Business Case Update: Decisions Under BAPCPA Affecting Businesses and Chapter 11 Cases

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I. UTILITY SERVICE: 11 U.S.C. § 366

A. Section 366 Pre-BAPCPA

Prior to the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act ("BAPCPA"), the provisions of § 366 of the Bankruptcy Code recognized both the monopoly position usually enjoyed by utility companies and the critical role of the services they provide in the survival and reorganization prospects of a debtor in bankruptcy. Accordingly, § 366 prevented discrimination against a debtor in bankruptcy and limited the circumstances under which the utility company may alter, refuse or discontinue post-petition services provided to such a debtor. A utility company was prohibited from discriminating against a debtor simply because the debtor filed a bankruptcy petition, so that a debtor who is current on its pre-petition payments cannot be treated differently from any other similarly non-delinquent customer just because of a bankruptcy filing. Equally, a debtor in bankruptcy seeking service as a new customer of the utility, may not be treated differently from any other new customer seeking service.

Subsection (b) provided that for the first twenty days of a case, a utility was enjoined from altering, refusing or discontinuing service on the basis of the continued non-payment of a pre-petition debt, and thereafter the utility could only alter, refuse or discontinue service if the debtor failed to provide the utility with adequate assurance of future payment. After notice and a

[1] The authors would like to thank Joshua Pemstein, an attorney in the Bankruptcy and Restructuring Practice at Foley Hoag LLP, for his substantial assistance in preparing this article.

hearing, the utility could apply to the court to modify the amount of assurance offered by the debtor, but the burden was on the utility to seek modification. Not defined in the Code, "adequate assurance of future payment" had over time become understood to typically mean one or more of the following: the giving of a deposit, a history of timely pre-petition payments, strong positive cash projections, or elevation to administrative expense priority for post-petition obligations.

B. Section 366 as Amended by BAPCPA

The new Section 366(c) provides that a utility may alter, refuse, or discontinue service to the debtor if the trustee does not provide adequate assurance of payment satisfactory to the utility. BAPCPA substantially augments the protections afforded utilities in Chapter 11 bankruptcies by narrowly defining "adequate assurance of payment" to require a cash payment or similar deposit, such as a letter of credit, surety bond, or certificate of deposit. 11 U.S.C. § 366(c)(1)(A). BAPCPA's definition of adequate assurance expressly excludes factors such as a showing by the debtor of a strong projected cash flow or a history of timely payment. Additionally, in determining whether a debtor's assurance of payment is adequate, the court may not consider the availability of administrative expense priority or the timeliness of prepetition payments. 11 U.S.C. §§ 366(c)(1)(B), (c)(3)(B).

The revised section 366 is seemingly ambiguous with respect to the amount of time a trustee or debtor in possession has to provide adequate assurance. Section 366(b) provides that a utility may alter, refuse or discontinue service if it does not receive adequate assurance within 20 days of the date of the order for relief. Under section 366(c), however, the utility may alter,

refuse or discontinue service it does not receive adequate assurance that is satisfactory to the utility within 30 days of the petition date.[2]

BAPCPA also allows a utility company to recover or set-off a pre-petition deposit against a pre-petition claim without notice or any order of the court and notwithstanding any other provision of law. This set-off provision of § 366(c)(4) is not referenced in § 362(b) as an exception to the stay of set-offs generally in § 362(a)(7), but since § 366(c)(4) is the more specific provision it would be expected to override the more general provisions of § 362.

C. Reported Cases

1. In re Lucre

In In re Lucre, Inc., 333 B.R. 151 (Bankr. W.D. Mich. Nov. 9, 2005), one of the first reported cases under BAPCPA, the Bankruptcy Court for the Western District of Michigan held that the term "utility service" as used in section 366(c) "means only traditional services that the debtor in possession itself consumes in contrast to other services and rights provided by the utility." Id. at 155. Section 366(c), therefore, did not apply to telecommunications services received by the debtor under an "interconnection agreement" pursuant to which the debtor provided telecommunications services to its own customers. Id. The Court distinguished between section 366(a), which prohibits a utility from altering, refusing or discontinuing post-petition "services" solely on the basis of the commencement of a case from the new section 366(c), which uses the term "*utility* service." Id. (emphasis added). Accordingly, the Court

[2] The inconsistency between subsection (b), in which the deadline is calculated by counting from the date of the order for relief, and subsection (c), which calculates the deadline by counting from the date of the filing of the petition, creates a potentially confusing scenario in an involuntary case where the order for relief may be entered long after the filing date and well beyond section 366(c)'s thirty-day period.

continued the 366(a) injunction against those utilities that provided services under the interconnection agreement.

Based on this distinction, however, the Court refused to continue the 366(a) injunction against the utilities that provided "utility service" that the debtor itself used directly. Those utilities did not respond to the debtor's proposals to provide adequate assurance of payment. Under 366(c), the subsection (a) injunction terminates after 30 days unless the debtor provides assurance of payment that is "satisfactory to the utility." Because 366(c) "clearly requires as a condition to continuing the injunction . . . the utility's acceptance of assurance offered by the [debtor]," the court lacked the discretion to enjoin those utilities simply because they failed to respond to the debtor's proposals. Id. at 154 (emphasis added). Additionally, the Court held that while section 366(c)(3) gives the debtor the right to have the adequate assurance payment modified by the court, "that right only arises after the adequate assurance payment has been agreed upon by the parties." Id.

The Court also attempted to address the ambiguity under BAPCPA concerning whether the period within which a debtor can provide adequate assurance lapses after 20 days, under subsection (b), or 30 days, under subsection (c). The court held that "[s]ubsections (b) and (c) are not mutually exclusive." Id. at 155. Rather, by furnishing a proposal for adequate assurance within 20 days, the debtor apparently satisfied subsection (b), thereby preventing the utilities from terminating utility services. Nevertheless, because the proposal was not "satisfactory to the utilit[ies]," the § 366(a) injunction terminated after 30 days under § 366(c). Id.

