

**HOW THAT PESKY CONSUMER  
PROTECTION ACT HAS AFFECTED BUSINESS  
BANKRUPTCIES: BAPCPA AND SIGNIFICANT  
RECENT RULINGS**

**By**

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# HOW THAT PESKY CONSUMER PROTECTION ACT HAS AFFECTED BUSINESS BANKRUPTCIES: BAPCPA AND SIGNIFICANT RECENT RULINGS

On April 20, 2005, the President signed the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"). BAPCPA § 1501 provides both that (a) BAPCPA will have a general effective date of October 17, 2005, and (b) BAPCPA is applicable only to bankruptcy cases filed on or after the effective date. *In re OptinRealBig.com, LLC*, 345 B.R. 277 (Bankr. D. Colo. 2006) (BAPCPA does not apply where a bankruptcy case was filed before the effective date). Even in cases filed before the effective date, however, some bankruptcy courts have found that BAPCPA is instructional. *See, e.g., In re Tom Foods Inc.*, 341 B.R. 82, 90 (Bankr. M.D. Ga. 2006); *In re Mirant Corporation*, 348 B.R. 720 (Bankr. N.D. Tex. 2006).

## I. LIMITATIONS ON EXECUTIVE COMPENSATION UNDER SECTION 503

### A. BAPCPA Provisions

BAPCPA took specific aim at congressional concern over what it viewed as abuses in key employee retention payments, known as "KERPs." The "import of the BAPCPA provisions dealing with KERPs was Congress's effort 'to eradicate the notion that executives were entitled to bonuses simply for staying with the Company through the bankruptcy process.'" *In re Global Home Products, LLC*, 2007 Bankr. LEXIS 758 at \*15 (Bankr. D. Del., March 6, 2007) (citations omitted). As noted in *In re Dana Corporation*, 358 B.R. 567 (Bankr. S.D.N.Y. 2006):

Senator Edward Kennedy proposed the amendment to section 503 of the Bankruptcy Code as a last-minute addition to the bill, expressing his concern over the "glaring abuses of the bankruptcy system by the executives of giant companies like Enron Corp. and WorldCom Inc. and Polaroid Corporation, who lined their

own pockets, but left thousands of employees and retirees out in the cold.

358 B.R. at 575 (citations omitted). To accomplish this goal, Congress enacted three changes to § 503 of the Bankruptcy Code, each as discussed below.

**1. Amended Section 503(c)(1)**

First, amended § 503(c)(1) prohibits the allowance and payment of sums to "insiders" (as that term is defined in § 101(31) of the Bankruptcy Code) "for the purpose of inducing such person to remain" with the business "absent a finding by the court based on the evidence in the record" that (1) the payment is "essential" to the retention of the individual "because the individual has a bona fide job offer from another business at the same or greater rate of compensation;" and (2) the services of that individual are "essential to the survival of the debtor's business." Section 503(c)(1), sometimes known as the "KERP statute" also fixes the measure of acceptable retention bonuses for insiders by linking them to a multiple of bonuses available to non-management employees. The amount to be paid or incurred must not be greater than an amount equal to 10 times the mean of a similar kind given to nonmanagement employees or, if no such similar transfers were made or incurred, the amount must not be greater than 25% of the amount of any similar transfer made or incurred for the benefit of such insider for any purpose during the calendar year before the year in which the transfer or obligation was incurred.

**2. Amended Section 503(c)(2)**

Second, amended § 503(c)(2) prohibits a severance payment to an insider **unless**:

- The payment is part of a program that is generally applicable to all full-time employees; and
- The amount of the payment is not greater than 10 times the amount of the mean severance pay given to nonmanagement employees during the calendar year in which the payment is given. § 503(c)(2).

### 3. Amended Section 503(c)(3)

Finally, amended § 503(c)(3) prohibits the payment or other transfers or obligations outside the ordinary course of business incurred for the benefit of officers, managers or consultants hired after the commencement of bankruptcy **unless** “justified by the facts and circumstances of the case.” § 503(c)(3).

The revisions to § 503(c)(1)-(3) make it “abundantly clear” that “KERPs and severance arrangements subject to review under § 503(c) – those whose purpose it is to retain employees – are severely limited.” *Global Home*, 2007 Bankr. LEXIS 758 at \*17 (emphasis added).

#### B. BAPCPA Cases

In *In re Dana Corporation*, 358 B.R. 567 (Bankr. S.D.N.Y. 2006), the debtor proposed an executive compensation plan that violated amended § 503(c)(1), because it did not provide sufficient performance incentives and provided compensation based primarily on retention rather than performance. The debtor then proposed a revised plan, consisting of executive salary, annual incentive pay, long term incentive pay and the assumption of certain unfunded pension obligations conditioned upon (among other things) the non-termination of certain union pension plans.

In *Dana*, the court noted that § 503(c)(1) was not intended to foreclose a chapter 11 debtor from reasonably compensating employees, including insiders, for their contribution to the debtor’s reorganization to the extent that such payments are made within the ordinary course of business. 358 B.R. at 575. Stated differently, § 503(c)(1) “restricts transfers or payments by debtors to the extent that such payments are outside the ordinary course” of business. *Id.*

The court in *In re Nellson Nutraceutical, Inc.*, 2007 Bankr. LEXIS 1778 at \*33 (Bankr. D. Del. May 24, 2007), “respectfully disagree[d]” with the *Dana* finding that § 503(c)(1) only applies to payments made outside of the ordinary course of business. In so ruling, the court found as follows:

Nothing in § 503(c)(1) of the Bankruptcy Code limits its applicability to transactions or payments made outside the ordinary course of business. The only limitation in section



503(c)(1) is that the transfer be "for the benefit of, an insider of the debtor for the purpose of inducing such person to remain with the debtor's business." 11 U.S.C. § 503(c)(1). Under well-established canons of statutory construction, the Court need go no further than the plain meaning of the statute to determine its meaning. . . . Under the principle of *noscitur a sociis*, the meaning of an unclear word or phrase should be determined by the words immediately surrounding it. . . . The inclusion of the limiting language "outside the ordinary course of business" in section 503(c)(3) counsels against reading such a limitation into section 503(c)(1). Thus, under the established canons of statutory construction, section 503(c)(1) of the Bankruptcy Code is applicable to the Debtors' modification of the 2006 OCP [KERP], provided that the payments under the bonus program are to "an insider of the debtor for the purpose of inducing such person to remain with the debtor's business." 2007 Bankr. LEXIS 1778 at \*34-35 (citations omitted).

Having determined that § 503(c)(1) was applicable the *Nellson Nutraceutical* court next examined whether the proposed KERP constituted a transfer to an insider of the debtor for the purpose of inducing such person to remain with the debtor's business. First, § 503(c)(1) only applies to "insiders," which includes the debtor's directors and officers under § 101(31). 2007 Bankr. LEXIS 1778 at \*35. Therefore, proposed payments to sales directors, sales managers, and office managers did not come within the ambit of § 503(c)(1). 2007 Bankr. LEXIS 1778 at \*36. Second, § 503(c)(1) only applies where the payment is "for the purpose of inducing such person to remain with the debtor's business." The court noted that because "[a]ny payment to an employee, including regular wages, has at least a partial purpose of retaining the employee, . . . if the Court did not apply a materiality standard, all payments to insiders would be subject to 503(c)(1), which would be an absurd result." 2007 Bankr. LEXIS 1778 at \*37. Thus, the *Nellson Nutraceutical* court read § 503(c)(1) to mean "'a transfer made to . . . an insider of the debtor for the [primary] purpose of inducing such person to remain with the debtor's business." 2007 Bankr. LEXIS 1778 at \*37 (quoting § 503(c)(1) (emphasis added)). Accord *Dana*, 358 B.R. 571; *In re Global Home Products, LLC*, 2007 Bankr. LEXIS 758 (Bankr. D. Del. March 6, 2007). The *Nellson*

*Nutraceutical* court concluded that the KERP in that case was for the primary purpose of motivating employees and, thus, the limitations of § 503(c)(1) were inapplicable. 2007 Bankr. LEXIS 1778 at \*38-39.

The *Nellson Nutraceutical* court also reviewed § 503(c)(3). That subsection limits payment of obligations outside of the ordinary course of business that are not covered by subsection (1) or (2), providing: there shall neither be allowed, nor paid- (3) other transfers or obligations that are outside the ordinary course of business and not justified by the facts and circumstances of the case, including transfers made to, or obligations incurred for the benefit of, officers, managers, or consultants hired after the date of the filing of the petition. 11 U.S.C. § 503(c)(3). The court found that the debtors' modification of the KERP was in the ordinary course of the debtors' business and, therefore, under the plain meaning of the statute, § 503(c)(3) was inapplicable. 2007 Bankr. LEXIS 1778 at \*44-45. In so ruling, the court rejected the argument that the use of the phrase "outside of the ordinary course of business" in § 503(c)(3) was "illustrative as opposed to exclusive." 2007 Bankr. LEXIS 1778 at \*44.

## **II. OFFICIAL COMMITTEES UNDER SECTION 1102**

Section 1102 of the Bankruptcy Code, 11 U.S.C. § 101 *et seq.* (the "Bankruptcy Code"), deals with the appointment and duties of official committees. Under BAPCPA § 405, several changes were made to § 1102, as discussed below.

