Senate with various amendments proposed. There also appeared to be some effort at trying to draft a bi-partisan Bill at the time.

a. Title IV of this bill is nearly identical to a bill introduced in October by Senator Durbin, S. 2136, 110th Cong. (2007). Bill S. 2136 was co-sponsored by 13 additional senators, including both democratic presidential candidates.

b. Section 1322(b) would be amended to read in relevant part as follows:

(b) Subject to subsections (a) and (c) of this section, the plan may—

...
(2) modify the rights of holders of secured claims, other than a claim secured only by a security interest in real property that is the debtor's principal residence, or of holders of unsecured claims, or leave unaffected the rights of holders of any class of claims;

...
(11) notwithstanding paragraph (2) and otherwise applicable nonbankruptcy law—

(A) **modify an allowed secured claim secured by the debtor's principal residence**, as described in subparagraph (B), **if**, after deduction from the debtor's current monthly income of the expenses permitted for debtors described in section 1325(b)(3) of this title (other than amounts contractually due to creditors holding such allowed secured claims and additional payments necessary to maintain possession of that residence), **the debtor has insufficient remaining income to retain possession of the residence** by curing a default and maintaining payments while the case is pending, as provided under paragraph (5); **and**

(B) provide for payment of such claim—

(i) **for a period not to exceed 30 years** (reduced by the period for which the loan has been outstanding) from the date of the order for relief under this chapter; and

(ii) **at a rate of interest accruing after such date calculated at a fixed annual percentage rate**, in an amount equal to the most recently published annual yield on conventional mortgages published by the Board of Governors of the Federal Reserve System, as of the applicable time set forth in the rules of the Board, plus a reasonable premium for risk; and

(12) include any other appropriate provision not inconsistent with this title.

11 U.S.C. § 1322(b) (2008) (proposed).

c. This Bill would also

- i. amend § 109(h) to waive the pre-filing counseling requirement when a “foreclosure sale on the debtor’s principal residence has been scheduled”
- ii. amend 28 U.S.C. § 1334 to allow a bankruptcy judge, in any core proceeding under 28 U.S.C. 157(b), to ignore arbitration agreements and clauses in cases involving individual debtors “whose debts are primarily consumer debts”
- iii. amend § 522 to allow debtors over 55 years of age on the date of filing to exempt up to \$75,000 in value in “real property or personal property that the debtor or a dependent of the debtor uses as a principal residence”
- iv. amend § 502(b) to allow the court to limit claims to the extent that they are “subject to any remedy for damages or rescission due to failure to comply with” any applicable state or federal consumer protection laws, including the Truth in Lending Act

2. Home Owners Mortgage and Equity Savings (HOMES) Act, S. 2133, 110th Cong. (2007) (introduced by Senator Specter on October 3, referred to the Committee on the Judiciary, debated April 3, 2008).
 - a. Identical legislation was introduced in the House by Congressman Chabot on October 9th, H.R. 3778, 110th Cong. (2007) (referred to the Judiciary Committee and the Subcommittee on Commercial and Administrative Law).
 - b. Section 1322(b) would be amended to read in relevant part as follows:

(b) Subject to subsections (a) and (c) of this section, the plan may—

...
 (2) modify the rights of holders of secured claims, other than a claim secured only by a security interest in real property that is the debtor's principal residence, or of holders of unsecured claims, or leave unaffected the rights of holders of any class of claims;
 ...

(11) with respect to a claim secured by a security interest in real property initiated before September 26, 2007, that is the debtor's principal residence, if the current monthly income of the debtor and the debtor's spouse combined, when multiplied by 12, is less than, in the case of a debtor in a household of 1 person, 150 percent of the median family income of the applicable State for 1 earner, in the case of a debtor in a household of 2, 3, or 4 individuals, the highest median family income of the applicable State for a family of the same number or fewer individuals, or in the case of a debtor in a household exceeding 4 individuals, the highest median family income of the applicable State for a family of 4 or fewer individuals, plus \$525 per month for each individual in excess of 4—

(A) modify the rights of any holder of such claim by lowering the principal amount of the loan to the fair market value of the real property securing the loan at the time of submission of the plan, to the extent that such fair market value is less than the principal amount outstanding on the loan, if such action is agreed to in writing by the debtor and the holder of the claim;

(B) waive any otherwise applicable early repayment or prepayment penalties; and

(C) in any case in which the applicable rate of interest is adjustable under the mortgage contract, modify the rights of any holder of such claim, by prohibiting or delaying adjustments to the rate of interest applicable to the debt on and after the date of filing of the plan or voiding any such adjustments that occurred during the 2-year period preceding that date of filing; and

(12) include any other appropriate provision not inconsistent with this title.

11 U.S.C. § 1322(b) (2008) (proposed).

c. This Bill also

- i. would amend § 109(h) to delay the pre-filing counseling requirement until after the date of filing where a foreclosure has been initiated on the debtor's principal residence
- ii. would have a sunset clause of seven years

II. Single Asset Real Estate (SARE) Debtors

A. BAPCPA's removal of the \$4M cap in the § 101(51B) definition of a SARE debtor becomes more important in the current housing market crisis

1. § 362: Automatic Stay

(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* . . . 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 . . . be made from rents or other income generated before, on, or after the date of the commencement of the case by or from the property to each creditor whose claim is secured by such real estate . . . ; 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

...

11 U.S.C. § 362(d).

2. § 101: Definitions

“The term “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.*” 11 U.S.C. § 101(51B).