Under Lucre, therefore, a Chapter 11 debtor must reach an agreement with, or obtain a court order preventing exercise of remedies by, a utility in the early stages of a case to prevent

the potentially catastrophic disruption of the business that would result if the plug is pulled. This seems likely to increase the burden on the courts from adversary proceedings for injunctive relief in those early weeks.

2. In re Astle

In re Astle, 338 B.R. 855 (Bankr. D. Idaho, March 14, 2006), the only other reported decision involving the revised section 366, holds that the more restrictive requirements for supplying adequate assurance under section 366(c) apply only in Chapter 11 bankruptcies and not to Chapter 12 debtors. The Court relied on the language of § 366(c) which states that "with respect to a case filed in Chapter 11," a utility referred to in § 366(a) may insist on adequate insurance of payment acceptable to it. This language, the Court reasoned, "rather clearly" makes section 366(c) applicable only in Chapter 11 cases. Id. at 859.

In dicta, the Court rejected the debtors' argument that a lien which secured their promise to pay would have constituted adequate assurance of payment under subsection (c) because such a lien was the legal or economic equivalent of providing the utility with a cash deposit, letter of credit, or a surety bond. The Court noted that section 366(c)(1)(A) provides an exclusive list of what can be considered adequate assurance of payment for purposes of section 366(c). That exclusive list did not apply to section 366(b), however. Accordingly, the Court held that such a lien provides sufficient adequate assurance where only subsection (b), and not (c), is implicated. Id. at 860-61.

D. Unreported Orders

In re Lucre suggests that the revised section 366 will significantly enhance the rights of utility providers in Chapter 11, as noted by most commentators prior to the effective date of BAPCPA. Nevertheless, in a series of unreported orders in some very large cases, bankruptcy courts have granted debtors' motions adopting proposed procedures that considerably diminish

the new powers afforded utility provides under BAPCPA and look remarkably like pre-BAPCPA orders.

1. In re Calpine, Ch. 11 Case No. 05-60200 (BRL) (Bankr. S.D.N.Y.)

In re Calpine typifies this trend. On December 20, 2005, the debtors filed a first day motion for interim and final orders determining adequate assurance of payment for future utility services (the "Utility Motion"). In the Utility Motion, the debtors sought entry of interim and final orders that, among other things, would (i) determine that the debtors' utility providers had been provided with adequate assurance of payment within the meaning of section 366; (ii) approve the debtors' proposal for adequate assurance and procedures whereby the utilities could request additional or different adequate assurance; (iii) enjoin the utilities from altering, refusing, or discontinuing services to the debtors on the basis of unpaid prepetition invoices or the perceived inadequacy of the debtors' proposed adequate assurance; (iv) establish procedures for the utilities to opt out of the debtors' proposed adequate assurance procedures; (v) determine that the debtors would not be required to provide any additional adequate assurance; and (vi) set a final hearing on the debtors' proposed adequate assurance -- in other words, the standard first-day utility motion, notwithstanding the intervening changes wrought by BAPCPA.

In the Utility Motion, the debtors proposed as adequate assurance "a deposit equal to two weeks of utility service . . . to any Utility Provider who requests such a deposit in writing, provided that such requesting Utility Provider does not already hold a deposit equal to or greater than two weeks of utility services, and provided further that such Utility Provider is not currently paid in advance for its services." The debtors further submitted that such deposit, together with the debtors' ability to pay for future utility services in the ordinary course of business "constitutes sufficient adequate assurance to the Utility Providers."

In order "to avoid a potential hostage situation," wherein utility companies threatening to terminate services could "extract whatever amount of adequate assurance they might desire," the debtors also proposed certain "Adequate Assurance Procedures." Those procedures provided, among other things, that (i) any utility seeking additional assurances of payment must serve a written request including a summary of the debtors' payment history and setting forth reasons that the debtors' proposed adequate assurances were insufficient; (ii) the debtors had the greater of 14 days from the receipt of a written request or 30 days from the petition date to negotiate with the utility to resolve the request for additional assurance of payment (the "Resolution Period"); (iii) the debtors could request a hearing to determine the adequacy of assurances of payment in the event they determined that a utility's request for additional assurance of payment was unreasonable and they were unable to reach an alternative resolution during the Resolution Period; and (iv) pending resolution of the hearing, the utilities would be forbidden to discontinue, alter or refuse service on account of any unpaid prepetition charges or an account of any objections to the proposed adequate assurance. Moreover, following the entry of an interim order, utilities would be deemed to have consented to the Adequate Assurance Procedures unless they filed an objection within 20 days of the entry of an interim order.

The following day, the bankruptcy court entered an interim order granting the Utility Motion in its entirety. Thereafter, sixteen objections were filed by roughly forty utility providers. In the objections, the utility providers argued that the Utility Motion and the interim order ignored the amendments to section 366 under BAPCPA. The interim order, they argued, imposed upon the utility providers the requirement that they obtain permission from the debtors or the court prior to discontinuing service for lack of adequate assurance, and that such requirement contradicts revised section 366. Moreover, they asserted that the order completely

ignored the requirement under section 366(c)(2) that the debtor furnish to the utility provider "adequate assurance of payment . . . that is satisfactory to the utility," and instead placed the burden on the utility providers to submit evidence showing that the debtors' proposed assurances were inadequate.

Relying on In re Lucre, Inc., some utility providers argued that section 366(c) obligated the debtors to provide adequate assurance that the utilities deemed satisfactory, and the debtors' right to seek modification of adequate assurance by the court could arise "only after the adequate assurance payment has been agreed upon by the parties." The utility providers also argued that, by enjoining them from discontinuing services and by providing the debtors with discretion to reject the utility provider's counter-proposals and seek a hearing, the court's order reversed the procedure set forth in new section 366(c). Additionally, the utilities objected on the ground that order ran afoul of section 366(c) by extending the 30 day period during which the debtors must provide adequate assurance satisfactory to the utilities.