### **A. Committee Membership Disputes**

#### **1. Before BAPCPA**

Before BAPCPA, § 1102(a)(1) of the Bankruptcy Code provided that, as soon as practicable, the office of the United States Trustee (the "UST") shall appoint a committee of creditors holding unsecured claims, and "may" appoint additional committees of creditors or equity security holders, as the UST "deems appropriate." Pre-BAPCPA § 1102(a)(2) further provided that the bankruptcy court, on request of a party in interest, may appoint additional committees of creditors or equity security holders "if necessary to assure adequate representation of creditors or of equity security holders." Based on the express language of former §

1102(a)(1) and (a)(2), some courts found that only the UST could appoint members to an official committee, and that bankruptcy courts were without power to become involved in any disputes regarding committee membership. Additionally, the UST took the position that, under § 1102 before BAPCPA, the bankruptcy court did not have authority over committee membership disputes.

In the few cases where adequate representation was litigated, it was clear that the moving party had the burden of proving the lack of adequate representation on the currently constituted committee. Prior to the enactment of § 1102(a)(4), in determining "adequate representation" for purposes of § 1102(a)(2), bankruptcy courts applied certain factors to determine the adequacy representation, including but not limited to, (1) the ability of the committee to function, (2) the nature of the case, (3) the standing and desires of the various constituencies, (4) the ability for creditors to participate in the case without committee representation, (5) whether different classes may be treated differently under the plan and need representation, and (6) the motivation of the movant. *See In re Winn-Dixie Stores Inc.*, 326 B.R. 853, 857 (Bankr. M.D. Fla. 2005); *In re Enron Corp.*, 279 B.R. 671, 685 (Bankr. S.D.N.Y. 2002).

Courts have held that adequate representation exists as long as the diversified interests of various creditor groups are represented and participate in the committee. *In re Doehler-Jarvis Inc.*, No. 97-953, 1997 WL 827396 at \*3 (D. Del. Oct. 7, 1997). Further, creditors are adequately represented if their interests "have a meaningful voice in the committee relative to their posture in the case." *In re Garden Ridge Corp.*, No. 04-10324, 2005 WL 523129 at \*3 (Bankr. D. Del. March 2, 2005) (citing *In re Dow Corning Corp.*, 194 B.R. 121, 141 (Bankr. E.D. Mich. 1996)), *rev'd on other grounds*, 212 B.R. 258 (Bankr. E.D. Mich. 1997). A committee's ability to function is a strong indicator as to whether the committee is able to adequately represent all unsecured creditors in a case. *Enron*, 279 B.R. at 686. At the same time, courts have recognized that a committee of unsecured creditors often consists of creditors with "a variety of viewpoints, and thus conflicts are not uncommon, especially when creditors are acting individually to protect their separate business interests." *In re Garden Ridge Corp.*, 2005 WL 523129 at \*4. Courts

have focused on whether "conflicts of interest on the committee effectively disenfranchise particular groups of creditors." *Enron*, 279 B.R. at 686. Adequate representation is lacking when conflicts on a creditors' committee prevent it from upholding its fiduciary obligations to all general unsecured creditors. *Garden Ridge*, 2005 WL 523129 at \*4.

## 2. BAPCPA Provisions

BAPCPA expressly authorizes the bankruptcy court to order the UST to change committee membership in order "to ensure adequate representation of creditors or equity security holders." § 1102(a)(4). Accordingly, the bankruptcy court's authority to alter the membership of the committee is not unfettered. *See* 7 COLLIER ON BANKRUPTCY ¶ 1102.07[2], 1102-31 (15<sup>th</sup> ed. 2007). Moreover, although the court will order the UST to change the membership, the appointment of replacement members is still a decision that will be made by the UST. *Id.*

Because the UST has resolved most committee membership disputes, some creditors have been frustrated with the constitution of committees. Actively involving the courts in membership disputes, on the other hand, could be disruptive of the bankruptcy process. Unhappy with a member's position, or a committee's position, interested parties could raise membership issues as a litigation tactic designed to directly or indirectly attack legitimate committee decisions.

BAPCPA specifically requires "a notice and a hearing" before a court-ordered change in committee membership, whereas pre-BAPCPA § 1102(a)(2) did not expressly mention notice and hearing as a prerequisite to a court-ordered appointment of an additional committee. It seems doubtful, however, that this oversight in drafting will be interpreted as authority for dispensing with the notice and hearing requirements, as set forth in the Bankruptcy Rules or applicable local rules.

Section 1102(a)(4) is silent as to the standard of review a bankruptcy court will apply when reviewing the adequacy of representation. Prior to the enactment of § 1102(a)(4), courts in

different jurisdictions applied different standards of review when considering the adequacy of representation under § 1102(a) for purposes of determining whether an additional committee should be appointed or if a creditor should be appointed to a creditors' committee. The fact that § 1102(a)(4) does not place any restriction on the bankruptcy court's review of the composition of a creditors' committee arguably suggests that a *de novo* standard should be applied to this section. Application of the *de novo* standard would allow a bankruptcy court to substitute its judgment for that of the UST. See *In re Fast Mart Convenience Stores Inc.*, 265 B.R. 427, 431 (Bankr. E.D. Va. 2001).

Finally, new § 1102(a)(4) empowers the bankruptcy court to "order the United States Trustee to change the membership of a committee appointed under this subsection" if it determines a change is necessary to ensure adequate representation. It remains to be seen how a court will ultimately exercise this authority. In certain cases decided prior to the enactment of § 1102(a)(4), courts have directed the UST to reconstitute the committee. See, e.g., *In re Mercury Finance Co.*, 240 B.R. 270, 280 (N.D. Ill. 1999).

#### **B. Membership of "Small Business Concerns"**

Apparently concerned that small businesses have been excluded from committee membership, BAPCPA now authorizes, but does not require, the UST "to increase the number of members of a committee [and] to include a creditor that is a small business concern," as described in Section 3(a)(1) of the Small Business Act. In order to require additional members (or, inclusion of a small business concern as an additional member, as the section should read), the court must determine that the "creditor holds 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" compared to that creditor's annual revenues. § 1102(a)(4).

These amended provisions raise a number of issues concerning how the UST will solicit committee membership, especially since the UST would not know whether creditors holding claims that are not listed in the List of Twenty Largest Unsecured Creditors are

"small business concerns." In determining membership issues, the UST and perhaps the bankruptcy court will have the additional burden of both (a) trying to make a determination on whether the creditor constitutes a "small business concern" within the meaning of the Small Business Act, and (b) whether the creditor's claim is sufficiently large compared to its annual gross revenue in order to justify committee membership.

## C. Information Sharing

### 1. Before the BAPCPA

The role of a committee is vital to the bankruptcy process. The committee is formed to ensure that the rights and interests of unsecured creditors are protected. It is well-settled that the members of an official committee of unsecured creditors owe a fiduciary duty to all of the debtor's unsecured creditors. *See, e.g., In re SPM Manufacturing Corp.*, 984 F.2d 1305, 1315 (1st Cir. 1993); *In re Smart World Technologies LLC*, 423 F.3d 166, 175 n. 12 (2d Cir. 2005). Section 1103(c) of the Bankruptcy Code requires that a committee perform services which are in the interest of those represented, *i.e.*, all of the debtor's unsecured creditors. These services may include consultation with a trustee or debtor-in-possession (DIP) regarding the administration of the case, investigation into the financial condition of the debtor, investigation regarding the conduct of the debtor and potential causes of action, and participation into the formation of a plan. Further, upon court approval, a committee may act as a fiduciary on behalf of the debtor's estate. For example, committees have initiated adversary proceedings in chapter 11 cases on behalf of estate to pursue various causes of action. *See, e.g., In re Louisiana World Exposition Inc.*, 832 F.2d 1391 (5th Cir. 1987) (committee filed adversary proceeding against debtor's officers and directors, charging them with malfeasance and mismanagement). Committees must work with the debtor or trustee to obtain information necessary to carry out these duties. Often, the information received by the committee from the debtor is confidential, proprietary or privileged, and the parties may need to enter into a confidentiality agreement prior to disclosing such information.

## 2. BAPCPA Provisions

BAPCPA provides that an official committees "shall . . . provide access to information" to non-committee members who hold claims of the kind represented by the committee. § 1102(b)(3)(A). Many fear that the broad language of § 1102(b)(3) may hinder a committee's ability to fulfill its duties and will hinder the free flow of information between the debtor and the committee.

Before disseminating non-public, confidential or proprietary information, many debtors require committees to incorporate confidentiality provisions in their by-laws, or committee members to sign confidentiality agreements. Because the new access requirement is not expressly limited to public information, the access requirement will impact the extent to which debtors share non-public, confidential information with committees and their members. By way of example, the non-public information could include the debtor's business plans to expand into, or retreat from, highly competitive markets. Further, BAPCPA does not address the situation where "access" is sought by a competitor who holds a claim against the debtor. While committee members have fiduciary duties to the committee constituents, even without being bound by confidentiality, non-members have no such duties.