Text removed by BAPCPA: “~~thereto having aggregate noncontingent, liquidated secured debts in amount no more than \$4,000,000.~~”⁴

B. Avoidance of the SARE definition

1. *In re Scotia Pacific Co., L.L.C.*, 508 F.3d 214 (5th Cir. 2007).

a. *Facts*: Debtor owns 200,000 acres of timberlands in northern California and has over 60 employees. Debtor does not harvest timber itself, but sells standing timber, re-plants and manages future timber stands and ensures compliance with

⁴ In many places, the BAPCPA amendments seem to have created typos in the Bankruptcy Code. *See, e.g.*, 11 U.S.C. 707(b)(2)(B)(i) (a misplaced “that”). Here, the drafters may have struck out one word too many. It is unlikely that “thereto” was intentionally deleted, and several courts have continued to include the word when quoting the SARE definition.

various environmental regulations. In selling timber stands, debtor prepares and submits permit applications regarding harvesting activities, develops “Timber Harvesting Plans,” which include road planning, design and engineering, and supervises harvesting to ensure compliance with the Plan and state and federal regulations. Debtor is involved with additional specialized programs of parent company such as watershed analysis and litigation support.

- b. *Issue*: Are these activities of debtor merely the business of and incidental to the operation of the real property such that debtor could qualify as a SARE?
 - c. *Holding*: No, debtor does not qualify under the third prong of the SARE requirements—it conducts substantial business other than the operation of the real estate. After reviewing several post-1994 cases that apply the definition in § 101(51B), the Court held that Congress in 1994 was only codifying the definition of a SARE that had already been developed by bankruptcy courts, and therefore that it is appropriate to look at pre-1994 case law to determine the definition of a SARE. The Court cited the definition of a SARE found in *In re Little Creek Dev. Co.*, which defined a SARE debtor as generally having few employees, little or no cash flow and no additional sources of income. 779 F.2d 1068 (5th Cir. 1986). The Court held that this debtor “conducts substantial business other than operating the real property and activities incidental thereto,” noting that the debtor’s timberland is more than a passive investment, that the debtor has over 60 employees, that the debtor conducts sophisticated operations and builds and maintains roads, and that the sale of timber “extends beyond the sale or lease of the underlying land.” 508 F.3d at 224-25.
2. *In re Webb MTN, L.L.C.*, 2008 WL 656271 (Bankr. E.D. Tenn. Mar. 6, 2008).
 - a. *Facts*: The debtor, a real estate developer, purchased five separate parcels of property, which are contiguous, in order to build a large resort to include, a hotel, condominiums, single family homes, two golf courses, restaurant, spa and more. Development plans were drawn up, without regard to the boundary lines of the original tracts, but no development began, and the developer filed for Chapter 11, owing under notes on four of the five parcels of land totaling nearly \$25 million.
 - b. *Issue*: Although the real estate in question is comprised of five separate parcels of land and plans exist for a wide variety of business activities to take place on the single resort yet to be constructed, does debtor still qualify as a SARE?
 - c. *Holding*: Yes, debtor is a SARE. First, the court decided that it was not dispositive that there were originally five separate tracts of land involved, since they are contiguous and “were at all times contemplated by the Movants and the Debtor as comprising one large parcel of real property to be developed by the Debtor as one large resort project.” 2008 WL 656271 at *4. The SARE definition encompasses single projects in addition to single properties. Secondly, while the debtor has plans to develop many different businesses, those plans “are still part and parcel of one large land development.” The court noted that no development had actually commenced on the land in question. Therefore, the court held that the debtor is not conducting any active business, but merely “mowing the grass and waiting for the market to turn.” *Id.* at *6 (quoting *In re Scotia Pacific Co.*,

L.L.C., 508 F.3d at 221 (quoting *In re Club Golf Partners, L.P.*, 2007 WL 1176010, *5 (E.D. Tex. Feb. 15, 2007)).⁵

3. *In re Club Golf Partners, L.P.*, 2007 WL 1176010 (E.D. Tex. Feb. 15, 2007).
 - a. *Facts*: The debtor owns and operates a golf club that includes an eighteen hole golf course, a driving range, tennis courts, and a restaurant. Its revenue is derived from memberships, greens fees, golf cart rental, driving range fees, tennis court fees, merchandise sales, food and beverage sales and special events rental. It has a number of third party employees.
 - b. *Issue*: Does this golf club constitute a SARE debtor?
 - c. *Holding*: No, this debtor is not a SARE. The court found persuasive four prior decisions holding that a golf course is not a SARE because “running a golf course is a substantial business other than the operation of the real property itself” and “involves significant income-producing activities that exist independently of the operation of the real estate.” 2007 WL 1176010 at *3. In applying the definition in §101(51B), The court “interpret[ed] the definition according to an active-versus-passive criterion that inquires into the nature of the revenue generation on and by the property, that is, whether the revenue is the product of entrepreneurial, active labor and effort . . . or is simply and passively received as investment income,” finding that such an interpretation was consistent with the provisions of the code. *Id.* at *4.
4. *In re Kara Homes, Inc.*, 363 B.R. 399 (Bankr. D.N.J. 2007).
 - a. *Facts*: A group of affiliated debtors filed under Chapter 11, identifying themselves as SARE cases. After the appointment of a Chief Restructuring Officer, the debtors filed amended petitions and schedules to reflect that they were not SARE entities. Each debtor owns a separate real estate development project for the construction of single family homes or condominiums. These entities in turn are 90% owned by Kara Homes. The debtors business consists of acquiring developable land, designing homes or condominiums for the land, arranging for the construction of the buildings, which they then market and sell. The debtors also build common spaces, amenities and roadways.
 - b. *Issue*: Do the business activities of these debtors qualify as sufficiently active that they do not meet the third requirement for a SARE under § 101(51B)?
 - c. *Holding*: The debtors meet the first two requirements of SARE without question. Adopting a “pragmatic approach” to gauging the substantiality of the debtors’ business operations, the court held that the business activities of the debtor “are merely incidental” to selling homes and condo units. 363 B.R. at 406. In reaching its holding, the Court “querie[d] whether the nature of the activities are of such materiality, that a reasonable and prudent business person would expect to generate substantial revenues from the operation activities—separate and apart