Finally, some utilities argued that the debtors ignored section 366(c) by linking to adequate assurance their ability to pay for future utility services in the ordinary course of business. The utility providers maintained that the debtors' ability to pay for future services was not only absent from the exclusive list set forth in § 366(c)(1)(A), but also was expressly prohibited by section 366(c)(1)(B).

The debtors, in their omnibus response to these objections, disputed the utility providers' interpretation of section 366 as imposing a "pay first, ask questions later" regime. The debtors maintained that a utility's right under § 366(c)(2) to alter, refuse, or discontinue service if it does not receive satisfactory adequate assurance within the thirty day period was subject to the right

of the court to modify the amount of assurance pursuant to § 366(c)(3). The Court agreed with the debtors and entered a final order on January 18, 2006, granting the debtors' Utility Motion.

2. Additional Unreported Orders:

a. In re Dana Corp., Ch. 11, Case No. 06-10354 (BRL) (Jointly Administered) (Bankr. S.D.N.Y.)

In Dana Corp., the debtors filed a first-day motion on March 3, 2006 seeking interim and final orders (a) prohibiting utilities from altering, refusing, or discontinuing services to the debtors; (b) determining that the utilities are adequately assured of future payment; (c) establishing procedures for determining requests for additional assurance; and (d) permitting utility companies to opt out of those procedures (the "Utility Motion"). The Utility Motion in Dana Corp. was virtually identical to the one filed in In re Calpine. As in Calpine, the debtors proposed as adequate assurance of future payment a deposit equal to the cost of two weeks' worth of utility service in conjunction with the ability to pay for future utility services in the ordinary course of business. The debtors also proposed virtually identical "Adequate Assurance Procedures" to those proposed by the debtors in Calpine. On March 6, 2006, Judge Lifland entered an interim and proposed final order. The objections filed by the utilities, many of whom had also objected in Calpine, made the same arguments as in Calpine. On March 29, 2006, the Court entered a final order overruling those objections.

b. In re French Automotive Castings, Inc. et al., Ch. 11, Case No. 06-10119 (Jointly Administered) (Bankr. D. Del.)

A Delaware case, In re French Automotive Castings, followed a substantially similar pattern as Calpine and Dana Corp. The debtors filed a first day motion on February 10, 2006, seeking the same relief and submitting the same proposal for adequate assurance (i.e., two weeks of utility service). Judge Walrath entered an interim order granting the motion upon payment of

the deposit. Ultimately, the Court entered a final order granting the motion, while certain objections were later resolved by court-approved stipulations.

c. In re Refco, Inc. et al., Ch. 11, Case No. 05-60006 (RDD) (Jointly Administered) (Bankr. S.D.N.Y.)

In Refco, the earliest example of this approach to BAPCPA's revision of section 366, the Bankruptcy Court for the Southern District of New York adopted procedures somewhat similar to those used in the other cases. On November 9, 2005, the debtors filed a motion under which they proposed to deposit approximately $285,000 into an interest-bearing account (the "Utility Deposit Account"), which sum represented 50% of the estimated cost of the debtors' monthly utility consumption. The motion also requested approval of procedures for a utility company to make additional requests for adequate assurance by serving a written request within 45 days of the date of the order granting the motion, or be barred from requesting additional adequate assurance. Without further order of the Court, the debtors could enter into an agreement for further assurance with any utility company that served a timely request. If, however, the debtors believed that a request was unreasonable, they could file a motion pursuant to section 366(c)(2) (the "Determination Motion"), within 30 days of the "Request Deadline," seeking a determination from the Court that the Utility Deposit Account plus any additional consideration offered by the debtors, constituted adequate assurance of payment. Pending notice and a hearing on the Determination Motion, the utility company would be barred from altering, refusing or discontinuing services to the debtors nor could it recover or setoff against a pre-petition deposit. On November 21, 2005, Judge Drain entered an interim order approving the motion, omitting the forty-five day limitation period for a utility company to request additional assurance, but retaining the 30 day period for the debtors to file a Determination Motion. No objections were filed and on December 9, 2005 a virtually identical final order was entered.

d. In re G+G Retail, Inc., Ch. 11, Case No. 06-10152 (RDD) (Bankr. S.D.N.Y.)

In In re G+G Retail, another Southern District of New York case, the debtor filed a motion on January 25, 2006 seeking entry of an order (a) prohibiting utility providers from altering, refusing or discontinuing services; (b) deeming utility providers adequately assured of future performance; and (c) establishing procedures for determining adequate assurance of future payment.

The debtor submitted that the requisite adequate assurance was provided to the utilities because, under the terms of an agreement to sell substantially all of its assets, the debtor was also entering into a $10 million DIP loan that could be used inter alia, to pay for utility services. Apparently aware that the availability of cash to pay utilities on a going forward basis was not a recognized "assurance of payment" under section 366(c)(1)(A), the debtor also proposed to deposit $50,000 into a "Utility Deposit Account" to be held in escrow for the purpose of providing the utilities additional adequate assurance of payment for post-petition date services, which the debtor argued was adequate in light of the very brief period the debtor anticipated operating in Chapter 11 prior to the proposed sale of all its assets. The debtor asserted that, although the types of "assurance of payment" were limited under BAPCPA, the amount of the assurance of payment remained "fully within the reasonable discretion of the Court."

The proposed procedures by which a utility could request additional adequate assurance of future payment were substantially similar to those requested in Refco, Calpine and Dana Corp., including the 45 day period for utilities to request additional assurance, the 30 days for the debtor to file a "determination motion" if the utility's request was unreasonable, and the injunction against the utility providers exercising their right of setoff against pre-petition deposits pending notice and a hearing on a determination motion.