On its face, the plain language of § 1102 (b)(3) is ambiguous and may be broadly construed. The legislative history of § 1102(b)(3) does not provide much guidance on determining what type of "information" a committee must share with the unsecured creditors not appointed to the committee or the mode in which the committee must solicit and receive comments from such creditors. The House Report offers little help in interpreting the requirements of § 1102(b)(3), but only states that this section "requires the committee to give creditors having claims of the kind represented by the committee access to information. In addition, the committee must solicit and receive comments from these creditors and, pursuant to court order, make additional reports and disclosures available to them." H.R. Rep. No. 109-31, 109th Cong., 1st Sess. 87 (2005).

### 3. BAPCPA Cases

Indeed, the uncertainties associated with amended § 1102(b)(3) have lead some committee's to file a motion for entry of an order that clarifies the committee's requirements to provide access to information and setting and fixing creditor information sharing procedures and protocol (the "Committee Motion"). Judge Brown recently granted such a Committee Motion in *In re OCA, Inc., et al.*, case no. 06-10179(B) (P-370) on the docket of the United States Bankruptcy Court for the Eastern District of Louisiana (the "OCA Committee Motion"). Other examples of Committee Motions include *In re Premium Papers Holdco, LLC et al.*, case no. 06-10269 (CSS) on the docket of the United States Bankruptcy Court for Delaware, and *In re Calpine Corporation*, case no. 05-060200 (BRL) on the docket of the United States Bankruptcy Court for the Southern District of New York.

In *Refco Inc.*, 336 B.R. 187, 190 (Bankr. S.D.N.Y. 2006), the court's first inclination was to deny a Committee Motion filed in that case only three days after the committee's appointment, because (a) there was "no case or controversy," and (b) no "adverse consequences" articulated for a failure to comply with amended § 1102. Ultimately, the court granted the Committee Motion, finding that it was "a large and rapidly moving case, and meaningful information may become stale before the completion of litigation over whether and how it should be provided." *Id.* (the order granting the Committee Motion is attached to the opinion). The court was also persuaded by the fact that "unsecured creditors apparently were pressing for information in ways that raised issues neither expressly addressed by statute nor, given the section's recent enactment, in the case law." *Id.*

Interestingly, the *Refco* court also found that the "access to information" language contained in amended § 1102(b)(3)(A) is similar to the requirements of § 704(7) of the Bankruptcy Code for bankruptcy trustees. *Refco*, 336 B.R. at 192. That section provides that the trustee shall, unless otherwise ordered, "furnish such information concerning the estate and the estate's administration as is requested by a party in interest." The court went on to conclude that the differences between amended § 1102(b)(3)(A) and § 704(7)



are "immaterial," even though § 704(7) only requires the trustee to furnish information upon request. *Refco*, 336 B.R. at 192.

In *Refco*, the court discussed the importance of confidentiality and non-public, proprietary information, and concluded that "[m]aintaining the parties' reasonable expectations of confidentiality . . . is critical to a committee's performance of its oversight and negotiating functions, compliance with applicable securities laws, and the proper exercise of committee members' fiduciary duties." *Refco*, 336 B.R. at 197. In addition, "[m]aintaining confidentiality against unsecured creditors generally also may be necessary to preserve a committee's attorney-client privilege." *Id.* Therefore, the committee must "proceed cautiously concerning the disclosure of information that could reasonably have the effect of waiving the attorney-client or other privileges . . . , notwithstanding Bankruptcy Code section 1102(b)(3)." *Refco*, 336 B.R. at 197.

The *Refco* court also acknowledged that confidentiality concerns must be balanced against "the right of unsecured creditors to be informed of material developments in the case before they are presented with what in practical terms may be a *fait accompli*." *Id.* The court concluded that, by granting the Committee Motion, the "balance has been achieved by not requiring in the first instance -- that is without further court order -- the Committee's disclosure of information (a) that could reasonably be determined to be confidential and non-public or proprietary, (b) the disclosure of which could reasonably be determined to result in a general waiver of the attorney-client or other applicable privilege, or (c) whose disclosure could reasonably be determined to violate an agreement, order or law, including applicable securities laws." *Id.* at 198. On the other hand, the order also provides that, when deciding whether to release otherwise protected information, the committee must take into account the requesting party's willingness to agree to such constraints on confidentiality and/or trading constraints. *Id.* If a creditor disagrees with the committee's decision not to disclose protected information, the creditor is free to raise "any argument to show that the Committee's need to protect specified information is not outweighed by the creditor's legitimate need to receive it." *Id.*

Other cases where orders were entered similar to *Refco* include the following: *In re Amcast Automotive of Indiana Inc.*, Case No. 05-33322 (FJO) (Bankr. S.D. Ind.); *In re FLYi Inc.*, Case No. 05-20011 (MFW) (Bankr. D. Del.); *In re Nobex Corp.*, Case No. 05-20050 (MFW) (Bankr. D. Del.); *In re Pliant Corp.*, Care No. 06-10001 (MFW) (Bankr. D. Del.); *In re Riverstone Networks Inc.*, Case No. 06-10166 (PJW) (Bankr. D. Del.); *In re Fibrex Cordage LLC*, Case No. 05-38080 (RFH) (Bankr. M.D. Ga.); *In re The Consumers Trust*, Case No. 05-60155 (REG) (Bankr. S.D.N.Y.); *In re Airway Industries Inc.*, (JKF) (Bankr. W.D. Pa.); *In re Gooding's Supermarkets Inc.*, Case No. 05-17769 (Bankr. M.D. Fla.); *In re Hardwood P-G Inc.*, Case No. 06-50057 (LMC) (Bankr. W.D. Tex.); *In re Verilink Corp.*, Case No. 06-80566(JAC) (Bankr. N.D. Ala.); *In re Larry's Markets Inc.*, Case No. 06-11378 (PHB) (Bankr. W.D. Wash.); *In re Buffalo Coal Co. Inc.*, Case No. 06-00366 (PMF) (Bankr. N.D. W.Va.); *In re Best Manufacturing Group LLC*, Case No. 06-17415 (DHS) (Bankr. D. N.J.); *In re Complete Retreats LLC*, Case No. 06-50245 (AHWS) (Bankr. D. Conn.).

#### **D. "Additional Reports and Disclosures"**

##### **1. BAPCPA Provisions**

BAPCPA also provides that the court may compel "additional reports or disclosures to be made to creditors." § 1102(b)(3)(C). In other words, it appears that committees may be "compelled" to prepare and disseminate "additional reports" or "disclosures." Further, the preparation and dissemination of "additional reports or disclosures" could be costly and time-consuming. If the estate is administratively insolvent, the committee may not have the resources to produce "additional reports or disclosures." In that instance, presumably the court would not compel the committee to make "any additional reports or disclosures." Again, this is an area that will be addressed in litigation.

##### **2. BAPCPA Cases**

Some of the Committee Motions contain provisions that outline the type of information (i.e., reports and disclosures) that will be provided to the constituents of the committee, typically via a password protected website. By way of example, additional

reports and disclosure may include (i) quarterly reports summarizing recent proceedings, (ii) events and public financial information, (iii) highlights of significant and material events in the bankruptcy case, (iv) a calendar with upcoming significant and material events or hearings in the bankruptcy case, (v) responses to creditor questions, and (vi) comments and requests for access to information. (Order granting the OCA Committee Motion, at Paragraph 4.)

#### **E. Soliciting "Comments"**

BAPCPA also provides that the committee "shall . . . solicit and receive comments from the creditors" that the committee represents. § 1102(b)(3). The new section does not address the frequency of, reasons for, extent of, or format of, such "solicitations."

"Perhaps the simplest way [for a committee to satisfy its obligation to solicit and receive comments] would be for a committee to send a letter to creditors notifying them that they would be welcome to provide comments to the committee or its professionals." 7 COLLIER ON BANKRUPTCY at 1102-34.1. According to this commentator, "[i]f this were included as part of a general distribution by the debtor to creditors, this duty could be fulfilled at nominal additional cost." *Id.*

Some of the Committee Motions contain a provision that the committee is not required to solicit comments from any entity that has not demonstrated, to the satisfaction of the committee, "in its sole discretion, or to the Court, that it holds claims of the kind described in § 1102(b)(3) (meaning, creditors holding claims that are represented by the committee) (Order granting the OCA Committee Motion, at Paragraph 7).

### **III. APPOINTMENT OF A TRUSTEE OR EXAMINER UNDER SECTION 1104**

Section 1104 of the Bankruptcy Code deals with the appointment of a trustee or examiner in a chapter 11 case. Under BAPCPA §§ 416, 442(b), and 1405, several changes were made to § 1104, as discussed below.

## A. Appointment of a Chapter 11 Trustee or Examiner

### 1. Before BAPCPA

Before BAPCPA, § 1104(a) provided that, on request of a party in interest or the UST, the court "shall" order the appointment of a trustee in a chapter 11 case "for cause," including certain examples such as fraud, dishonesty, incompetence or gross mismanagement.

### 2. BAPCPA Provisions

After BAPCPA, amended § 1104(a)(4) continues to contain a non-exhaustive list of the reasons supporting the appointment of a trustee. BAPCPA alters the examples to the non-exhaustive list, including a number of new examples. After BAPCPA, the court "shall" order the appointment of a trustee "if grounds exist to convert or dismiss the case under amended § 1112, *but* the court determines that the appointment of a trustee or *examiner is in the best interests of creditors and the estate.*" § 1104(a)(3)(emphasis added). In other words, if the court finds that grounds exist to order conversion or dismissal, the court can appoint a trustee or examiner instead if such appointment would be in the best interests of creditors and the estate. This concept is incorporated into amended § 1112(b).