⁵ The phrase originally was used by the manager of a debtor real estate developer to describe current business activities, which the court quoted in holding that the debtor could not be reorganized under Chapter 11, for “[t]he ‘business’ of Humble Place, as Conner acknowledged, had for several years consisted of ‘mowing the grass and waiting for market conditions to turn.’” *In re Humble Place Joint Venture*, 936 F.2d 814, 817 (5th Cir. 1991).

from the sale or lease of the underlying real estate.” *Id.* As to these debtors, the answer was clearly no.

5. *In re Whispering Pines Estate, Inc.*, 341 B.R. 134 (Bankr. D.N.H. 2006).
 - a. *Facts*: The debtor operates an eighty-nine room hotel that serves continental breakfast, maintains a swimming pool and common areas, provides phone and internet service, and provides room-cleaning and towel-laundry services. The hotel does not have additional services such as a gift shop or restaurant.
 - b. *Issue*: Is a hotel that does not operate additional businesses to the business of running the hotel meet the third requirement of the SARE definition?
 - c. *Holding*: No, the debtor is not a SARE because it does not meet the third requirement—the hotel operations, even without additional services, constitute more than the business of operating the real property. The Court held that while in previous cases hotels that were not considered SAREs did often have additional services and businesses operated on-site, the absence of such additional businesses was not determinative.

III. Rule 6003 and Applications to Employ Chief Restructuring Officers (CROs) and Chapter 11 Debtor’s Counsel

A. The new Rule 6003, which became effective on December 1, 2007, prevents the bankruptcy court from granting applications under Rule 2014 within 20 days of filing unless it is necessary “to avoid immediate and irreparable harm”

1. Rule 6003. Interim and Final Relief Immediately Following the Commencement of the Case—Applications for Employment . . .

Except to the extent that relief is necessary to avoid immediate and irreparable harm, the court shall not, within 20 days after the filing of the petition, grant relief regarding the following:

- (a) an application under Rule 2014;

. . . .

FED. R. BANKR. PRO. 6003 (2007).

2. Advisory Committee Notes on Rule 6003.
 - a. The purpose given for this Rule is to “alleviate some of the time pressures present at the start of a case so that full and close consideration can be given to matters that may have a fundamental impact on the case.”
 - b. The committee noted that the “flurry of activity” in the beginning of a bankruptcy case often happens before the formation of a creditors’ committee.
 - c. The standard for relief is taken from Rule 4001(b)(2) and (c)(2), and the committee notes that “decisions under those provisions should provide guidance for the application of this provision.”
3. Application of Rule 6003 to a corporate Debtor in Possession (DIP). A corporate DIP typically requests approval of employment of legal counsel and a Chief Restructuring Officer (CRO) immediately upon filing under Chapter 11. Rule 6003 prevents the

approval of employment during the 20 days following filing absent a showing of “immediate and irreparable harm.”

- a. Legal Counsel. The necessity of legal counsel is obvious, since a corporation cannot represent itself *pro se*. A corporate debtor in possession would be unable to file any motions or act in any way during those first 20 days of its bankruptcy without representation.
- b. CRO. In the weeks and months prior to filing, many corporate debtors contemplating filing under Chapter 11 are guided by a CRO, an individual or entity experienced in helping corporations successfully reorganize under Chapter 11. It would be a great disadvantage to require a 20-day hiatus of the CRO during the crucial first weeks of bankruptcy. Furthermore, in order to prevent the appointment of a Chapter 11 Trustee under § 1104, it may be necessary that the CRO remain in complete control of the management of a corporate DIP if there have been bad acts by past management.
- c. While the Rule does not prevent professionals from working without pay or assurance of pay during the first 20 days in the hope that their applications for employment will be approved, it is not clear that this is a realistic option.

B. First Day Applications to Employ and Rule 6003

1. *In re First NLC Financial Services, L.L.C.*, 382 B.R. 547 (Bankr. S.D. Fla. 2008).
 - a. *Facts*: A Chapter 11 Debtor requested the entry of an order at the first-day hearings to approve, on an interim basis, the application for employment of counsel for the Debtor in Possession. The U.S. Trustee objected, arguing that Rule 6003 does not provide for such interim relief.
 - b. *Issue*: Does Rule 6003 prevent a Court from entering an order to approve the employment on an interim basis of a Chapter 11 Debtor in Possession’s legal counsel?
 - c. *Holding*: No, a bankruptcy court may, notwithstanding Rule 6003, enter an order for interim relief approving and application for appointment of debtor’s attorney. The Court noted that the Advisory Committee directly suggested that in interpreting the new Rule 6003 courts refer to Rule 4001(b)(2) and (c)(2), which “provide for bifurcation of relief into interim and final components.” 382 B.R. at 549. Furthermore, the Court noted that a corporation, such as the debtor, may not appear in court *pro se*, but required legal representation in order to present first-day requests for relief. The Court finally noted that Collier on Bankruptcy, which noted that no party would be prejudiced by the 20-day wait because a court could allow for full compensation from day one, overlooked the “unwieldy” procedure in which a court would have to enter several orders approving past compensation and then denying further employment in order to ensure compensation for a professional who is ultimately not approved for employment. *Id.* at 550.

