

The “Other” Reforms: Selected Provisions on Business Bankruptcy in S.256

The primary focus on S.256 has been on its consumer bankruptcy provisions in general, and the means test, in particular. But, with over 500 pages of reform, there are plenty of changes in store for business bankruptcy cases. These changes include an entirely new chapter of the Code, Chapter 15, addressing cross-border insolvency cases, and complicated rules governing the netting of certain financial contracts. Title IV of the Bill includes general and small business bankruptcy provisions, and this paper highlights a number of those amendments.

Title IV of the Bill is titled General and Small Business Bankruptcy Provisions. Subtitle A of the title of the bill is titled “General Business Bankruptcy Provisions,” and Subtitle B is “Small Business Bankruptcy Provisions.” Notwithstanding this apparent split in the two subtitles, several of the provisions in Subtitle B (Small Business) actually apply to all cases. Therefore, this analysis includes first the generally applicable provisions, then the provisions applicable to small business debtors, and finally the provisions in the small business debtor subtitle that nonetheless apply to all cases.

Amendments that apply generally:

- **Section 402** of the bill would amend § 341 of the Code by adding a new subsection (e) that permits the court, after notice and a hearing, to dispense with a meeting of creditors if the debtor has filed a plan and solicited acceptances of the plan prior to the commencement of the case.
- **Section 404** of the bill amends current § 365(d)(4) to provide that the unexpired leases of nonresidential real estate in which the debtor is the lessee are deemed rejected and must be immediately surrendered to the lessor by the earlier of 120 days after the commencement of the case, or the date of the confirmation of a plan. The court, for cause, may extend the 120 day period for an additional 90 days, but any extension subsequent to the additional 90 days is available only with the consent of the lessor.
- **Section 405** of the bill recognizes the authority of the court to order the U.S. trustee to adjust the number of members and the makeup of committees under § 1102. The provision also suggests (“the court may order the United State trustee...”) that small business concerns, as defined in § 3(a)(1) of the Small Business Act, be added to the appropriate creditors’ committee if the claim the small business concern holds, in comparison with its annual gross revenue, is disproportionately large. So, a small business that has a “large” claim against the debtor can be added to the creditors’ committee and thereby play an active role in the case while holding down their costs.
- **Section 406** of the bill includes added protections for a warehouseman’s lien. They would be protected from actions under Code § 545 to avoid statutory liens.
- **Section 408** of the bill amends § 1125 of the Code to authorize the solicitation of acceptances or rejections of a plan if the entity “was solicited before the

commencement of the case in a manner complying with applicable nonbankruptcy law.” Thus, if a creditor received a solicitation to vote in favor of a plan in a prepackaged chapter 11, other lawful solicitations can be made during the pendency of the case.

- **Section 409** of the bill amends § 547(c)(2) of the Code by restructuring the provision (former subparagraphs (B) and (C) become (A) and (B), while former subparagraph (A) is subsumed into the opening language of the exception). More importantly, however, the “and” between former subparagraphs (B) and (C) becomes an “or” under the amended section. This effectively expands the exception to preference recoveries, especially in those jurisdictions that required proof of each of the conjunctively linked elements under § 547(c)(2).
- **Section 410** of the bill continues the focus on preferences although this is an amendment to the venue provision governing actions to collect money or property. Under the amendment, these actions must be brought in the defendant’s home district for any action to collect a consumer debt of less than \$15,000, or any other debt in excess of \$10,000. The \$10,000 business debt limit applies only if the defendant is a noninsider. If the defendant is an insider, the \$1,000 venue limit continues.
- **Section 411** of the bill imposes a new deadline for the exclusivity period for filing a plan under § 1121 of the Code. Under the amendment, the 120 day exclusivity period cannot be extended beyond 18 months from the date of the order for relief. Under the existing law, the court can extend or reduce the 120 day period on a showing of good cause. The existing law also contains no limit on the extent to which the court can reduce or extend the period. The amendment, however, sets an absolute limit for the exclusivity period to 18 months from the date of the order for relief. Extensions of the exclusivity period continue to require a good cause showing, but no extension can be made beyond 18 months from the order for relief. To the extent that the expiration of the exclusivity period results in a shifting of the balance of power in a chapter 11 case, this amendment will make this shift more certain in the future in cases where the debtor has a need for additional time in which to craft a plan.
- **Section 414** of the bill amends § 101(14) of the Code by deleting the provisions of that section that automatically render investment bankers for a security of the debtor (without regard to the timing of the issuance of the securities) and their attorneys not disinterested. Under the amendment, the only provision that would render investment banks not disinterested is the general provision that they may not have an interest materially adverse to the estate or any class of creditors or equity security holders.
- **Section 415** of the bill adds a new subparagraph (E) to § 330(a)(3) of the Code directing the court to consider whether a professional person is board certified or has otherwise demonstrated skill and experience in the bankruptcy field. The amendment makes board certification a specific factor in the award of compensation to professionals.
- **Section 417** of the bill amends § 366 of the Code by adding a fairly detailed definition of “assurance of payment” for purposes of that section. There are several mechanisms offered as appropriate “assurances of payment”, such as

prepayment or surety bonds. Interestingly, the amendment specifically provides that the timely payment of utility charges in the past is not evidence of assurance of payment in the future. Not surprisingly, the availability of an administrative expense priority is not an assurance sufficient under the provision.