On March 9, 2006, Judge Drain entered a final order granting the debtor's motion as modified. Prior to the entry of the order, the debtor had furnished the utilities adequate assurance of postpetition services by depositing $552,000 plus $50,000 in a segregated interest-bearing account. Additionally, the order did not include the 45 day limitation period for utilities to request additional adequate assurance, and the proposed 30 day period for the debtor to seek a determination hearing was reduced to 20 days. The order further provided that utility providers were not prevented from exercising their rights of setoff pursuant to section 366(c)(4). On April 5, 2006, one of the utility providers, Pepco Holdings, Inc., filed a Notice of Appeal.

II. KEY EMPLOYEE RETENTION PLANS: 11 U.S.C. § 503(c)

A. Introduction

Prior to the enactment of the BAPCPA, there was no statute that explicitly addressed the standard of review that applied to "key employee retention plans" or other similar payments to insiders (hereinafter referred to generally as "KERPs"). In the absence of any specific standard, courts relied on §363(b) and §105(a) and considered whether a proposed plan represented a proper exercise of the debtor's business judgment, and whether its terms were "fair and reasonable." Not surprising, this standard gave considerable leeway to debtors in proposing such plans, and significant discretion to the courts in approving them.

In an apparent effort to curb the perceived abuses that were developing in the use of KERPs to make significant payments to insiders during the early stages of a bankruptcy case, Congress included in a new section §503(c). Section §503(c) sets forth narrow limits on when a debtor may make payments to "insiders" for the purpose of inducing an insider to remain employed with the debtor, or in the form of severance. To the extent such payments are permitted, the new section includes caps on the amount of such payments. The new section also includes a catch-all provision in §503(c)(3) that limits a debtor's ability to make any other type of payment to any person – whether or not the person is an insider – if such payments are outside the debtor's ordinary course of business.

As of the date of these materials, there are no official reported cases involving the application of §503(c). There are a few unreported cases in which a debtor has sought approval to make certain compensation payments to insiders and others under the new §503(c). The discussion that follows examines the arguments that have been made in these cases under §503(c), and the resulting court decisions.

B. Changes Under BAPCPA

Section 503(c) provides

> Notwithstanding subsection (b), there shall neither be allowed, nor paid –
>
> (1) a transfer made to, or an obligation incurred for the benefit of, an insider of the debtor for the purpose of inducing such person to remain with the debtor's business, absent a finding by the court based on evidence in the record that –
>
> (A) the transfer or obligation is essential to retention of the person because the individual has a bona fide job offer from another business at the same or greater rate of compensation;
>
> (B) the services provided by the person are essential to the survival of the business; and
>
> (C) either –
>
> (i) the amount of the transfer made to, or obligation incurred for the benefit of, the person is not greater than an amount equal to 10 times the amount of the mean transfer or obligation of a similar kind given to nonmanagement employees for any purpose during the calendar year in which the transfer is made or the obligation is incurred; or
>
> (ii) if no such similar transfers were made to, or obligations were incurred for the benefit of, such nonmanagement employees during such calendar year, the amount of the transfer or obligation is not greater than an amount equal to 25 percent of the amount of any similar transfer or obligation made to or incurred for the benefit of such insider for any purpose during the calendar year before the year in which such transfer is made or obligation incurred;
>
> (2) a severance payment to an insider of the debtor, unless-
>
> (A) the payment is part of a program that is generally applicable to all full-time employees, and
>
> (B) 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 made; or
>
> (3) other transfers or obligation 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.

C. Recent Cases

1. In re Refco, Inc., Docket No.: 05-60006 (Bankr. S.D.N.Y. Jan. 17, 2006) (Drain, J.)

Refco and several of its related entities filed for chapter 11 relief on October 17, 2006. Refco is undertaking a liquidation of its various businesses. In connection with the winding down process, Refco sought the court's approval to implement a "key employee compensation program" to induce the continued employment of approximately 32 "key employees," who Refco argued were essential to the efficient winding down of the business operations.

According to Refco, none of the 32 key employees were officers or directors of Refco. Accordingly, the plan did not implicate the provisions of §503(c)(1) or (2). Because the plan proposed payments that were "outside the ordinary course" of Refco's business, presumably Refco had to establish that the payments under the plan were "justified by the facts and circumstances of the case" under the catch-all provision in §503(c)(3). Refco's motion, however, failed to even mention §503(c). Instead, Refco argued that its proposed key employee compensation program should be granted under the standards previously developed under §363(b) and §105(a).

The only objection against Refco's key employee compensation program was made by an organized "consumer group." The consumer group took issue with the fact that Refco's motion failed to contain sufficient information upon which the court could determine whether the provisions of §503(c) applied to Refco's request.

Despite the objection, the court granted Refco's motion approving of the plan without addressing the issue raised by the consumer group, and without making any particular findings under §503(c).

2. In re Nobex Corporation, Docket No. 05-20050 (Bankr. D. Del. Jan. 19, 2006) (Walrath, J.)

Nobex is a privately held biopharmaceutical company that filed for bankruptcy protection under chapter 11 on December 1, 2005. When it filed, Nobex was planning the sale of substantially all of its assets. The filing was intended to preserve those assets to facilitate the sale. In connection with its sale effort, Nobex desired to retain its senior management team, which consisted of its Chairman and CEO, and its Vice President of Finance and Administration. Nobex characterized these individuals as essential to the sale effort and Nobex's ability to satisfy its obligations under §363 in connection with the sale. To that end, Nobex asked the court to approve of a plan under which it would be permitted to make certain incentive payments to these individuals based on a percentage of the proceeds received from the sale of the assets. These individuals also would continue to receive their ordinary compensation consistent with Nobex's pre-petition practice.

By crafting a plan that contemplated incentive payments rather than outright retention or severance payments, Nobex was attempting to avoid the significant limitations that would have applied if the payments appeared to be retention or severance payments under §503(c)(1) and (2). Nobex, instead, took the position that its incentive payment plan fell under the "catch-all" exception under §503(c)(3) for payments outside the ordinary course of its business. According to Nobex, under the catch-all exception, the court should apply the standard that applied to such compensation plans prior to BAPCPA to determine whether the proposed incentive payments were "justified by the facts and circumstances of the case." This argument is essentially the

same as the argument that Refco advanced in support of its motion discussed above, albeit not explicitly.