IV. Trustee Appointment and § 1104(e)

- A. With the addition of § 1104(e) under BAPCPA, the U.S. Trustee is now obligated to move for the appointment of a Chapter 11 trustee if there are reasonable grounds to

suspect actual fraud, dishonesty or criminal conduct by the current governing body of the debtor.

1. Section 1104. Appointment of trustee or examiner

(a) At any time after the commencement of the case but before confirmation of a plan, on request of a party in interest or the United States trustee, and after notice and a hearing, **the court shall order the appointment of a trustee—**

(1) for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor **by current management**, either before or after the commencement of the case, or similar cause, but not including the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor;

...

*(e) The United States trustee shall move for the appointment of a trustee under subsection (a) if there are **reasonable grounds to suspect that current members of the governing body of the debtor**, the debtor's chief executive or chief financial officer, or members of the governing body who selected the debtor's chief executive or chief financial officer, participated in actual fraud, dishonesty, or criminal conduct in the management of the debtor or the debtor's public financial reporting.*

11 U.S.C. § 1104.

2. While technically this provision does not change the standard by which courts are to decide whether to appoint a Chapter 11 trustee, the question that arises with the inclusion of this new provision is whether it will only increase the frequency with which such motions are made, or whether it will also change the way in which courts analyze the decision of whether to appoint a Chapter 11 trustee.

B. Effect of § 1104(e) on the Court's Determination of Whether to Appoint a Trustee

1. *In re The 1031 Tax Group, L.L.C.*, 374 B.R. 78 (Bankr. S.D.N.Y. 2007).

a. *Facts*: The debtor corporations had been subject to various types of mismanagement leading up to its bankruptcy filing. Three days before filing, various actions were taken to divest the former managing director of all management authority in place of an outside restructuring professional. Shortly after the Chapter 11 filing, the U.S. Trustee filed a motion for the appointment of a Chapter 11 trustee or, alternatively, conversion to Chapter 7.

b. *Issue*: What affect did the newly enacted § 1104(e) have on the Court's analysis regarding whether a trustee should be appointed under § 1104(a)?

c. *Holding*: The Court denied the U.S. Trustee's motions, holding that while cause certainly existed under § 1104(e) for the U.S. Trustee to bring its motion, cause did not exist for appointing a trustee under § 1104(a). The Court was persuaded that the new management of the debtor was free from the taint of and undue influence from previous management, which had legally divested itself of all power and control over the debtor. The Court specifically noted that the addition

of §1104(e), with its lower standard governing when a U.S. Trustee must bring a motion, does not change either the standard the Court uses to decide the motion under §1104(a) or the standard for establishing a *prima facie* case. The Court also noted that § 1104(e) identifies specific members of the debtor’s governing body, and while the CRO is not one of the positions “specifically identified” thereunder, since the powers of the CEO (which is specifically identified) had been irrevocably delegated to the CRO, he was functionally the debtor’s CEO. 374 B.R. at 90.

V. The Discretion and Equitable Powers of the Bankruptcy Court and *Marrama*

A. BAPCA greatly limited the discretion of bankruptcy judges

1. Example: *In re Tubular Technologies, L.L.C.*, 2006 WL 2405711 (Bankr. D.S.C. 2006) (holding that the clear language of § 365 does not allow Debtor to obtain an order extending the time to assume a lease once the deadline has passed, comparing the provision to a statute of limitations preclusion, and rejecting the Debtor’s argument of excusable neglect due to a miscommunication with the clerk’s office).

B. *Marrama*: Discretion Reborn?

1. *Marrama v. Citizens Bank of Mass.*, 127 S.Ct. 1105 (2007) (upholding the ruling of a bankruptcy judge that a Debtor who filed in bad faith under Chapter 7 is not entitled to convert to Chapter 13 when concealed assets are discovered by the trustee, notwithstanding § 706(a)).
 - a. “A statutory provision protecting a borrower from waiver is not a shield against forfeiture. Nothing in the text of either § 706 or § 1307(c) (or the legislative history of either provision) limits the authority of the court to take appropriate action in response to fraudulent conduct by the atypical litigant who has demonstrated that he is not entitled to the relief available to the typical debtor. On the contrary, **the broad authority granted to bankruptcy judges to take any action that is necessary or appropriate “to prevent an abuse of process” described in § 105(a) of the Code, is surely adequate** to authorize an immediate denial of a motion to convert filed under § 706 in lieu of a conversion order that merely postpones the allowance of equivalent relief and may provide a debtor with an opportunity to take action prejudicial to creditors.” 127 S.Ct. at 1111-12.
 - b. “Indeed, as the Solicitor General has argued in his brief amicus curiae, even if § 105(a) had not been enacted, **the inherent power of every federal court to sanction ‘abusive litigation practices,’ . . . might well provide an adequate justification** for a prompt, rather than a delayed, ruling on an unmeritorious attempt to qualify as a debtor under Chapter 13.” *Id.* at 1112.
2. *In re Kingsley*, 518 F.3d 874 (11th Cir. 2008) (holding that a bankruptcy court did not abuse its discretion in using its equitable powers to allow credit for pre-petition payments to a relative of the debtor although it deemed that transfer to be fraudulent to creditors).
 - a. “Federal law also endows the bankruptcy court with **equitable powers to ‘issue any order, process, or judgment that is necessary or appropriate** to carry out the provisions of this title.’ 11 U.S.C. § 105.” 518 F.3d at 877.