### 3. BAPCPA Cases

The UST moved to dismiss a chapter 11 case in *In re Incredible Auto Sales*, 2007 WL 1100276 (Bankr. D. Mont. April 10, 2007). Under BAPCPA, the court must determine whether conversion is in the best interest of the creditors and the estate and the movant must establish cause. The court in *Incredible Auto Sales* noted that pre-2005 amendments, the language was "may" as opposed to "must" convert or dismiss absent unusual circumstances or where the debtor can show that a chapter 11 plan will be confirmed within a reasonable time period. The debtor failed to appear for more than 3 weeks in the case and had made what the court called, "pathetic attempts" to formulate a chapter 11 plan so the court found that conversion to chapter 7 was in the best interest of the debtor's creditors. Additionally, the court found that the debtor's

management had grossly mismanaged the debtor's business both before and after filing bankruptcy. *Id.* at \*6. The evidence also "overwhelmingly" showed that the debtor's organization had falsified certificates of title and other financial information. *Id.* at \*4. See *In re 10 Bears at Chiloquin, Inc.*, 2007 WL 1673538 \*4 (Bankr. D. Or. June 6, 2007) (case filed under BAPCPA was converted to chapter 7, after the court found a "pattern of bad faith and mismanagement which has caused considerable loss" to creditors).

In *In re Broad Creek Edgewater, LP*, 2007 WL 2094059 (Bankr. D. S.C. July 18, 2007), the debtor moved to convert an involuntary chapter 7 case to a chapter 11 reorganization. The court noted that, after BAPCPA, the court's discretion to convert to chapter 11 was diminished; that is, cause exists to convert or dismiss a case only if (a) the court makes specific findings of unusual circumstances that establish that the conversion or dismissal is not in the best interests of the estate, or (b) if an objecting party in interest establishes that the facts of a case fall within the confines of § 1112(b)(2). *Broad Creek*, 2007 WL 2094059 at \*6. While the debtor made a prima facie showing of cause to convert the case in *Broad Creek*, the court found that the creditors also established gross mismanagement of the company before the commencement of the case, which would be cause to dismiss or convert the case. *Id.* at \*7. Accordingly, the court denied to motion to convert. *Id.*

In *In re The 1031 Tax Group, LLC*, 2007 Bankr. LEXIS 2661 (Bankr. S.D.N.Y., August 13, 2007), the bankruptcy court denied the UST's motion to appoint a trustee or convert the debtors' chapter 11 cases. Although decided under BAPCPA, the court noted that "[t]here is a strong presumption that a debtor should remain in possession absent a showing of need for the appointment of a trustee." *Id.* at \*13-14. Further, although "the court's finding is limited to a factual determination whether 'cause' exist, a court is given wide latitude in determining whether the challenged conduct rises to the level of 'cause.'" *Id.* at \*15 (citing *Comm. of Dalkon Shield Claimants v. A.H. Robins Co., Inc.*, 828 F.2d 329, 241-242 (4<sup>th</sup> Cir. 1987)). The court in *Tax Group*, the court found that conversion was not in the best interests' of the creditors. In so ruling, the court noted that the "fact that there is a continuing loss to the estate, due to the

mounting administrative costs and lack of any new business entering the estate, is insufficient to establish 'cause' within the meaning of § 1112(b)." 2007 Bankr. LEXIS 2661 at \*38 (citing *In re Photo Promotion Assocs., Inc.*, 47 B.R. 454, 458 (S.D.N.Y. 1985) (must also show absence of a reasonable likelihood of rehabilitation)).

## **B. UST's Obligations to Seek Appointment**

### **1. BAPCPA Provisions**

Under BAPCPA, the UST is obligated to seek the appointment of a trustee under amended § 1104(e) "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 report.*" BAPCPA § 1405, entitled, "Appointment of trustee in cases of suspected fraud;" § 1104(e) (emphasis added).

After BAPCPA, the UST is under no obligation to seek the appointment of a trustee for any grounds other than for "fraud, dishonest, or criminal conduct" in managing the company, as specified in amended § 1104(e). Further, although the UST's obligations are triggered by "reasonable grounds to suspect," the bankruptcy court applies a different standard in deciding whether to appoint the trustee. That is, the court must conclude, as opposed to "suspect," that (i) cause exists for the appointment of a trustee, and (ii) the appointment is in the best interests of the creditors, stockholders, and the estate under amended § 1104(a).

### **2. BAPCPA Case**

The court examined § 1104(e) in *In re The 1031 Tax Group, LLC*, 2007 Bankr. LEXIS 2661 (Bankr. S.D.N.Y., August 13, 2007). The court found that, while the UST may be obligated to bring § 1104 motions under certain circumstances (as discussed below with respect to § 1104(e)), BAPCPA did not change the standards for mandatory or discretionary appointment of a trustee under. 2007 Bankr. LEXIS 2661 at \*20. After examining the meager legislative history of

BAPCPA, the court concluded that § 1104(e) gave the UST “an important but ill-defined role requiring vigilance and action where fraud, dishonesty, or criminal conduct by ‘current members’ of management is suspected.” 2007 Bankr. LEXIS 2661 at \*17. That is, the UST must “seek an order requiring appointment of a chapter 11 trustee whenever the ‘reasonable grounds to suspect’ standard is met.” *Id.* Although the court ultimately denied the motion, the court also found that the “reasonable grounds to suspect” standard in § 1104(e) (reasonable grounds to suspect) was met in the *Tax Group* case when the UST brought the motion. *Id.* The court concluded that the UST acted “prudently” in bringing the motion, and challenging “whether new management is tainted by an association with, or selection or appointment by, the governing body” where selected by tainted members of the then current governing body of the debtor. *Id.* at \*19.

In a case of first impression, in *Tax Group*, the court found that where the UST has established “a *prima facie* case that a tainted current member of the governing body has selected or appointed new management shortly before or after a chapter 11 filing, a court should apply a heightened scrutiny in reviewing whether new management is also tainted, thereby requiring appointment of a chapter 11 trustee for ‘cause.’” *Id.* at \*20. After the *prima facie* showing is made by the UST, “the burden then shifts to the debtors, or other parties opposing the appointment . . . , to demonstrate that the new management is unconflicted by any association with the tainted members of the governing body that made the selection or appointment.” *Id.* at \*20-21. “Reasonable grounds” to bring the motion, however, is not the same thing as a *prima facie* showing. *Id.* at \*21 n.9.

In *In re Bayou Group, LLC*, 363 B.R. 674 (S.D.N.Y. 2007), in April of 2006, prior to the UST’s filing a motion to appoint a trustee, and at the request of a group of creditors, the district court appointed an attorney to act as the *non*-bankruptcy federal equity receiver (the “Receiver”) of the Bayou On-shore entities (collectively, the “Bayou Entities”). *Id.* at 676. The Receiver was appointed the “exclusive managing member” of the Bayou Entities, and was given the “sole and exclusive power and authority to manage and direct the

business and financial affairs of the Bayou Entities, including without limitation, the authority to petition for relief under the Bankruptcy Code . . . and in connection therewith be and deemed a debtor-in-possession for any or all of the Bayou Entities.” *Id.* at 678.

Shortly after entry of the district court’s order appointing the Receiver, each of the Bayou Companies filed voluntary petitions for relief under chapter 11, and the Receiver continued to serve as exclusive managing members for the group of companies. Upon learning of this arrangement, the UST filed a motion to appoint a chapter 11 trustee, which was denied by the bankruptcy court. *See id.* at 677. In so ruling the bankruptcy court found that the appointment of a chapter 11 trustee would be tantamount to overturning the district court’s order appointing the Receiver. *Id.* On appeal, the district court found that the Receiver was authorized to act as management, pursuant to the district court’s previous order; therefore, the Receiver was the preferred manager of the debtors under the Bankruptcy Code, rather than a chapter 11 trustee. *Id.*

The UST argued that a trustee should be appointed “for cause,” the cause being that the Receiver was nothing more than a custodian within the meaning of § 543(b) of the Bankruptcy Code who must turnover operations of the debtors upon the commencement of the bankruptcy cases to management, 363 B.R. at 681, because management had been replaced by the district court based on fraud. In affirming the bankruptcy court, the district court found that the Receiver was much more than a custodian and was empowered with the exclusive rights of management.

## **C. Electing a Chapter 11 Trustee**

### **1. Before BAPCPA**

Before BAPCPA, under § 1104(b), on request of a party in interest made within 30 days after the court orders the appointment of a trustee, the UST was obligated to convene a meeting to elect a disinterested person to serve as trustee. Before BAPCPA, the creditors did not elect chapter 11 trustees. Instead, the trustee was appointed by the UST.



## **2. BAPCPA Provisions**

Under BAPCPA, a request for a meeting of creditors to elect a trustee must be in writing, filed with the court, and transmitted to the UST. The request may be made by a "party in interest," a term which is not defined. If an election is held under amended § 1104(a), and an "eligible, disinterested trustee is elected," the UST must file a report certifying the election. BAPCPA 416; amended § 1104(b)(2)(A). The "selection and appointment" of the elected trustee is effective as soon as the UST's report is filed. § 1104(b)(2)(B)(i) and (ii). Further, the court must resolve any dispute about the trustee's election. § 1104(b)(2)(C).