Just prior to the hearing on Nobex's motion, Nobex and the Creditors Committee reached an agreement on the proposed incentive payments. Over the continuing objections of the U.S. Trustee and another group of interested parties, the court granted Nobex's request for relief as modified by its agreement with the Creditors Committee. In its order, the court found that the proposed incentive pay was not retention or severance compensation under §503(c)(1) and (2) but, rather, was a payment subject to the provisions of §503(c)(3). In considering whether the incentive pay was "justified by the facts and circumstances of the case" under §503(c)(3), the court agreed with Nobex and applied the business judgment standard previously developed under §363(b) and §503(c) 105(a).

3. In re Flyi, Inc., Docket No. 05-20011 (Bankr. D. Del. Feb. 3, 2006) (Walrath, J.)

Flyi, Inc. was a low cost, low fare regional airline that filed for relief under chapter 11 on November 7, 2005. The bankruptcy filing was part of an effort to either secure necessary investor funds or sell the business as a going concern. By late December 2005, it became clear that Flyi was not going to be able to do either and, as a consequence, it developed a plan for liquidating the company. The liquidation plan included a "Wind-Down Employee Plan" that provided for, among other things, compensation for the 171 employees who were to remain with the debtor to assist in the winding down process. Six of those remaining employees were officers of the debtor and, thus, "insiders."

Any payments to the six insiders who were to remain with Flyi during this period arguably implicated the requirements under §503(c)(1) applicable to retention payments to insiders. Flyi, however, argued that its Wind-Down Employee Plan was not subject to the

requirements of 503(c)(1) because Flyi was liquidating its business. Flyi argued that, in a liquidation, there was no "business" as that term is used in the context of §503(c)(1). According to Flyi, the term "business" in §503(c)(1) applies to a "viable commercial enterprise" or, at least, an enterprise for which there was an effort underway to render it viable because the focus of this subsection is on what is necessary for the survival of such a business. It argued that a liquidation, in contrast, means that "the 'business' will not survive," and payments to persons who remain with Flyi during such a process could not by definition be for the purpose of inducing them to remain with any on-going business as these persons were "literally working [themselves] out of a job."

In the alternative, Flyi indicated to the court in its motion that it would consider several other options to avoid an absolute bar on the "retention" of and payment to these insiders. Those options included attempting to stay within the cap set by §503(c)(1)(C) for some of the insiders, terminating those insiders for whom the cap was not sufficient and re-hiring them as consultants, demoting the insiders so they were no longer "insiders" subject to the limitations of 503(c), or re-casting the payments as incentive based bonuses that would be not be subject to the cap.

The court never reached the issues raised by Flyi. Instead, Flyi, the U.S. Trustee and the Creditors Committee reached a negotiated agreement on a proposed order following two hearings before the court, which order was endorsed by the court over objections asserted by the Association of Flight Attendants.

The negotiated agreement and the Flight Attendants' objections gave rise to another interesting issue under §503(c). The agreement reached among Flyi, the U.S. Trustee and the Creditors Committee involved characterizing the payments to insiders under the Wind-Down Employee Plan as severance payments subject to the requirements of §503(c)(2). As argued by

Flyi, because all of the non-insider employees remaining with Flyi during the liquidation would be entitled to a severance payment, such payments to the six insiders are permitted under §503(c)(2)(A). The calculation of the cap on severance payments to the six insiders as agreed to by Flyi, the U.S. Trustee and the Creditors Committee, would not exceed 10 times the average of the payments to all of the remaining non-insider employees.

The Flight Attendants argued that the payments to insiders were barred under §503(c)(2) or, at a minimum, the amount of those payments should be substantially reduced. The Flight Attendants' argument was premised on its assertion that the reference to "all full-time employees" under §503(c)(2), for purposes of approving any severance payment and setting the cap, includes all employees who were to remain with Flyi during the liquidation under the proposed severance plan, and all employees who had been laid off without severance payments prior to the commencement of the severance plan. Any other interpretation, according to the Flight Attendants, would permit a debtor to jerry-rig a severance program by retaining and paying token non-insider employees a substantial severance amount that would artificially inflate the calculation of the cap for severance payments to insiders. Applying this interpretation, unless Flyi retroactively paid severance to the terminated employees, no insiders could be paid a severance under the proposed plan. Alternatively, the Flight Attendants argued that, if insiders are nonetheless entitled to receive a severance payment, the calculation of the "mean severance payment" to non-insiders – from which the cap on insider payments is to be determined – must take into account that the terminated employees received $0 as their severance payment, a factor that would substantially decrease the mean severance payment to non-insiders and, thus, the cap for severance payments to insiders.

The court declined to adopt the Flight Attendants' arguments. The court determined that §503(c)(2) related to the severance program under consideration by the court for the employees who were to remain employed during the liquidation period. The court held that there was no basis for requiring a debtor to retroactively give severance to employees who were previously been terminated as part of the debtor's cost cutting efforts. Accordingly, as long as the program under consideration proposed severance payments to all remaining full time employees, the insiders could also receive a severance payment under §503(c)(2)(A), and the calculation of the cap would only be determined based on the payments proposed to be made to those remaining employees.

4. Riverstone Networks, Inc., Docket No.: 06-10110 (Bankr. D. Del. Mar. 28, 2006) (Sontchi, J.).

Riverstone is a publicly traded technology company in the business of marketing and selling certain Ethernet routers for telecommunication service providers. Riverstone filed for relief under chapter 11 on February 7, 2006 with the intent to complete the sale of the company's assets to Lucent Technologies, Inc. Riverstone projected that the proceeds from the sale to Lucent would be sufficient to allow a full recovery to creditors and a substantial recovery to equity holders.