- b. “We have indicated that ‘**the cornerstone of the bankruptcy courts has always been the doing of equity**’ ‘Equitable determinations by the Bankruptcy Court are subject to review under an abuse of discretion standard’” *Id.* (citations omitted).

VI. Utilities’ Adequate Assurance Under § 366

- A. Under § 366, a utility may discontinue service if they do not receive adequate assurance during the 30 days after the debtor’s filing “that is satisfactory to the utility.” However, § 366 also provides for modification of the terms of adequate assurance by the Court.

1. The relevant provision is as follows:

(2) Subject to paragraphs (3) and (4), with respect to a case filed under chapter 11, a utility referred to in subsection (a) may alter, refuse, or discontinue utility service, if during the 30-day period beginning on the date of the 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**.

11 U.S.C. § 366(c)(2).

- B. May the court extend the automatic stay where a utility company has failed to respond to the debtor in possession’s offer of adequate assurance?

1. *In re Lucre*, 333 B.R. 151 (Bankr. W.D. Mich 2005).

- a. *Facts*: A debtor corporation that provides telecommunications services files under Chapter 11 and shortly thereafter contacts its utility providers with offers of adequate assurance. Three of these utilities had notified the debtor of their intention to discontinue service pre-petition, but none had yet done so. Only one utility responded with a counter-offer. Debtor moved the court to continue the injunction notwithstanding § 336(c), because of their failure to respond to the offer of adequate assurance. Two of the utilities, IXC and Opex, do not provide services used by the debtor; the debtor uses the telecommunication services provided by those utilities to service its own clients. Sprint and Consumers Energy, on the other hand, provide utility services consumed by the debtor.
- b. *Issue*: Does the failure of these utilities to respond to the offer for adequate assurance allow the Court to affirm the debtor’s offer of adequate assurance under §366(c)?
- c. *Holding*: No, the failure of three of the utilities to respond to the debtor’s offers does not give the Court discretion to ignore subsection (c), which clearly requires that in order to continue the injunction, either the utility must have accepted adequate assurance offered by the debtor in possession or the debtor in possession must have accepted what was offered by the utility. Only after there has been agreement can the debtor in possession ask the court to modify its terms. The Court suggests that a good faith requirement *might* be implied to require the utilities to negotiate in good faith. The Court then distinguishes between the utilities who provide utility services consumed by the debtor and the utilities who have a interconnection agreement, holding that the later do not provide the debtor with a “utility service” as required under § 336(c). The companies that provide

utility services used by the Debtor, on the other hand, are bound by the injunction for 30 days under § 366(b), after which the Debtor must meet the requirements of § 366(c) in order to continue the injunction.

2. *In re Syroco, Inc.*, 374 B.R. 60 (Bankr. D. Puerto Rico 2007).
 - a. *Facts*: The Debtor corporation gave offers of adequate assurance to its utility providers. Several failed to respond, and Debtor in Possession moved the court to establish that the offer proposed constituted adequate assurance as to the non-responding utility companies.
 - b. *Issue*: Does silence constitute acceptance or acquiescence to the Debtor's offer of adequate assurance?
 - c. *Holding*: Yes, the Court declined to follow the *Lucre* holding, and determined that silence can be interpreted as acquiescence in this case, and that the lack of objection or counter-demand prior to the expiration of the 30-day injunction constitutes acceptance of the Debtor's offer. The Court found that the clear language of § 366 and its legislative history did not prevent the Court from continuing an injunction when the utility has failed to reply to the Debtor's offer of adequate assurance. The Court concluded that the alternative interpretation was unreasonable since it would mean that the Debtor in Possession would lose the protection of § 366 merely by the failure of a utility company to respond.
3. *In re Viking Offshore (USA), Inc.*, 2008 WL 782449 (Bankr. S.D. Tex. Mar. 20, 2008).
 - a. *Facts*: Jointly administered Debtors in Chapter 11 filed motions with the Court, first asking that two utilities' current security deposits be deemed adequate assurance, and second asking the court to establish a procedure by which utilities must request adequate assurance in writing by a certain date and file a motion seeking adequate assurance. Until such motion is heard, services may not be terminated. No utilities had contacted debtor since filing seeking increased deposits or payment.
 - b. *Issue*: May the Court establish a new procedure by the Court's broad powers under § 105(a) to alter § 366(c)?
 - c. *Holding*: No, the Court chose to follow *Lucre* and rejected both of the debtor's motions. The Debtors' proposal would impermissibly reverse the framework established by § 366(c). The ability of the Court to order modification of the amount of adequate assurance does not include the ability to dispense with the requirement of adequate assurance altogether. The Court noted that the Debtors may continue to pay a utility and receive its services absent an injunction.
4. *In re Beach House Property, L.L.C.*, 2008 WL 961498 (Bankr. S.D. Fla. Apr. 8, 2008).
 - a. *Facts*: The Debtor in Possession moved the Court to enter an Order to determine adequate assurance of payment, giving utilities 15 days in which to object. The Court did so. One utility company objected both to the amount of adequate

assurance and to the procedure the Court adopted to determine the amount of adequate assurance.