## **IV. DUTIES OF A TRUSTEE OR EXAMINER UNDER SECTION 1106**

### **A. Before BAPCPA**

Section 1106 of the Bankruptcy Code deals with the duties of an examiner or trustee in a chapter 11 case.

### **B. BAPCPA Provisions**

BAPCPA made a number of changes that cover individuals in chapter 11 cases. Included in those changes, amended § 1107 contains a number of provisions that require a chapter 11 trustee to give the requisite notice to state and federal agencies in the collection of "domestic support obligations." §§ 1105(a)(8) and 1105(c)(1) and (2). The term "domestic support obligation" is defined by BAPCPA in amended § 101(14)(A).

## **V. CONVERSION OR DISMISSAL UNDER SECTION 1112**

Section 1112 of the Bankruptcy Code deals with the conversion or dismissal of a chapter 11 case. Under BAPCPA § 442(a) (entitled, "Expanded Grounds for Dismissal or Conversion"), several changes were made to § 1112, as discussed below.

## **A. "Cause" for Conversion or Dismissal**

### **1. Before BAPCPA**

Before BAPCPA, § 1112 listed ten non-exclusive types of "cause" sufficient to support the conversion or dismissal of a chapter 11 case.

### **2. BAPCPA Provisions**

BAPCPA contains expanded examples of "cause" to convert or dismiss, including the following:

- Substantial or continuing loss to or diminution of the estate and absence of a reasonable likelihood of rehabilitation [adds the word "substantial"]
- Gross mismanagement of the estate [new]
- Failure to maintain appropriate insurance that poses a risk to the estate or the public [new]
- Unauthorized use of cash collateral "substantially harmful to one or more creditors" [new]
- Failure to comply with an order of the court [new]
- Unexcused failure to timely satisfy reporting requirements [new]
- Failure to attend § 341 meeting of creditors, or a Rule 2004 examination without "good cause" [new]
- Failure to provide information, or attend meetings, reasonably required by the UST [new]
- Failure to timely pay post-petition taxes, or file tax returns [new]
- Failure to file a disclosure statement within the time fixed by the Bankruptcy Code or the court [new]

- Failure to confirm a plan within the time fixed by the Code or the court [using the word "confirm" as opposed to "propose"]
- Failure to pay UST's quarterly fees [new]
- Revocation of a confirmation order [unchanged]
- Inability to effectuate "substantial consummation" of a confirmed plan [unchanged]
- Material default by the debtor with respect to a confirmed plan [unchanged]
- Termination of a confirmed plan by reason of the occurrence of a condition specified in the plan [unchanged]
- Failure to pay any post-petition domestic support obligations [new]

§ 1112(b)(4). While courts have considered some or all of the foregoing examples of "cause" in determining whether to grant a motion to convert or dismiss, the inclusion of some of the examples of "cause," together with the other amendments to § 1112, will undoubtedly lead to more frequent motions to convert or dismiss.

### 3. BAPCPA Cases

In *In re TCR of Denver, LLC*, 338 B.R. 494, 500-01 (Bankr. D. Colo. 2006) (decided under BAPCPA), the court held that the use of "and" at new § 1112(b)(4)(P) (the last element listed) should be read in the disjunctive, as "or" instead of "and." In so ruling, the court found that the elements listed in § 1112(b)(4) are illustrative, not exhaustive, and that it would be virtually impossible for *each* of the 14 elements listed in § 1112(b)(4) to be satisfied. *Id. Accord In re 3 Ram, Inc.*, 343 B.R. 113, 117 (Bankr. E.D. Pa. 2006).

In *3 Ram*, 343 B.R. at 118, the bankruptcy court found that, after BAPCPA, conversion or dismissal of a chapter 11 case is "appropriate where the court finds that the proposed plan is not feasible and that a feasible plan is not possible." In so ruling, the court expressly noted that the ability to propose a feasible plan is

no longer an enumerated ground under amended § 1112(b)(4). The court in *3 Ram* nonetheless dismissed the case for "cause," after finding that "a confirmable plan is not possible in this case" and that "no reorganization was in process" because the bankruptcy was nothing more than a "two party dispute." 343 B.R. at 119.

In *In re Jayo*, 2006 WL 2433451 (Bankr. D. Idaho July 28, 2006), the court followed the reasoning of *TCR*, 338 B.R. 494, and *In re 3 Ram Inc.*, 343 B.R. 113, by construing BAPCPA's use of the word "or" as being conjunctive, rather than disjunctive. Additionally, in *Jayo*, the creditor, Maynard, filed a motion for conversion that, in the alternative, sought the appointment of a Chapter 11 trustee. The debtor raised an argument that UST did not seek § 1104 relief in her motion and requested that it be excluded from the present determination. The debtor argued that, under the BAPCPA amendments to § 1112(b), there is no specific incorporation of § 1104(a)—meaning cause to appoint a trustee cannot be used to support a motion for conversion or dismissal. The court found this interpretation unpersuasive. The court found that "while cause is not specifically incorporated into § 1112(b), there is a cross-reference." *Jayo*, 2006 WL 2433451 at \*8. "Except as provided in paragraph (2) of this subsection, subsection (c), and section 1104(a)(3), the court shall convert or dismiss a case . . . if the movant establishes cause.'" *Id.*

Citing *TCR*, the court expounded that Congress amended § 1112 to make it broader and strict as to debtors. Thus, the argument that Congress intended the amendment in § 1104(a)(3) to be construed as to limit the court's consideration of potentially relevant grounds for dismissal under a broadened or expanded § 1112(b) would render the changes superfluous. *Jayo*, 2006 WL 2433451 at \*7. Ultimately, the court did not dismiss the case, but rather found that cause existed to convert the case to chapter 7.

## **B. Deadlines to Commence the Hearing and Rule**

Under BAPCPA, the court must commence a hearing on a motion to convert or dismiss no later than 30 days after the motion is filed, *and* the court must "decide the motion" no later than 15 days after the commencement of the hearing, unless (i) the movant expressly

consents to a continuance "for a specific period of time," or (ii) "compelling circumstances prevent the court from meeting the time deadlines" of amended § 1112(b)(3).

**C. "If the Movant Establishes Cause"**

Under BAPCPA, if the movant establishes "cause," the court "shall" (as opposed to "may") convert or dismiss the case, or appoint a trustee under amended § 1104(a)(3), BAPCPA § 416, depending on the best interests of creditors, unless the court "specifically" identifies "unusual circumstances" that "establish that the requested conversion or dismissal is not in the best interests of creditors and the estate." § 1112((b)(1). In addition, the debtor or another party opposing the motion must establish each of the following: (a) there "is a reasonable likelihood that a plan will be confirmed within the timeframes" established in the Bankruptcy Code (or, if those timeframes do not apply, within a reasonable time); (b) there is a reasonable justification for the act or omission that established the "cause"(except where "cause" is the substantial or continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation); and (c) that act or omission will be cured within a reasonable period of time fixed by the court. § 1112((b)(2).

**VI. RETIREE BENEFITS UNDER SECTION 1114**

**A. Before BAPCPA**

Section 1114 prohibits a chapter 11 debtor from modifying benefits under a post-retirement health plan without complying with a lengthy negotiation process, somewhat like the process required with respect to a collective bargaining agreement. In addition, the debtor (a) must show the court that the modifications are necessary to permit the reorganization to succeed, and (b) treat retirees equitably as compared to other parties in interest. Because some retiree health plans permit an employer to unilaterally modify the plan, some courts have held that § 1114 supersedes the health plan provisions, but some other courts have held that such provisions are not superseded by § 1114.

## **B. BAPCPA Provisions**

BAPCPA provides that the bankruptcy court, upon a party in interest's motion, may reverse any modification made to retiree benefits during the 180 days before bankruptcy, *if* the debtor employer was insolvent at the time of the modification, *unless* "the court finds that the balance of the equities clearly favors such modification." § 1114(l) (emphasis added). BAPCPA does not expressly resolve the issue as to whether a retiree health plan that permits an employer debtor from unilaterally modifying a plan notwithstanding amended § 1114. In addition, BAPCPA specifically gives the UST the authority to appoint a committee of retired employees, if the bankruptcy court orders the formation of such a committee. § 1114(d).

## **VII. PROPERTY OF THE ESTATE UNDER NEW SECTION 1115 WHERE THE DEBTOR IS AN INDIVIDUAL**

### **A. BAPCPA Provisions**

For an individual filing under chapter 11, "property of the estate" includes (a) all property defined in § 541 of the Bankruptcy Code, and (b) all property that is acquired after the commencement of the case, but before the case is closed, dismissed, or converted. "Property of the estate" also includes earnings from services performed by the debtor post-petition, until the case is closed, dismissed or converted. § 1115(a)(1) and (2). New § 1115(a) is similar to the definition of property of the estate for chapter 13 cases. 11 U.S.C. § 1306(a)(1) and (2) ("until the case is closed, dismissed, or converted"). New section 1115(b) further provides that the debtor shall remain in possession of all property of the estate unless a trustee or examiner is appointed, or a confirmed plan or order confirming a plan removes the debtor from possession. § 1115(b). As discussed below, § 1123 (contents of plan) was amended to provide that the chapter 11 plan of an individual (like the chapter 13 plan) must provide for the payment to creditors of all or such portion of post-petition earnings or income as is "necessary for the execution of the plan."

