JONES DAY

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PAY UP OR SURRENDER: THE SEVENTH CIRCUIT PUTS TEETH BACK INTO SECTION 1110

Mark G. Douglas

The bankruptcy laws of the United States have long provided special benefits to those who lease, finance or conditionally sell transportation equipment such as airplanes, trains and related parts to companies that later file for bankruptcy protection. This special interest legislation reflects lawmakers' intent to offer enhanced protection and encouragement to transportation financiers based upon the perception that the uninterrupted availability of low-cost financing in the industry and the ability of financiers to gain immediate access to their collateral notwithstanding a bankruptcy filing are vital to the continued functioning of the national economy. In the case of the aviation industry, section 1110 of the Bankruptcy Code describes the circumstances under which a chapter 11 debtor-in-possession ("DIP") or bankruptcy trustee can continue to use qualifying aircraft, vessels and related equipment. A pair of rulings recently handed down by the Seventh Circuit Court of Appeals in *United Airlines, Inc. v. U.S. Bank N.A.* indicate that the requirements of section 1110 are strictly applied, and that a debtor air carrier fails to adhere to the clear dictates of section 1110 at its own peril.

THE BANKRUPTCY CODE'S SPECIAL TREATMENT OF LEASED AND FINANCED AIRCRAFT AND PARTS

If a company that leases or has financed the acquisition of most kinds of personal property, such as equipment, files for chapter 11 protection, the DIP or any trustee appointed in the case to administer the debtor's assets generally has the right to

continue using the assets in question under the circumstances specified in sections 363 and 365 of the Bankruptcy Code.

For financed property, section 363 provides that the DIP or trustee may continue to use property that serves as collateral (other than cash) so long as the secured creditor's interest in the asset is adequately protected from diminution in value. By providing adequate protection, the DIP has the right to continue using the property during its bankruptcy case until it determines either to sell (or under certain circumstances, abandon) the asset, or to include it as part of a reorganization strategy involving confirmation of a chapter 11 plan and the continuation of its business afterward.

Different rules apply to most leased personal property. Section 365 provides that the DIP may either assume (reaffirm) or reject (breach) any unexpired lease of personal property. The decision to assume or reject can be deferred until confirmation of a plan of reorganization, unless the lessor prevails upon the bankruptcy court to direct the DIP to make the decision at some earlier time in the chapter 11 case. Pending its decision to assume or reject, a DIP must perform in a timely manner all of the obligations under the lease arising on or after 60 days following the bankruptcy petition date.

Section 1110 creates special rules designed to give both lessors and financiers of aircraft equipment readier access to qualifying equipment if a debtor air carrier is unable to comply with its obligations under whatever agreement governs the transaction in question. In contrast to sections 363 and 365, section 1110 provides in substance that financiers and lessors of aircraft and related equipment may not be prevented from taking possession of the assets in question in accordance with the terms of whatever agreement governs their relationship with the debtor *unless* the DIP or trustee timely agrees to perform the debtor's obligations and also timely cures certain defaults. These rights are expressly conferred upon financiers and lessors notwithstanding any injunctive power of the court, or the general applicability of the automatic stay, rules governing a DIP's use or lease of property, or provisions permitting the modification of secured debts under a chapter 11 plan.

The deadline established in section 1110 is generally 60 days after the bankruptcy filing. This means that the automatic stay will prevent the repossession of qualifying aircraft and parts only if the DIP agrees, with court approval, to perform all its contractual obligations, and cures any pre-existing defaults under the contract within 60 days of filing for bankruptcy. The 60-day period may be extended only if the lessor or financier agrees to an extension and the bankruptcy court approves the agreement. Upon expiration of the 60-day period (or any extension thereof) and the DIP's receipt of a written demand for surrender of the covered aircraft and related equipment, it must "immediately surrender and return" the assets to the lessor or financier.

Section 1110 does not apply to all leased or financed aircraft and related parts. The statute provides that the aircraft must be either an "aircraft, aircraft engine, propeller, appliance or spare part" as defined in title 49 of the United States Code, which broadly defines "aircraft" as "any contrivance invented, used, or designed to navigate, or fly in, the air." However, the purchaser or lessee of the aircraft must hold an air carrier operating certificate issued under title 49 of the United States Code "for aircraft capable of carrying 10 or more individuals or 6,000 pounds or more of cargo." Thus, section 1110 excludes most privately owned aircraft.

Section 1110's reach may be further limited if the aircraft or parts in question were first placed into service before 1994. Prior to that time, the statute applied only to lease, conditional sale or financing transactions that involved "purchase-money equipment security interests." As such, the lease or security interest involved had to relate to the debtor's original acquisition of the aircraft or parts in question for the lessor or vendor to be entitled to the protections of section 1110. Congress amended the statute in 1994 to eliminate this requirement, but the pre-1994 law still applies to equipment first placed into service before the amendments were enacted on October 22, 1994. Because many aircraft and related parts still fall into this designation, the exception for pre-1994 equipment may be significant. If, for example, a lease involving pre-1994 equipment is later determined to be a disguised financing transaction, but not purchase-money financing, the vendor may not be protected under section 1110.

As amended, section 1110 applies to all kinds of qualifying aircraft leases and financing transactions. It creates a powerful package of benefits for aircraft lessors and financiers. The extent of those benefits and the inability of the courts to interfere with them were recently addressed by the Seventh Circuit in *United Airlines*.

UNITED AIRLINES

At the time that United Airlines, Inc. filed for chapter 11 protection in 2002, approximately 175 of the 460 planes that it operated had been acquired by means of financings or leases that were covered by section 1110. Initially, many of the aircraft lessors agreed to permit United to continue using the leased aircraft under certain specified conditions and to accept rent at a reduced rate from that specified in their lease agreements. However, as the reorganization dragged on for more than two and one-half years, some of the aircraft lessors concluded that United could not successfully reorganize. They accordingly demanded that United immediately return their planes unless it cured all defaults and resumed paying the full rent due under their rental agreements.