- b. *Issue*: May the Court establish a procedure whereby adequate assurance is determined by court order absent objection of a utility?
 - c. *Holding*: The Court held that its procedure, which followed a proposed local rule that would shortly be enacted, was proper. A debtor may comply with § 366 by proposing a means and amount of adequate assurance in a motion that sets an objection deadline and hearing date. This procedure does not “reverse the burdens” but merely creates a reasonable way to resolve disputes and determine the amount of adequate assurance to be paid.
5. The Local Rule proposed by the Bankruptcy Court for the Southern District of Florida is produced below.

Utility Service—Adequate Assurance Motion.

- (1) . . . Where there is no agreement, the trustee or the debtor shall file a motion that complies with the requirements stated in subsection (b) below seeking a determination by the court that the assurance of payment furnished by the trustee or the debtor constitutes adequate assurance of payment necessary under 11 U.S.C. §§336(b) or (c).
- (2) Content of Motion. A motion to determine adequate assurance of payment for debtor’s utility services shall . . . include:
 - . . .
 - (b) a certification that movant’s attorney has contacted the utility service provider(s) and made a good faith effort to comply with the requirements under §366 prior to the filing of the motion . . .
 - . . .
- (3) Objection. The utility company shall serve a written objection no later than 4:30pm on the second business day prior to the scheduled hearing
- . . .

BANKR. S.D. FLA. R. 9013-1(L) (proposed 2008).

VII. Valuation of Contingent Liabilities in Determining Solvency

A. Valuation of Contingent Claims

- 1. Under § 547, the trustee or debtor in possession may avoid transfers made while the debtor was insolvent to a creditor in the 90 days prior to filing or in the year prior to filing if the creditor was an insider.
 - (b) Except as provided in subsections (c) and (i) of this section, the trustee may avoid any transfer of an interest of the debtor in property—
 - . . .
 - (3) **made while the debtor was insolvent;**

...

11 U.S.C. § 547(b).

2. Definition of Insolvency:

(32) The term “insolvent” means—

(A) with reference to an entity other than a partnership and a municipality, financial condition such that the sum of such entity's debts is greater than all of such entity's property, **at a fair valuation**, exclusive of—

...

11 U.S.C. § 101(32)(A).

B. Valuing Contingent Liabilities

1. *In re Trans World Airlines Inc.*, 134 F.3d 188 (3d Cir. 1998) (holding that while it is proper to include contingent liabilities in evaluating solvency, it was not proper to include as contingent liabilities the costs associated with the potential dissolution of the debtor).
 - a. “We agree with the bankruptcy court that it is proper to consider contingent liabilities when evaluating the insolvency of a corporation pursuant to 11 U.S.C. § 101(32)(A).” 134 F.3d at 197.
2. The Probability Discount Rule: *Matter of Xonics Petrochemical, Inc.*, 841 F.2d 198 (7th Cir. 1988) (opining at length on the valuation of contingent liabilities although the issue was not raised by either party to the appeal).
 - a. The court stated in dicta that a loan guarantee and note co-signed by the Debtor for the benefit of a subsidiary company created only a contingent liability, which must be devalued in order to evaluate whether the Debtor was insolvent at the time of the transfer.
 - b. “To value the contingent liability it is necessary to discount it by the probability that the contingency will occur and the liability become real.” 841 F.2d at 200.
 - c. “No more should the existence of remote contingencies, which do not seriously endanger the firm’s ability to pay its debts, be deemed to make an otherwise solvent firm bankrupt.” *Id.* at 201.

C. Blurring the lines between contingent and disputed claims

1. *In re Advanced Telecommunication Network, Inc.*, 490 F.3d 1325 (11th Cir. 2007), *cert. denied*, 128 S.Ct. 1326 (2008).
 - a. The Court of Appeals held that in determining solvency of the debtor, an ongoing contract dispute in which a creditor claimed \$39 million to be owed by the Debtor should have taken into account. The Court held that this debt was a “contingent liability” that should be taken into account.
 - b. “The ‘fair value’ of a contingent liability, of course, should be discounted according to the possibility of its ever becoming real.” 490 F.3d at 1335.

2. The Court of Appeals failed to distinguish between a true contingent claim and a disputed claim. In this case, the liability was not contingent on any future event occurring, and moreover, the valuation of the claim had already been done by both sides in the litigation. *See generally* Kit Weitnauer, *Eleventh Circuit Muddles Valuation Rules*, 26 AM. BANKR. INST. J. 34 (2007).

VIII. Key Employee Retention Plans (KERP)

- A. Under new provisions of § 503(c), BAPCPA severely reduced the ability of bankruptcy judges to approve a KERP

1. The relevant section provides:

§ 503. Allowance of administrative expenses

...

- (c) Notwithstanding subsection (b), there shall neither be allowed, nor paid—

(1) a **transfer** made to, or an obligation incurred for the benefit of, an insider of the debtor **for the purpose of inducing such person to remain with the debtor's business**, absent a finding by the court based on evidence in the record that—

(A) the transfer or obligation is essential to retention of the person because the individual has a bona fide job offer from another business at the same or greater rate of compensation;

(B) the services provided by the person are essential to the survival of the business; and

(C) either—

(i) the amount of the transfer . . . is not greater than an amount equal to 10 times the amount of the mean transfer or obligation of a similar kind given to nonmanagement employees . . . ; or

(ii) . . . the amount of the transfer or obligation is not greater than an amount equal to 25 percent of the amount of any similar transfer or obligation made to . . . such insider . . . ;

...