- **Section 419** of the bill directs the Judicial Conference of the United States to prescribe forms for all chapter 11 debtors to disclose the “value, operations, and profitability” of entities in which the debtor holds a controlling or substantial interest. Not addressed by the provision is what happens if the entity, which is not in bankruptcy and which may not be controlled by the debtor (but rather is an entity in which the debtor’s interest is “substantial”) does not submit such a report. The entity is not itself a debtor, and the debtor may not be in a position to force the entity to complete the form.
- **Section 331** is an amendment that was added during the Senate markup of the bill. It includes strict limitations on the payment or allowance of claims for retention bonuses or severance pay to key personnel of the debtor. Specifically, the amendment provides that payments to induce persons who are insiders to remain in the debtor’s employ are not allowed unless the payment is essential to retain the person who has “a bona fide job offer from another business at the same or a greater rate of compensation”, and the amount of the payment does not exceed ten times the amount of a similar transfer to a non-management employee during the calendar year of the proposed transfer, or if no such transfer has been made to a non-management person during the calendar year of the case, then it may not exceed 25 times the amount of any similar transfer to an insider in the calendar year preceding the case. Severance pay is similarly limited to an amount not to exceed 10 times the amount of the mean severance pay given to non-management employees, unless the severance pay is a part of a program generally applicable to all employees. The amendment also prohibits the payment or allowance of any other obligations outside of the ordinary course of business as priority administrative expenses unless they are “justified by the facts and circumstances of the case.” Tying the maximum amounts to payments made to other employees during the calendar year of the case presumably includes both pre and post bankruptcy payments.

Amendments that apply in “small business” bankruptcy cases:

- **Section 431** of the bill adopts a more flexible process for the confirmation of plans in small business cases. Under this amendment, the court may determine that the plan contains sufficient information such that no disclosure statement is required. Additionally, disclosure statements can be submitted on standard forms and can be conditionally approved, with final approval to be given at the confirmation hearing. The hearing on approval of the disclosure statement may also be combined with the confirmation hearing itself. This should allow the case to proceed to confirmation with fewer hearings and less cost to the participants.
- **Section 432** of the bill sets out the definition of a small business. It is a person engaged in commercial or business activities, other than owning or operating real estate, and it must have no more than \$2 million in debt (excluding debt to

insiders or affiliates). Furthermore, for the debtor to be a “small business debtor”, either the U.S. trustee has not appointed a creditors’ committee in the case, or if a creditors’ committee was appointed, it “is not sufficiently active and representative to provide effective oversight of the debtor.” Since the U.S. trustee cannot appoint a committee until the case is filed and the debtor has identified some creditors, it would seem that a debtor that otherwise meets the definition at the moment of the filing of a voluntary petition would be a small business debtor, and would seem to lose that status when a committee is appointed. If the committee thereafter becomes “insufficiently active and representative”, the debtor might revert back to being a small business debtor. The definition has several loose ends.

- **Section 434** of the bill adds a new § 308 to the Code. That section establishes new reporting requirements for small business debtors. They must file periodic reports setting out their “profitability” (i.e. “the amount of money that the debtor has earned or lost during current and recent fiscal periods”), reasonable approximations of their projected cash receipts and disbursements, comparisons of their actual receipts and disbursements to their earlier projections, and stating their compliance with the Bankruptcy Rules, tax and other governmental filing obligations, and the payment of taxes. This reporting obligation does not become effective until 60 days after rules are prescribed to establish the forms for use in reporting the data. Section 435 of the bill directs the Judicial Conference to prescribe the forms.
- **Section 436** of the bill inserts a new § 1116 into the Code. That section sets out a list of 7 duties for the trustee or debtor in possession in small business cases. (Remember, it may be difficult in some cases to determine whether the debtor is a small business debtor. See the discussion of Section 432, supra.) Among the duties are filing financial statements and tax returns within 7 days of the date of the order for relief, meeting with the U.S. trustee prior to the § 341 meeting, timely filing other documents and tax returns during the case, and permitting the U.S. trustee to inspect the debtor’s premises and books and records.
- **Sections 437 and 438** of the bill set new deadlines for plan exclusivity and the filing and confirmation of a plan in a small business case. **Section 437** sets the exclusive period for the debtor to file a plan at 180 days after the order for relief, and the plan and disclosure statement, in any event, must be filed within 300 days after the order for relief. **Section 438** then provides that the court shall confirm a plan in a small business case not later than 45 days after the plan is filed, as long as it complies with the applicable provisions of the Bankruptcy Code. The deadlines for the exclusivity period, the time for filing plans, and the time for confirmation of a filed plan can only be extended for a reasonable time at the end of which confirmation of a plan will result. The order extending the time also must be signed before the existing deadline has expired. Thus, requests for extensions must be made in sufficient time to allow the court to hear and determine whether an extension is warranted. The passage of the deadline means that the debtor would not have a confirmable plan, and that would be grounds for conversion or dismissal of the case.