## B. BAPCPA Case

Section 1115 was discussed in *In the Matter of Tegeder*, 2007 Bankr. LEXIS 1756 (Bankr. D. Neb., May 23, 2007). In *Tegeder*, the court noted that “§ 1115 is clear that property of the estate in a case in which the debtor is an individual includes the property described in § 541 (which includes, but is not limited to, all legal or equitable interests of the debtor in property as of the commencement of the case), as well as post-petition property and earnings.” 2007 Bankr. LEXIS 1756 at \*6-7. Further, “[s]ince § 1115 broadly defines property of the estate to include property specified in § 541, as well as property acquired post-petition and earnings from services performed post-petition, the absolute priority rule no longer applies to individual debtors who retain property of the estate under § 1115.” 2007 Bankr. LEXIS 1756 at \*7. As one commentator has noted:

The absolute priority requirements imposed by Code 1129(b)(2)(B)(ii) were waived by permitting a debtor to retain property included in the estate under 1115. Although 1115 was added by the 2005 Amendments to include post-petition property and earnings, it also incorporates property of the estate under 541, and accordingly it is assumed that the debtor shall be entitled to retain property under 541 as well. A more narrow interpretation would cause this amendment to have little effect.

Hon. William L. Norton, Jr., 4 NORTON BANKRUPTCY LAW & PRACTICE 2d § 84A: 1 (database updated March 2007, available on Westlaw) (*quoted in Tegeder*, 2007 Bankr. LEXIS 1756 at \*7).

## VIII. DUTIES OF TRUSTEE OR DEBTOR-IN-POSSESSION IN SMALL BUSINESS CASES UNDER SECTION 1116

### A. BAPCPA Provisions

#### 1. The “Small Business Debtor”

Under BAPCPA, a “small business debtor” is defined in § 101(51D) as follows:

(A) a person engaged in commercial or business activities (including any affiliate of such person that is also a debtor

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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 date of the order for relief in any amount not more than \$2,000,000 (excluding debts owed to one or more affiliates or insiders) for a case in which the UST has not appointed under § 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 \$2,000,000 (excluding debt owed to one or more affiliates or insiders).”

A "small business debtor" is first any person engaged in commercial or business activities. § 101(51D). Because the definition of a person includes individuals, § 101(41), a small business debtor would include sole proprietors who file bankruptcy. The statute does not provide us with a definition of what it means to engage "in commercial or business activity," but it clearly does not require that the commercial or business activity be substantial. Under its plain meaning, the statute would sweep even individuals with a small amount of self employment income. If a particular debtor is engaged in a "commercial or business activity," the statute next asks whether the debtor has more than \$2,000,000 in noncontingent liquidated secured and unsecured debt. If the debt falls below that amount, the debtor is a small business debtor. Debts owed to affiliates or insiders are not counted.

## **2. The “Small Business Case”**

The term "small business case" under § 101(51C) means a case filed under chapter 11 of this title in which the debtor is a “small business debtor.” Therefore, as it relates to small business, the biggest feature of BAPCPA, therefore, is that the status of being a



"small business debtor" is **no longer elective**. Instead, this status now comes with a set of burdens and requirements that the debtor cannot avoid. All small business cases in chapter 11 will involve a small business debtor, but small business debtors in chapters 7, 12, or 13 will not be a small business case.

The distinction would not matter if chapter 11 contained all of the small business provisions, but one new section applies to all small business debtors in all chapters of the Bankruptcy Code. Section 308 of the Bankruptcy Code will require all small business debtors to file periodic financial reports. Because a small business debtor need not be in chapter 11, and because § 308 applies to all chapters, § 103(a), these reporting requirements apply, on their face, to any debtor who meets the definition. Thus, a chapter 7, 12, or 13 debtor who qualified as a small business debtor would be subject to these new reporting requirements.

### **3. Reporting Requirements**

BAPCPA imposes substantial new duties on small business debtors. Many of these new duties involve new disclosures that small business debtors must make after filing a bankruptcy case, such as the filing of financial and other reports disclosing the following information about the debtor, profitability, reasonable approximations of projected cash receipts and disbursements, comparisons of actual cash receipts and disbursements with projections from prior reports. Section 308 concludes with a catch-all, requiring disclosure of "such other matters as are in the best interests of the debtor and creditors." BAPCPA law directs that these reporting requirements are not to go into effect until sixty days after forms are produced for reporting the information.

### **4. Section 1116 Duties for Chapter 11 Trustees**

In addition to new reporting requirements in § 308, § 1116 imposes five new disclosure requirements on the debtor:

- "Append" to the petition the most recent balance sheet, statement of operations, cash-flow statement, and Federal income tax return (or a statement that these

documents were not prepared or filed) (collectively, the “Small Business Documents”);

- Timely filing schedules and statements of financial affairs;
- Filing of all postpetition financial and other reports required by the Bankruptcy Code, the Bankruptcy Rules, Local Bankruptcy Rules, or an order of the court;
- Timely filing of tax returns; and
- Allowing the UST to inspect the business premises, books, and records.

Section 1116 also imposes the follow new substantive duties on a small business debtor in chapter 11:

- Senior management attendance at meetings scheduled by the UST or the court;
- Maintenance of insurance customary and appropriate to the debtor's industry;
- Timely payment of all taxes entitled to administrative expense priority;

These new substantive duties are not as new as they might appear. The debtor certainly had no excuse not to appear at meetings scheduled by the court. Failure to maintain insurance could be grounds for lifting the automatic stay. Section 1116 now makes these duties express, again possibly providing grounds for dismissal of the case.

## **5. Fast Track to Confirmation**

BAPCPA puts small business cases on a fast track to confirmation. Section 1121(e) expands the period of exclusivity for small business cases to 180 days, rather than the 120 days for all other cases.

## 6. Standard Form Disclosure Statements and Reorganization Plans

Although BAPCPA generally makes it more difficult for small businesses to navigate the chapter 11 process, the changes to the disclosure statement and reorganization plan could provide some new flexibility and perhaps cost savings that were not previously present. Section 1125(f) allows a court to conditionally approve a disclosure statement and allows a confirmation hearing based on a standard form, or the waiver of a disclosure statement if the plan contains adequate information. There is no requirement that the standard form disclosure statement be used. Instead, if used, the standard forms provides the debtor with a safe harbor under § 1125(f).

### B. BAPCPA Cases

The court examined new § 1116 in *In re Franmar, Inc.*, 361 B.R. 170 (Bankr. D. Colo. 2006). In that case, the court noted that § 1116 imposes new “and not insubstantial duties” on a debtor-in-possession in a small business case, including the duty “to timely file designated business records and financial documents with the court, attend certain meetings, maintain insurance, and timely pay taxes.” 361 B.R. at 172. The UST filed a Motion to Dismiss after the small business debtor in that case failed to “append” the required Small Business Documents to the bankruptcy petition. The UST, by its Motion to Dismiss, alleged two grounds for the dismissal under § 1112(b)(4): (1) the debtor’s “unexcused failure to satisfy timely any filing or reporting requirement established by [the Bankruptcy Code or applicable rule]” under § 1112(b)(4)(F); and (2) the debtor’s failure timely to provide information or attend meetings requested by the UST under § 1112(b)(4)(H). *Franmar*, 361 B.R. at 173. The Motion to Dismiss presented an issue of first impression under BAPCPA regarding the discretion, if any, the court has to dismiss or not dismiss a case for a deficiency in compliance with the requirements of § 1116(1). The court considered: (a) whether a failure to “append” the Small Business Documents is an “unexcused failure” pursuant to § 1112(b)(4)(F), and (b) whether or not the failure to “append” the Small Business Documents and other facts

in this case constitute a failure timely to provide information or attend meetings requested by the UST pursuant to § 1112(b)(4)(H).

The court found that “append” to the petition meant that § 1116(1) creates a requirement that a debtor “append” to the voluntary petition certain documents, including debtor’s most recent balance sheet, statement of operations, cash-flow statement, and Federal income tax return, or debtor’s 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. 361 B.R. at 177. Referring to Webster’s Dictionary, the court determined that “append” meant to “attach” or “affix” to the bankruptcy petition. *Id.* at 177 n.9. Although § 1116(1) requires Small Business Documents, or a statement that they have not been prepared, to be appended to a small business petition, the court went on to find that statute does *not* provide either a remedy or a consequence for a debtor’s failure to comply. *Id.* at 177. The court further found a failure to append Small Business Documents does not mandate dismissal, although it could be a reason to dismiss if it constitutes “cause” under § 1112. *Franmar*, 361 B.R. at 178.