11 U.S.C. § 503(c).

2. The intent of this section is fairly clear. However, several recent cases have demonstrated the creative ability of lawyers where the happiness of top management is concerned.

B. The new Key Employee *Incentive* Plan

1. *In re Nobex Corp.*, 2006 Bankr. LEXIS 417 (Bankr. D. Del. Jan. 19, 2006).
 - a. *Facts*: Debtor corporation in Chapter 11 liquidation sought court authorization of an incentive program to benefit the two key employees of the corporation. Under the program, these employees would be eligible to receive bonuses if the sale price exceeded a certain threshold amount, pursuant to a tiered bonus structure

based on percentages of the amount of the sale price exceeding the threshold amount. The creditors' committee endorsed the program.

- b. *Issue*: Is this bonus structure a retention bonus subject to the requirements of § 503(c) or is it otherwise permissible as an exercise of the debtor's business judgment under § 363?
 - c. *Holding*: The Court held that this "sale-related incentive pay" was not prohibited under § 503(c), for it was not proposed "to induce [the employees] to remain with the debtor." 2006 Bankr. LEXIS 417 at *7. Neither of the employees had indicated a desire to terminate their employment and the incentive pay is not severance pay. The bonuses will not be given unless the gross sale price exceeds the proposed stalking horse bid and are designed to encourage the employees "to act above and beyond the level required by their normal fiduciary duties." *Id.*
2. *In re Dana Corp.*, 351 B.R. 96 (Bankr. S.D.N.Y. 2006).
- a. *Facts*: Debtor corporations proposed a compensation plan for the debtor's CEO and five executives. The plan included an annual incentive bonus conditioned on the debtor's short term financial performance, a completion bonus that would replace a long-term incentive program under the executive's employment contracts, awarding amounts on the effective date of the plan of reorganization, a "non-compete" package that would give the executives payments for 18 months after resignation for signing an 18-month non-compete agreements, and a "senior executive retirement program" that would assume a pre-petition retirement program resulting in claims of up to 6 million.
 - b. *Issue*: Is this compensation plan a retention plan disguised as an incentive program, and a severance bonus disguised as a "non-compete" contract?
 - c. *Holding*: The Court held that "this compensation scheme walks, talks and is a retention bonus." 351 B.R. at 102. The Court held that the compensation scheme was subject to the restrictions of § 503(c). The completion bonus had an artificially low threshold guaranteeing the payout of the bonus, and the non-compete payment was "payment due on termination of employment," thus severance pay. The Court noted that it may be possible to formulate a compensation package that meets the requirements of §§ 503(c) and 363, but that this plan did not.
3. *In re Global Home Products, L.L.C.*, 369 B.R. 778 (Bankr. D. Del. 2007).
- a. *Facts*: Debtor corporation sought approval of a "performance and incentive based bonus plan," which provided for bonus programs to certain management and sales employees. The management plan provided for quarterly bonuses based on quarterly performance, but as to the CEO, amortized existing obligations on a prepetition loan of a relocation allowance and would not exceed the amount of the prepetition obligation. The sales bonus plan provided bonuses to several sales managers based on a percentage of their annual salary that would be applicable and increase upon meeting certain sales goals. Both plans are intended to be self-funded. An objection was heard by the United Steel Workers Union. The creditors' committee did not object.

- b. *Issue*: Does this incentive plan “walk[] like a duck (KERP)?” 369 B.R. at 785. Or, in other words, is it primarily motivated to retain personnel and thus subject to the requirements of § 503(c)?
 - c. *Holding*: The Court held that these bonus plans “are primarily incentivizing and only coincidentally retentive,” and since they are not retention plans, are not subject to the requirements of § 503(c). *Id.* at 786. The Court thus held that they were only subject to § 363 and the general business judgment standard, which was met.
4. *In re Nellson Nutraceutical, Inc.*, 369 B.R. 787 (Bankr. D. Del. 2007).
- a. *Facts*: Debtor corporation sought to modify a bonus plan to authorize bonuses to all employees covered by the plan notwithstanding the fact that they did not meet the EBITDA target that would have triggered payment of bonuses. In the past, the corporation had regularly modified its bonus plan in this manner, increasing bonuses paid.
 - b. *Issue*: If this is a business decision made regularly in the course of business, do the restrictions in § 503(c) still apply? If so, is this bonus plan primarily incentivizing?
 - c. *Holding*: The Court held that § 503(c) applies regardless of whether the bonus plan was a decision made in the regular course of business. It further held that § 503(c) should be read to apply to transfers made “for the [*primary*] purpose of inducing such person to remain with the debtor’s business.” 369 B.R. at 802. The Court found that the primary purpose of this bonus program was to motivate employees, and that the modification of the bonus is also not for the primary purpose of inducing employees to remain with the business.

C. Proposed Legislation

- 1. An amendment to § 503(c) has been proposed in both the House and Senate. S. 2092, 110th Cong. (proposed 2007); H.R. 3652, 110th Cong. (proposed 2007) (proposed provisions italicized).