In connection with consummating the sale to Lucent, Riverstone sought the court's approval to modify its Employee Bonus Program for alleged non-insider employees to include retention bonuses for those who stay with Riverstone during the sale process, and to continue a Management Bonus Program (applicable to a small number of management level employees) and a personal time off policy ("PTO policy") (applicable to all employees). The debtor argued that the continuation of these programs was justified under the business judgment standard under §363(b), and was necessary under §105(a) to facilitate the orderly sale of Riverstone's assets.

Regarding §503(c), Riverstone contended that it did not apply to the Employee Bonus Program or the Management Bonus Program because those programs did not involve payments to insiders, and the continuation of those programs were not "outside the ordinary course" of Riverstone's business. As to the PTO policy, Riverstone argued that it satisfied the requirements of §503(c)(2) because the policy applied to all of its employees and that the payments would not exceed the cap.

Riverstone's motion provided little detail upon which to assess the merits of its arguments. The U.S. Trustee and the equity security holders committee primarily objected based on this lack of detail. Nonetheless, presumably given the significant projected recovery on claims in the case, the court approved Riverstone's request without any significant discussion of the underlying rationale.

D. Conclusion

Although the law on new §503(c) has not developed much since BAPCPA was enacted, these few cases shed some light on how parties and courts are addressing its application. The Refco and Nobex cases suggest that, in considering whether proposed payments under §503(c)(3) are "justified by the facts and circumstances of the case," courts may revert to the former standards applied by courts under §363(b) and §105(a) and consider whether the payments are a proper exercise of the debtor's business judgment, and its terms are "fair and reasonable." Debtors also may attempt to avoid the significant limitations of §502(c)(1) and (2) by proposing payments that look less like retention or severance payments so as to trigger an examination under the potentially more discretionary standard of §503(c)(3), as Nobex attempted to do. It also is likely that we will see a further development of the theory advanced by Flyi that §503(c) simply does not apply to a liquidation case.

III. COMMITTEE INFORMATION: 11 U.S.C. § 1102(b)(3)

A. Section 1102 as Amended by BAPCPA

Under the new 11 U.S.C. § 1102(b)(3), a creditors' committee is required to provide unsecured creditors who are not members of the committee with "access to information." Section 1102(b)(3) provides:

> A committee appointed under subsection (a) shall (A) provide access to information for creditors who (i) hold claims of the kind represented by that committee; and (ii) are not appointed to the committee; (B) solicit and receive comments from the creditors described in subparagraph (A); and (C) be subject to a court order that compels any additional report or disclosure to be made to the creditors described in subparagraph (A).

The "information" that section 1102(b)(3)(A) requires a creditors committee to make available to its constituents is not defined in BAPCPA, nor does BAPCPA's legislative history provide meaningful direction concerning the kind of information that should be made available or the manner in which it should be communicated. Questions left unanswered by BAPCPA therefore include whether section 1102(b)(3) requires the disclosure of confidential or privileged information; whether such disclosure must be made to all similarly situated creditors at once, or instead only to individual creditors who demand the information; and what type of solicitation of comments is required and from whom.

B. Reported Case: In re Refco

In re Refco, 336 B.R. 187 (Bankr. S.D.N.Y. Jan. 20, 2006), the only reported case to date on the subject, provides meaningful guidance concerning creditors committees' new disclosure obligations. In Refco, the creditors committee filed a motion to clarify its obligations under section 1102(b)(3)(A) to provide unsecured creditors who are not members of the committee with access to information, thereby helping to ensure that confidential, privileged, proprietary and/or material non-public information would not be disseminated to the detriment of the

debtors' estates. The committee's motion was based upon the concern that section 1102(b)(3)(A) might be interpreted to impose obligations contrary to other applicable laws and the committee's fiduciary duties. Id. at 190.

In analyzing the disclosure requirement under section 1102(b)(3)(A), the court noted that the Code contains a similar requirement for trustees. Section 704(a)(7) provides that a "trustee shall . . . furnish such information concerning the estate and the estate's administration as is requested by a party in interest." While a trustee's duty to provide requested information under section 704(a)(7) has been broadly interpreted, it does not apply to confidential or proprietary information, nor to information protected by the attorney-client privilege. Further, trustees need not disclose information if doing so would frustrate a countervailing fiduciary duty, thereby causing harm greater than the harm that would result from withholding the requested information. The court held that these principles apply to a creditor committee's analogous obligations under section 1102(b)(3)(A). Id. at 194.

In construing section 1102(b)(3)(A), the Refco court also relied upon In re Gilchrist Co., 410 F. Supp. 1070 (E.D. Pa. 1976), a case under the Bankruptcy Act. The Court concluded that a creditors committee was "not required to 'forward to each creditor all the raw data it considers' as if it were a virtual information bank for its constituents in the process of carrying out its duties." Refco, 336 B.R. at 194 (quoting Gilchrist, 410 F. Supp at 1078). Additionally, the Court stated that the proper scope of section 1102(b)(3)(A) could be analyzed by analogy to several pre-BAPCPA decisions that considered a creditors committee's confidentiality restrictions in light of its diverse duties and functions. The Court observed that in performing its oversight and negotiation functions, committee members "should and will receive commercially sensitive or proprietary information from the debtor and other parties." Id. at 196. The Court

further noted that "[i]t has frequently been held that committee members' fiduciary duties of loyalty and care to the unsecured creditor body require such information to be held in confidence. Otherwise, communications between the committee and third parties and among committee members themselves would be improperly curtailed, or the debtor might be harmed with a resulting decline in the creditors' recovery." Id.

The Court clearly sought to achieve a balance between, on the one hand, the committee's need to preserve its access to sensitive information, to protect the attorney-client privilege, and to comply with the securities laws, and, on the other hand, the obligation, embodied in BAPCPA, to inform unsecured creditors of material developments in the case before they are presented with what "in practical terms may be a fait accompli." Id. at 197.

1. Protected Information:

In its Order Regarding Creditor Access to Information, entered on December 23, 2005, the Court ruled that, in the absence of a further order, the committee was not required to disclose 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 200.