- **Section 439** of the bill creates a new obligation for the United States trustee to conduct initial interviews with small business debtors prior to the § 341 meeting of creditors. The interview is to evaluate the debtor’s financial viability and business plan and to set up an agreed scheduling order. It is also intended to provide an opportunity for the United States trustee to advise the debtor of various reporting and filing obligations. The amendment also requires the United States trustee to promptly move for conversion or dismissal whenever there are grounds for such a motion.

Amendments from the Small Business Subtitle that apply to all cases:

- **Section 440** of the bill amends § 105(d) of the Code to require (rather than simply to allow) the court to hold “such status conferences as are necessary to further the expeditious and economical resolution of the case.”
- **Section 441** of the bill places new limits on the availability of the automatic stay if a small business debtor has filed a previous bankruptcy case. Under the amendment, the automatic stay would not apply in a small business case if the debtor has another case pending simultaneously (presumably the stay in that case would be in effect), and the stay would not operate if the debtor was in a small business case that was dismissed within 2 years of the order for relief in the second case, or if the debtor had a plan confirmed in a small business case within 2 years of the new case. The provision also applies if an entity acquired all or substantially all of the assets in a small business of the kinds described above. The debtor can overcome this denial of the automatic stay by showing by a preponderance of the evidence that the second bankruptcy filing resulted from circumstances beyond the debtor’s control, and that it is more likely than not that the court will confirm a plan, other than a liquidating plan, in a reasonable time.
- **Section 442** of the bill is another provision that is included among the small business case changes, but the amendment applies in fact to all chapter 11 cases. It amends § 1112 of the Code by restating examples of cause for conversion or dismissal of chapter 11 cases. This section also amends § 1104(a) of the Code by adding a new subparagraph (3) which permits the court to appoint a trustee or examiner in lieu of converting or dismissing the case. The court also may deny an otherwise well-taken motion if the debtor or another party in interest establishes that there is a reasonable likelihood that a plan will be timely confirmed and that as to the grounds for granting the motion to dismiss or convert, there is a reasonable justification for the act or omission, and the failure will be cured within a reasonable time. If the “cause” for dismissal or conversion is substantial or continuing loss or diminution of the estate and an absence of a reasonable likelihood of rehabilitation, however, the court cannot deny dismissal or conversion even if the debtor shows a reasonable likelihood of timely confirmation of a plan. An interesting aspect of the amendment is that it substantially copies existing § 1112(b), and it adds a number of additional examples of grounds for dismissal or conversion. In the opening language of the proposed § 1112(b)(1), however, the bill would seem to change the category of

persons eligible to move for conversion or dismissal. Under the current provision, the issue is raised “on request of a party in interest or the United States trustee or bankruptcy administrator.” The bill, however, says that the issue can be raised “on request of a party in interest.” There is no mention of the United States trustee or bankruptcy administrator as parties that can raise this issue. Given the Supreme Court’s decision in *Lamie v. United States Trustee*, 540 U.S. 526 (2004), in which the Court held that the removal of the debtor’s attorney from the list of persons entitled to payment out of the estate prevented the payment of fees to the debtor’s attorney, the deletion of the United States trustee and the bankruptcy administrator from existing § 1112(b) could be construed as a Congressional determination that those parties cannot raise the issue of conversion or dismissal of chapter 11 cases. On the other hand, § 307 of the Code provides that the United States trustee may appear and be heard on any issue, and this separate statutory authority may be enough to grant standing to the U.S. trustee in these matters. It would also be unusual for Congress to create an entirely new set of duties for the United States trustee relative to the oversight of small business debtors, and then preclude the trustee from moving to dismiss or convert those cases in appropriate circumstances.

- **Section 444** of the bill amends § 362(d)(3) in a couple of aspects. The section sets out a requirement that as to single asset real estate, the debtor either must have filed a confirmable plan or have commenced making monthly payments to the secured creditor to keep the automatic stay in effect. This requirement arises under the existing law “90 days after the entry of the order for relief.” However, it may be difficult to know whether a particular case is a single asset real estate case, so the amendment provides that the important date is the later of the 90 day period, or 30 days after the court determines that the debtor has “single asset real estate.” The amendment also clarifies that the debtor may make payments to the creditor from the rents or other income generated by the property. Finally, the amendment changes the amount of the payment necessary to continue the stay in effect. Under the existing provision, the debtor must pay an amount “equal to interest at a current fair market rate on the value of the creditor’s interest in the real estate.” Under the amendment, the payment must be in the amount of the “nondefault contract rate of interest on the value of the creditor’s interest in the real estate.”
- **Section 445** of the bill adds a subparagraph (7) to § 503(b) of the Code. This provision caps the amount of an administrative expense claim resulting from the rejection of an unexpired lease of nonresidential real estate to the monetary obligations for a period of 2 years from the later of the rejection of the lease or the turnover of the premises. This amount is further limited to the extent that the claimant either recovers or has a right to receive payment from another source. Of course, any amount of the claim in excess of the cap would constitute a general unsecured claim allowable to whatever extent § 502(b)(6) permits.