As to dismissal for “cause,” § 1112(b)(1) requires the court to convert or dismiss a case if the “movant establishes cause.” “Cause” is established pursuant to § 1112(b)(4)(F) by the “unexcused failure to satisfy timely any filing or reporting requirement.” *Franmar*, 361 B.R. at 178. That section was part of the expanded lists of factors under BAPCPA that may establish “cause” for purposes of considering motions to dismiss or convert Chapter 11 cases. In *Franmar*, the court concluded that the use of the word “unexcused” means the court had leeway to find, under appropriate circumstances, that “cause” has not been established if the failure to satisfy timely any filing or reporting requirement is excused. By inference the court, therefore, has the ability and some discretion to determine what was an “excused” or “unexcused” failure to “timely file” the designated documents. Moreover, if an extension of time is granted, as is permitted, then failing to timely file would be excused and “cause” would not be present for dismissal under 11 U.S.C. § 1112(b)(4)(F). *Franmar*, 361 B.R. at 178-79.

## **IX. FILING PLANS AND DISCLOSURE STATEMENTS UNDER SECTION 1121**

### **A. Before BAPCPA**

Section 1121 of the Bankruptcy Code limits the time within which a debtor has the exclusive right to file a plan and obtain acceptance of that plan. Before BAPCPA, extensions could be obtained "for cause" without limitation.

### **B. BAPCPA Provisions**

Under BAPCPA, a court cannot extend (a) the debtor's exclusive right to file a plan *beyond 18 months* from the date the petition was filed, or (b) the debtor's exclusive right to solicit acceptances *beyond 20 months*. § 1121(d). There are no exceptions to these deadlines, except as to "small business" cases, as discussed below.

In a small business case, the debtor has the exclusive right to file a plan within the *180 days* period after entry of the order for relief (extending previous law by 80 days), unless, before the deadlines expire, the period is extended after notice and hearing, or the court, for cause, orders otherwise. § 1121(e)(1)(A) and (B). The small business debtor's plan and disclosure statement must be filed not later than *300 days* after entry of the order for relief (extending previous law by 140 days). § 1121(e)(2). In order to obtain an extension of the 180 or 300 day deadlines, (i) the small business debtor, after appropriate notice, must demonstrate, *by a preponderance of the evidence*, that it is more likely than not that the court will confirm a plan within a reasonable period of time, (ii) the new deadline is imposed at the time the extension is granted, and (iii) the order extending exclusivity is signed before the existing exclusivity deadline has expired. § 1121(e)(3). It should be noted that amended § 1129(e) provides that exclusivity "*may be extended*" (as opposed to "shall be granted") if the foregoing requirements are satisfied.

The BAPCPA limitations on extending exclusivity are intended to cause debtors to propose and confirm a plan more quickly than in the past. In large reorganizations, where debtors and committees are grappling with such complex issues as collective bargaining agreements, pension and

retiree benefits, or mass tort liability, limitations on exclusivity may be detrimental to the negotiation of consensual plans.

### **C. BAPCPA Cases**

In *In re Florida Coastal Airlines, Inc.*, 361 B.R. 286 (Bankr. S.D. Fla. 2007), Alliance, an entity that had been in negotiations with the debtor to purchase an interest in the reorganized debtor, filed a competing plan more than 300 days after the petition date. *Id.* at 286 and 290-291. The debtor argued that § 1121(e)(2) *prohibits* the filing of *any* reorganization plan and disclosure statement more than 300 days after the petition date. *Id.* at 290-291. The court agreed that the debtor's argument was "one possible reading of the statute which some commentators have suggested." *Id.* at 291 (citing 7 COLLIER ON BANKRUPTCY ¶ 1121.07[4] (15<sup>th</sup> ed. 2006)). The bankruptcy court rejected this reading, however, and found that § 1121(e)(1) should be read to only limit the debtor's ability to file a plan after 300 days. 361 B.R. at 291. Therefore, in *Florida Coastal*, the competing plan was permitted. *Id.*

## **X. CONTENTS OF AN INDIVIDUAL'S PLAN UNDER SECTION 1123**

### **A. Before BAPCPA**

Section 1123 of the Bankruptcy Code lists provisions that must be contained in a plan, and provisions that may be contained in a plan.

### **B. BAPCPA Provisions**

Under BAPCPA, a chapter 11 plan of an individual must provide for the payment to creditors of all or such portion of earnings from personal services the debtor performs after bankruptcy, or other future income of the debtor, as is "necessary for the execution of the plan." § 1123(a)(8). This provision is a corollary to new § 1115, which § provides that property of the estate, in the case of an individual in chapter 11, includes post-petition income and earnings until the case is dismissed, converted, or closed. Interestingly, amended § 1123 does not require that the individual devote all of his or her disposal income to plan payments, as required in a Chapter 13 case. Notwithstanding this omission, amended § 1127 permits an unsecured creditor or the UST to seek to modify a confirmed plan of an

individual at any time before completion of all plan payments. See § 1127(e) (discussed below).

## **XI. IMPAIRMENT UNDER SECTION 1124**

### **A. Before BAPCPA**

Section 1124 of the Bankruptcy Code addresses when a claim is "impaired" for purposes of plan confirmation.

### **B. BAPCPA Provisions**

The BAPCPA amendments to § 1124 appear to conform to the BAPCPA amendments to § 365.

First, § 1124(2)(A) was modified to add that, in addition to being unnecessary to cure an *ipso facto* default of a kind specified in section 376(b)(2), it is likewise unnecessary to cure a default of a kind that section 365(b)(2) expressly does not require to be cured." 7 COLLIER ON BANKRUPTCY ¶ 1124.LH[3], at 1124-27.

The second modification is more complicated, and requires an examination of the BAPCPA modifications to § 365. Section 365 requires a debtor or trustee to cure, or provide adequate assurance of prompt cure, in order to assume an unexpired lease or executory contract. At times, based on "historical fact," nonmonetary defaults simply cannot be cured because history cannot be rewritten. For example, if a franchise agreement provides that the closing of the franchisee's operations is a default, and if the operations close, it is too late to cure that nonmonetary default. See *Worthington v. General Motors Corp.*, 113 F.3d 1202 (9th Cir. 1997) (ruling that a franchise could not be assumed because the nonmonetary default, caused by a closing of operations, could not be cured). The amendments to §§ 365 and 1124 attempt to address nonmonetary defaults in unexpired leases and executory contracts, as discussed below. Section 365(b)(2)(D) was amended in BAPCPA to provide that the debtor or trustee is not required to cure "any penalty rate or penalty provision related to a default arising from a nonmonetary default before assumption." § 365(b)(2)(D). BAPCPA's change of "other provisions" to "penalty provisions" should mean that the cure of a "penalty" arising from a nonmonetary default is not a required element of

cure for assumption. By negative implication, courts should require the cure of *non-penalty*, non-monetary defaults.

Section 365(b)(1)(A) was also amended. After BAPCPA, that subsection contains the exceptions to when a non-penalty, nonmonetary default must be cured in connection with an assumption, as follows:

(a) Under amended § 365(b)(1)(A), the trustee or debtor is not required to cure a non-penalty, nonmonetary default of an *unexpired lease real property* (both residential and nonresidential) where it is impossible to cure that default by performing nonmonetary acts. If, however, the default arises from a failure to operate as required in a lease of *nonresidential real property (excluding residential leases)*, the debtor or trustee must perform under that lease "at and after" assumption. *Further, cure includes the payment of pecuniary losses caused by the nonmonetary default in a nonresidential lease of real property.* § 365(b)(1)(A) (emphasis added).

(b) By negative implication, the debtor or trustee is required to cure non-penalty, nonmonetary defaults in executory contracts and unexpired leases of personal property. Therefore, the debtor or trustee will be precluded from assuming an executory contract or personal property lease where it is impossible to cure non-penalty, nonmonetary defaults. *See* § 365(b)(1)(A).

Corresponding to the foregoing amendments to § 365, BAPCPA also amends § 1124. Under BAPCPA, a claim is impaired if the claim is for pecuniary losses arising out of a nonmonetary default in a residential lease of real property. § 1124(2)(d). (BAPCPA likewise requires such pecuniary losses to be paid in connection with an assumption of a nonresidential real property lease.) More particularly, under pre-BAPCPA § 1124(2), a claim is not impaired, notwithstanding a contractual provision or applicable law that entitles the holder of that claim to demand or receive accelerated payment after default, where (a) the default is cured (unless cure is not required under § 365)), § 1124(2)(a), (b) the maturity of the claim is reinstated, § 1124(2)(b), (c) the claim holder is compensated for any damages incurred as a result of reasonable reliance of the contractual provision or applicable law that accelerated payment, § 1124(2)(c), and (d) the plan does not alter the holder's legal, equitable, or



contractual rights, § 1124(2)(d). Amended § 1124(2)(d) is consistent with amended § 365(b)(1)(A).

Under amended § 1124(2)(d), a claim is not impaired if it arises from the failure to perform a nonmonetary obligation *other than* a claim that compensates actual pecuniary loss (except the loss of the debtor or an insider) resulting from the debtor's failure to operate a nonresidential real property lease. § 1124(2)(d). In other words, if the claim is for compensation for actual pecuniary loss, caused by a nonmonetary default in a nonresidential real property lease, the claim is impaired under the plan unless it is paid. Stated differently, to be unimpaired under § 1124(2), , “the plan must provide for the compensation of actual pecuniary loss to the holder of a claim or interest arising from any failure to perform a nonmonetary obligation, other than a default arising from a failure to operate a nonresidential real property lease subject to section 365(b)(1)(A). 7 COLLIER ON BANKRUPTCY ¶ 1124.LH[3], at 1124-27.