The Court defined protected information as that information (i) relating to (a) the acts, conduct, assets, liabilities and financial condition of the debtors, (b) the operation of the debtors' business and the desirability of the continuance of such business, and (c) any other matter relevant to the debtors' cases or to the formulation of one or more Chapter 11 plans (including any and all confidential, proprietary, or other nonpublic materials of the committee) whether

provided voluntarily or involuntarily by or on behalf of the debtors or by any third party or prepared by or for the committee, and (ii) any other information the effect of the disclosure of which would constitute a general waiver of the attorney-client, work-product, or other applicable privilege possessed by the committee. Id. at 201.

The Court also instructed the committee to consider whether the requesting creditor was willing to enter into confidentiality or trading restrictions when the committee determined whether to release otherwise protected information. The Court ruled that if the committee elected to provide access to confidential information on the basis of such confidentiality and trading restrictions, the committee would have no responsibility for the creditor's compliance with, or liability for violation of, applicable securities or other laws. Id. at 200, 201.

2. Information on the Committee's Website:

The Court further held that, except with respect to protected information, the committee was obligated to provide updated information regarding the case on a website in furtherance of its obligations under 11 U.S.C. § 1102(b)(3)(A). That information included the following:

(1) general information concerning the Chapter 11 cases of the debtors including case dockets, access to docket filings, and general information concerning significant parties in the cases;

(2) monthly committee written reports summarizing recent proceedings, events and public financial information;

(3) highlights of significant events in the cases;

(4) a calendar with upcoming significant events in the cases;

(5) access to the claims docket as and when established by the debtors or any claim agent retained in the cases;

(6) a general overview of the Chapter 11 process;

(7) press releases (if any) issued by the committee and the debtors;

(8) a non-public registration form for creditors to request "realtime" case updates via electronic mail;

(9) a non-public form to submit creditor questions, comments and requests for access to information;

(10) responses to creditor questions, comments and requests for access to information; provided that the Committee may privately give such responses in the exercise of its reasonable discretion, including in the light of the nature of the information request and the creditor's agreements to appropriate confidentiality and trading constraints;

(11) answers to frequently asked questions; and

(12) links to other relevant Web sites.

Additionally, the Court held that the committee was obligated to distribute case updates via electronic mail for creditors that register for this service on the committee website, as well as establish and maintain a telephone number and electronic mail address for creditors to submit questions and comments. Id. at 200.

3. Creditor Information Requests:

The Court's order also provided that, if a creditor submitted a written request, including on the committee website or by e-mail, for the committee to disclose information, the committee had to provide a response as soon as practicable, but no more than 20 days after receipt of the request. The response had to either provide access to the information requested or the reasons it could not comply with the request. If the committee believed the request implicated protected information, it did not have to provide the requested information. If the request was deemed to be unduly burdensome, the requesting creditor could, after a good faith effort to meet and confer with an authorized representative of the committee, seek to compel such disclosure pursuant to a motion. Id. at 201.

C. Unreported Orders

1. In re FLYi, Inc., *et al*., Ch. 11, Case No. 05-20011 (MFW) (Jointly Administered) (Bankr. D. Del.)

In an order that predated the Refco decision, Judge Walrath ruled on November 17, 2005 that the creditors committee's disclosure obligations under section 1102(b)(3)(A) did not require it to disclose "confidential information" or "privileged information," as those terms were defined in the order. The committee was permitted, but not required, to provide access to privileged information to any party so long as such information was not also confidential information and the relevant privilege was held and controlled solely by the committee. The committee was directed to respond to written and telephonic inquires and comments received from the creditors. The committee was further permitted, but not directed, to utilize a website for the purpose of providing access to documents, pleadings and other materials that the committee believed, in its reasonable business judgment, were relevant and informative for creditors it represented, including documents pertaining to any plan of reorganization and pleadings filed by the committee.

2. In re Dana Corp. *et al*., Ch. 11, Case No. 06-10354 (BRL) (Jointly Administered) (Bankr. S.D.N.Y.)

On March 29, 2006, Judge Lifland entered an order similar to Judge Walrath's order in FLYi. As in FLYi, the committee in Dana Corp. was neither authorized nor required to provide access to any confidential or privileged information of the debtors to any creditor who was not a member of the committee. Unlike FLYi, the Court neither set a deadline by which the committee would be required to respond to inquiries for information, nor did it suggest (or require, as in Refco) that the committee provide access to information on a website.

3. In re Calpine Corp., *et al.*, Ch. 11, Case No. 05-60200 (BRL) (Jointly Administered) (Bankr. S.D.N.Y.)

On January 17, 2006, the creditors committee in Calpine filed motion for an order, *nunc pro tunc* to the date the committee was formed, clarifying that section 1102(b)(3)(A) did not require the dissemination of confidential, proprietary, non-public information concerning the debtors, or any other information if the effect of such disclosure would constitute a waiver of any privilege. Noting the ambiguity in section 1102(b)(3)(A), the committee added that absent clarification from the Court, the committee's efforts to discharge its obligations under section 1103(c) could be hindered because the debtors would be reluctant to share confidential, sensitive financial and strategic information, which is the precise information a committee needs and typically receives to assist it in the discharge of its fiduciary obligations.

In an order to show cause, dated January 17, 2006, Judge Lifland provisionally granted the committee's motion. The order provided that notwithstanding anything contained in section 1102(b)(3)(A) to contrary, the committee was not required to disseminate any non-public information concerning the debtors, including with respect to acts, conduct, assets, liabilities and financial condition of the debtors, the operation of the debtors' business and the desirability of the continuance of such business, and any other matter relevant to these cases or to the formulation of a chapter 11 plan, to anyone other than its members.