(c) Notwithstanding subsection (b), there shall neither be allowed, nor paid—

(1) a transfer made to, or an obligation incurred for the benefit of, an insider of the debtor for the purpose of inducing such person to remain with the debtor's business, *for the payment of performance or incentive compensation, or a bonus of any kind, or other financial returns designed to replace or enhance incentive, stock, or other compensation in effect prior to the date of the commencement of the case*, absent a finding by the court based on evidence in the record that—

...

(3) *other transfers or obligations, to or for the benefit of officers, of managers, or of consultants retained to provide services to the debtor, before or after the date of filing of the petition, in the absence of a finding by the court based upon evidence in the record, and without deference to the debtor's request for such payments, that such transfers or obligations are essential to the survival of the debtor's business or (in the case of a liquidation of some or all of the debtor's assets) essential to the orderly liquidation and*

maximization of value of the assets of the debtor, in either case, because of the essential nature of the services provided, and then only to the extent that the court finds such transfers or obligations are reasonable compared to individuals holding comparable positions at comparable companies in the same industry and not disproportionate in light of economic concessions by the debtor's nonmanagement workforce during the case.

11 U.S.C. § 503(c) (proposed 2007).

IX. Involuntary Petitions

A. A New Trend of Involuntary Filings

1. Annual Number of Involuntary Petitions in the Middle District of Florida

Year	Involuntary Petitions	Petitions filed under chapter 11	Corporations & L.L.C.s	Individuals w/primarily business debts
2004	6	1	4	1
2005	5	0	3	0
2006	15	4	8	6
2007	16	7	11	4
2008*	39	6	18	21

* Annualized forecast based on filings as of April 30, 2008.

B. Filing an Involuntary Petition

1. Requirements of filing under § 303(b):

(b) An involuntary case against a person is commenced by the filing with the bankruptcy court of a petition **under chapter 7 or 11** of this title—

(1) by **three or more entities**, each of which is either a **holder of a claim** against such person that is **not contingent as to liability or the subject of a bona fide dispute as to liability or amount**, or an indenture trustee representing such a holder, if such noncontingent, undisputed claims aggregate at least \$13,475 more than the value of any lien on property of the debtor securing such claims held by the holders of such claims;

(2) **if there are fewer than 12 such holders**, excluding any employee or insider of such person and any transferee of a transfer that is voidable under section 544, 545, 547, 548, 549, or 724(a) of this title, **by one or more** of such holders that hold in the aggregate at least \$13,475 of such claims;

...

11 U.S.C. § 303(b) (2008).

2. *In re All Media Properties, Inc.*, 646 F.2d 193 (11th Cir. 1981), *aff'g*, 5 B.R. 126 (Bankr. S.D. Tex. 1980).

a. *Facts*: Involuntary petitions were filed against two corporations. The alleged debtor corporations contested the filing, arguing that because some claims were disputed the creditors were not proper petitioning creditors under § 303, and the petition should be dismissed.

- b. *Issue*: What is required under the Code for the court to exercise jurisdiction over an involuntary debtor?
 - c. *Holding*: In a case of first impression, the bankruptcy court addressed the question of whether the requirements of § 303(b) had been met, and, concurrently held that these requirements were jurisdictional in nature and must be met for the court to exercise jurisdiction over an involuntary debtor. The old Fifth Circuit Court of Appeals adopted the bankruptcy court’s opinion.
 - i. “The intent of s 303(b) is that those who are not meeting their obligations can be forced to submit to the jurisdiction of the bankruptcy court.” 5 B.R. at 137.
 - ii. “Since all three claims are not contingent as to liability the court concludes that the jurisdictional requirements of s 303(h)(1) have been met and that there is jurisdiction to determine whether Artlite was generally not paying its debts as they become due.” 5 B.R. at 138.
 - iii. “This is not to say that the requirement that the petitioning creditors be holders of claims that are not contingent as to liability is not jurisdictional. It is only to say that this requirement does not mean that all claims must necessarily be liquidated, undisputed, matured, or reduced to judgment for the court to have jurisdiction.” 5 B.R. at 133.
3. *In re Trusted Net Media Holdings, L.L.C.*, 2008 WL 1816396 (11th Cir. Apr. 23, 2008).
- a. *Facts*: A single petitioning creditor with a contingent claim brought an involuntary petition against a debtor corporation with more than 12 creditors. The petition was not opposed, and the court entered an order for relief. Four years into the bankruptcy case, the corporation filed a motion to dismiss, arguing that § 303(b)’s requirements were not met and were jurisdictional and therefore could be raised at any point in the case. The bankruptcy court held that the requirements of § 303(b) were not jurisdictional and had been waived by the debtor. The district court affirmed, and the debtor appealed.
 - b. *Issue*: Are the requirements of § 303(b) jurisdictional and therefore not subject to waiver?
 - c. *Holding*: The Eleventh Circuit held that while it was persuaded that the better interpretation of § 303(b) is that its requirements are not jurisdictional, it was bound to follow *All Media*, which clearly held that § 303(b)’s requirements are jurisdictional, and therefore not subject to waiver:

Therefore, we conclude that we are bound by *All Media*’s decision that the requirements of § 303(b) must be satisfied in order for the bankruptcy court to have subject matter jurisdiction over an involuntary bankruptcy case. We recognize that the weight of authority—and, in our view, the superior reasoning—lie against that holding. Nevertheless, *All Media*’s holding in this regard is prior panel precedent, and therefore controls.

2008 WL 1816396 at *10.