## **XII. DISCLOSURES AND SOLICITATIONS UNDER SECTION 1125**

Section 1125 of the Bankruptcy Code governs disclosure made in connection with the solicitation of a plan of reorganization. Under BAPCPA §§ 408, 431, and 717, several changes were made to § 1125, as discussed below.

### **A. More Flexible Rules for Disclosures**

Amended § 1125(a) now provides that, in determining the adequacy of information, the court must “consider” (a) the complexity of the case, (b) the benefit of additional information to creditors and other parties in interest, and (c) the cost to provide the additional information. BAPCPA § 431 (entitled, “Flexible Rules for Disclosure Statements and Plans”); amended § 1125(a).

### **B. Prepackaged Chapter 11 Plans**

#### **1. Before BAPCPA**

Section 1125(b) of the Bankruptcy Code prohibited post-petition solicitations for the acceptances or rejections of a plan until the creditors received a court-approved disclosure statement. Before

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BAPCPA, this included post-petition solicitations of a “prepackaged plan.”

## 2. BAPCPA Provisions

Amended § 1125(g) permits post-petition solicitations of holders of claims and interests, provided the solicitations comply with applicable nonbankruptcy law and the holder that is being solicited post-petition was solicited before the bankruptcy “in a manner complying with applicable nonbankruptcy law.” § 1125(g).

### C. Tax Disclosures

Amended § 1125(a)(1) specifically provides that adequate information includes disclosures regarding potential, material federal tax consequences of the plan on the debtor, any successor to the debtor, and a hypothetical investor typical of the holders of claims or interests in the case. § 1125(a)(1).

## XIII. MODIFICATIONS TO PLANS OF INDIVIDUALS UNDER SECTION 1127

Section 1127 of the Bankruptcy Code governs modifications to a chapter 11 plan before and after confirmation, but before substantial consummation of the plan. Under BAPCPA § 321(e), major changes were made to § 1127, as discussed below.

### A. Expanded Ability to Modify Plans of Individuals in Chapter 11

Under amended § 1127(e), if the debtor is an individual, a plan “may” be modified *at any time* after confirmation “*until completion of payments under the plan,*” regardless of whether substantial consummation has occurred. (Emphasis added.) After confirmation, only the debtor, a chapter 11 trustee, the UST, or the “holder of an allowed unsecured claim” may move for such modification. The motion may seek to (i) increase or reduce the amount of payments on claims in a particular class, (ii) extend or reduce the time period for such payments, or (iii) alter plan payments to an individual creditor in order to account for payments received by that creditor from outside the plan. § 1127(e). Not surprisingly, amended § 1127(e) is substantially

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similar to the section governing modifications of a chapter 13 plan. *See* 11 U.S.C. § 1329(a)(1)(2) and (3) (modifications of a chapter 13 plan after confirmation).

Obviously, if an individual debtor's income significantly increases, unsecured creditors may file a motion to increase plan payments. The amendment is unclear as to whether an unsecured creditor who is impaired under a plan, but who has received all plan payments due the class of unsecured creditors, may move to increase plan payments to unsecured creditors where secured creditors, for example, have not received all plan payments. If so, because secured claims are often paid over much longer periods of time than unsecured claims, a confirmed chapter 11 plan of an individual would have no real finality.

Presumably creditors will negotiate for plan provisions that require more frequent or complete disclosures during the post-confirmation period. In this way, the creditors could better monitor any increases in the individual debtor's income. Since discharge is delayed until all plan payments are made, as discussed below with respect to amended § 1141, the individual debtor should have sufficient incentive to comply with any such post-confirmation reporting requirements.

#### **B. Plan Modification Requirements**

BAPCPA makes clear that (i) a modified plan is subject to the same requirements as an original plan, (ii) the modified plan requires disclosure under § 1125 (as the court may direct such disclosure), (iii) notice and hearing, and (iv) court approval of the modifications. § 1127(f)(1) and (2).

### **XIV. PLAN CONFIRMATION UNDER SECTION 1129**

To confirm a chapter 11 plan, the bankruptcy court must find that the plan satisfies each of the requirements of § 1129 of the Bankruptcy Code. Under BAPCPA §§ 710, 213(1), 321(c), and 1221(b), major additions and amendments were made to § 1129, as discussed below.

## **A. Payment of Tax Claims**

### **1. Before BAPCPA**

Before BAPCPA, § 1129 provided that a plan could not be confirmed unless § 507(a)(8) unsecured tax claims received deferred cash payments, over a period not to exceed six years after the date of assessment, and the deferred payments must have had a value, as of the effective date of the plan, equal to the allowed amount of such claim."

### **2. BAPCPA Provisions**

Under BAPCPA, the plan must provide that section 507(a)(8) unsecured tax claims are paid (a) in regular installments (as opposed to "deferred cash payments"), (b) in full within five years from the order for relief (rather than six years from the date of assessment), and (c) "in a manner not less favorable than other non-priority unsecured claims provided for in the plan" (a new provision). § 1129(a)(9). In addition, a secured tax claim that would be a § 507(a)(8) unsecured tax claim absent the collateral is entitled to the same treatment as an unsecured tax claim under amended § 1129(a)(9). After BAPCPA, new § 511 governs the determination of the appropriate interest of interest on tax claims and administrative expense tax claims. Under new § 511(a) interest "shall be the rate determined under applicable nonbankruptcy law," and, in the case of a confirmed plan, under new § 511(b), the rate "shall be determined as of the calendar month in which the plan is confirmed."

## **B. Domestic Support Obligations**

### **1. Before BAPCPA**

Before BAPCPA, the Bankruptcy Code allowed domestic support obligations to be paid in deferred cash payments over the life of a debtor's plan. Other creditors could be paid concurrently with domestic support creditors.

## **2. BAPCPA Provisions**

Under BAPCPA, the chapter 11 plan of an individual cannot be confirmed unless the plan provides for the payment of post-petition domestic support obligations required by judicial or administrative order, or by statute. § 1129(a)(14).

## **3. BAPCPA Case**

In *In re Reid*, 2006 WL 2077572 (Bankr. M.D.N.C. July 19, 2006), the bankruptcy court addressed the new provisions of BAPCPA dealing with domestic child support. That court noted that, after BAPCPA, the court must determine whether the debtor's plan provides for payment, in full, "of any prepetition past due domestic support obligations before any disbursement can be made on administrative expense claims, such as attorneys' fees." *Id.* at 2077572 \*1. This includes interest that accrued on the domestic support obligation pursuant to nonbankruptcy law. *Id.* at 2077572 \*2.

### **C. Unsecured Debt of an Individual in Chapter 11 Plan**

Under BAPCPA, the chapter 11 plan of an individual cannot be confirmed over the objection of an unsecured creditor unless the debtor shows that the value of the property to be distributed under the plan is less than (i) the amount of the unsecured creditor's claim, or (ii) the debtor's projected *disposable income for five years*, or the period for payments that is proposed in the plan, whichever is longer. § 1129(a)(15).

### **D. Small Business Cases**

Under BAPCPA, in a small business case, within 45 days of filing (unless the time for confirmation is extended as required by BAPCPA § 437l, at amended § 1121(e)(3)), the court must confirm a plan that complies with the requirements of the Bankruptcy Code, and was filed within the exclusivity period for small business debtors under amended § 1121. § 1129(e).

## **XV. EFFECT OF CONFIRMATION UNDER SECTION 1141**

Section 1141 of the Bankruptcy Code deals with the effect of confirmation. Under BAPCPA §§ 321(d), 330(b), and 708, three major changes were made to § 1141, as discussed below.

### **A. Delay in Discharge of an Individual**

Under BAPCPA, unless (after notice and hearing) the court orders otherwise “for cause,” confirmation of a chapter 11 case for an individual does not grant a discharge until the debtor has completed plan payments. § 1141(d)(5)(A). “Cause” is not defined.

After the plan payments are paid, the court will grant the individual debtor a discharge in accordance with the other provisions of the Bankruptcy Code. If all plan payments are not made, after notice and hearing, at any time after confirmation, the court *may* grant a discharge to the individual if (i) the plan payments that were made to that point exceeded what creditors would have received in a chapter 7 liquidation, and (ii) modification of the plan is “not practical.” § 1141(d)(5)(B).

### **B. Delay in Discharge Pending Certain Proceedings**

Under BAPCPA, the court will not delay entry of a discharge to an individual (see above) where the court finds that “there is no reasonable cause to believe” that there is a proceeding pending in which the debtor may be (i) found guilty of a felony or (ii) liable for a debt arising from a violation of the (A) federal Securities Exchange Act, or similar state law, (B) criminal acts, intentional tort, or willful or reckless misconduct that caused serious physical injury or death to an individual, or (C) civil RICO. § 1141(d)(5)(C).

### **C. No Discharge of Fraudulent Taxes**

Under BAPCPA § 708, confirmation of a plan does not discharge a corporation from (i) any debt owed to a governmental unit that is not dischargeable under amended § 532(a), amended § 1141(d)(6)(A), or (ii) a tax with respect to which the debtor either (A) made a fraudulent return, or (B) willfully attempted to evade or defeat the tax, amended § 1141(d)(6)(A).