On February 23, 2006, the court entered a Stipulation and Agreed Order Between the Debtors and the Official Committee of Unsecured Creditors Regarding Creditor Access to Information. The stipulation followed the guidelines set forth in the Refco decision. Most notably, the committee was not required to disseminate confidential or privileged information, but was required (1) to establish a committee website which would make available the same twelve categories of information set forth in the Refco decision; (2) to distribute case updates to

creditors via e-mail; and (3) to establish a telephone number and e-mail address for creditors to submit questions and comments. The stipulation also provided guidelines, like those in Refco, for responding to creditor information requests.

IV. CONVERSION/DISMISSAL: 11 U.S.C. 1112

A. Section 1112 as Amended by BAPCPA

BAPCPA's revisions to section 1112 substantially expand the grounds for conversion or dismissal of a Chapter 11 case. Section 1112(b), which formerly provided that the court "may" dismiss or convert the case for cause, now states that the court "shall" dismiss or convert a case if certain non-exclusive enumerated grounds are met, unless the debtor or an other interested party establishes "unusual circumstances specifically identified by the court" establishing that conversion or dismissal is not in the best interests of the creditors and the estate. In order to make such a showing, the interested party must establish that: (1) there is a reasonable likelihood that a plan will be confirmed within the time established in sections 1121(e) and 1129(e); (2) there is no substantial or continuing loss to or diminution of the estate and there is a reasonable likelihood of rehabilitation; and (3) there is reasonable justification for the debtor's act or omission constituting cause that will be cured within a reasonable period of time.

Further, the 10 grounds for cause in the pre-BAPCPA section 1112(b) have been replaced by 16 bad acts under section 1112(b)(4). New grounds for conversion or dismissal include: (1) gross mismanagement; (2) failure to maintain appropriate insurance; (3) unauthorized use of cash collateral substantially harmful to one or more creditors; (4) failure to comply with an order of the court; (5) unexcused failure to timely meet reporting requirements; (6) failure to attend the section 341 meeting or a Rule 2004 examination; (7) failure to provide information or attend meetings reasonably requested by the U.S. Trustee; and (8) failure to timely pay postpetition taxes or file tax returns.

B. Reported Case: In re TCR of Denver, LLC

In In re TCR of Denver, LLC, 338 B.R. 494 (Bankr. D. Col. Feb. 17, 2006), the only reported post-BAPCPA case, the bankruptcy court concluded that Congress could not have

intended to require that all the circumstances listed in the new section 1112(b)(4) be met before converting or dismissing a case for cause. The drafting problem at issue was that Congress replaced the conjunction "or" in an old section 1112(b) with the conjunction "and" in new subsection 112(b)(4)(O) between the penultimate and final examples of cause.

Reasoning that "the language of BAPCPA . . . tends to defy logic and clash with common sense," and if strictly construed "would result in an absurd decision and totally unworkable legal precedent," the Court concluded that a disjunctive reading of 1112(b)(4) was warranted. Id. at 495-96.

C. Unreported Order: In re Refco

The issue of conversion from chapter 11 to chapter 7 has been actively litigated in the Refco bankruptcy. In December 2005, a group of creditors known as the "Moving Customer Group" ("MCG"), filed a motion to covert the case of one of the debtors, Refco Capital Markets, Ltd ("RCM"), from chapter 11 to chapter 7. The primary argument advanced by the MCG was that RCM is a stockbroker, as defined by section 101(53A), and the case therefore should be converted to a chapter 7 subchapter III stockbroker liquidation. According to the MCG, there was sufficient "cause" to convert the case under section 1112(b) because, as a stockbroker, RCM was ineligible to be a chapter 11 debtor under section 109(d). Numerous objections were filed, but only a handful expressly raised the issue of "cause" under section 1112(b). The Ad Hoc Senior Subordinated Notes Committee argued that, in the absence of a finding that RCM was a stockbroker, none of the circumstances constituting cause enumerated in section 1112(b)(4) could apply and even if cause could be found, the case involved "unusual circumstances" that militate against conversion pursuant to 1112(b)(1).

V. ANCILLARY AND OTHER CROSS-BORDER CASES: CHAPTER 15

A. Introduction

BAPCPA adds a new Chapter 15, entitled Ancillary and Other Cross-Border Cases, the purpose of which is to "incorporate the Model Law on Cross-Border Insolvency so as to provide effective mechanisms for dealing with cases of cross-border insolvency." 11 U.S.C. § 1501(a). Generally, the provisions of Chapter 15 are applicable to cases where "assistance is sought in the United States by a foreign court or a foreign representative in connection with a foreign proceeding." 11 U.S.C. § 1501(b). Under Chapter 15, once a foreign bankruptcy proceeding is "recognized" by an order of a United States Bankruptcy Court, much of the relief available under the Bankruptcy Code immediately becomes applicable, including the automatic stay provision under section 362. See, 11 U.S.C. § 1520 (applying sections 361, 362, 363, 549, and 552 of the Code to debtors and debtors' property within the territorial jurisdiction of the United States).

B. Reported Case: United States v. J.A. Jones Construction Group, LLC

Such relief is available, however, only after a Bankruptcy Court grants a foreign representative's petition for recognition. 11 U.S.C. §§ 1504, 1515. In United States v. J.A. Jones Construction Group, LLC, 333 B.R. 637 (E.D.N.Y. 2005), the District Court for the Eastern District of New York held that it had no authority to consider a foreign debtor's request for a stay when the debtor had failed to commence an ancillary proceeding for recognition of the foreign proceeding before a United States Bankruptcy Court. Id. at 638 (citing 11 U.S.C. § 1504).

In Jones Construction, the federal government commenced an action against multiple defendants as a result of delays in the performance of a construction contract. The receiver of the Canadian corporate parent of one of the defendant companies moved for a stay of the action pursuant to Canadian bankruptcy law. Although the District Court held that in the absence of

"recognition" of the proceeding it lacked authority to issue a stay, it nevertheless determined that, "given the comity that American courts should accord foreign bankruptcy proceedings," it would stay the action for sixty days in order to provide the receiver an opportunity to seek relief under chapter 15. Id.