United did neither. Instead, it sued the indenture trustees representing the lessors, contending that they violated antitrust laws by coordinating their efforts to preserve the aircraft collateral and to negotiate regarding lease terms with United. United also sought an injunction preventing the trustees from repossessing the leased aircraft and parts.

The bankruptcy court issued a temporary restraining order granting United's requested relief pending a hearing on the motion for a preliminary injunction. United then sought discovery of all communications among the trustees, searching for evidence to support its illegal collaboration theory. The trustees refused on the basis of privilege, provoking the bankruptcy court to find them to be in contempt, although it never imposed any sanctions. The court simply adjourned the hearing on United's motion for injunctive relief until such time that the trustees complied with the discovery request.

The trustees appealed the temporary restraining order and the declaration of contempt to the district court, which dismissed both appeals based upon its determination that neither order was "final," and therefore subject to review by an appellate court. Thus, United was permitted to continue using the leased aircraft without either paying the full rent or returning the planes to the lessors. Moreover, it could continue to do so indefinitely because the bankruptcy court refused to convene a hearing on United's motion for injunctive relief until the trustees complied with United's discovery requests.

The lessors petitioned the Seventh Circuit, seeking a writ directing the district court to dissolve the temporary restraining order or at least to decide the discovery dispute. Concluding that it had appellate jurisdiction because the temporary restraining order became subject to review as an injunction after it remained in effect for more than 20 days, the Court of Appeals reversed the determinations below. It remanded the case with instructions to vacate the preliminary injunction and permit the trustees to take possession of the leased aircraft unless United immediately cured its defaults and paid the full rent due under the lease agreements.

Emphasizing that "[t]he final clause of § 1110(a)(1) prevents bankruptcy judges from using *any* source of law, including antitrust, as the basis of an injunction against repossession," the Seventh Circuit flatly rejected United's claims that section 1110 nullifies only powers conferred on a bankruptcy court under the Bankruptcy Code, and that holding otherwise would repeal the antitrust laws. "Unless it is to be empty," the Court of Appeals observed, "the phrase 'any power of the court' must deal with sources outside of the Bankruptcy Code." The Seventh Circuit went on to explain that, instead of repealing the antitrust laws, section 1110 merely curtails a particular remedy without affecting any substantive rule by providing that courts cannot prevent aircraft lessors or secured lenders from repossessing their collateral in accordance with the terms of their agreements. According to the Court, where violations of the antitrust laws have actually occurred, section 1110 does not preclude actions for damages, actions by the Federal Trade Commission or criminal prosecution.

The Seventh Circuit characterized United's antitrust claim as "thin to the point of invisibility." Creditors in a bankruptcy case, the Court explained, are clearly entitled to negotiate jointly in an effort to maximize the recovery on their

claims. Moreover, the Seventh Circuit emphasized, United's contention that the lessors "colluded with one another with respect to the *future* terms and prices on which they would make aircraft available to United" was not actionable under antitrust law because the allegation referred to planes that had already been leased to United, rather than new aircraft. Observing that "[n]egotiating discounts on products already sold at competitive prices is not a form of monopolization," the Court held that negotiating reductions to be taken in a bankruptcy case, when the buyer is unable to pay all of its debts, is "common and lawful." To hold otherwise, the Seventh Circuit emphasized, would mean that a prepackaged bankruptcy, in which all creditors negotiate to reach unanimous agreement before presenting a plan to the court for confirmation, "would be nothing but a colossal cartel, unlawful *per se*."

The Seventh Circuit concluded with the following remarks directed toward the economic policy considerations underpinning section 1110:

> The competitive solution is for *both* sides to have access to markets — and that outcome is achieved by allowing repossession. The lessors will get the current market price for airframes of the type and age involved. United, too, will enjoy a competitive price: it can buy or rent equivalent planes on going terms. If, as United and the Committee of Unsecured Creditors contend, the spot-market price is below not only the original rental terms but also the modified terms set when United filed for bankruptcy in 2002, then United will be better off as a result. Its problem arises if, as the lessors are betting, the price of used airplanes is higher than what United is now paying for these 14 aircraft. But if, as United contends, the highest and best use of these planes is with United, and the current competitive price is less than what United is paying in bankruptcy, then the threat to repossess is not credible, and United will keep the planes without judicial intervention (though tough bargaining may lie ahead to set the extent of the haircut from the old rental price). Only if potential sellers and lenders conspire to set the price at which United can acquire replacement aircraft would there be a genuine antitrust problem, and United does not contend that such a cartel is in prospect.

SUBSEQUENT EVENTS

Notwithstanding the Seventh Circuit's ruling concerning the lessors' rights under section 1110, the lower courts did nothing to implement its directives other than to schedule a status conference on the issue. The trustees accordingly returned to the Court of Appeals, which issued yet another decision on the subject barely three weeks after its initial ruling. Observing that "[d]isagreement with [a decision's] substance may furnish a basis for a petition for rehearing (or certiorari); it does not license defiance by a litigant or an inferior court," the Seventh Circuit strongly rebuked the courts below for failing immediately to implement the relief mandated in its previous ruling. It once again directed the lower courts to dissolve the injunction and held that "[a]s of this instant, the lessors are at liberty to exercise their statutory and contractual entitlements."

Section 1110 is designed to ensure that the market determines where aircraft resources are deployed, so that a bankruptcy filing disrupts the free functioning of that market as little as possible.

OUTLOOK

United Airlines has been perceived widely as a victory for aircraft financiers and lessors. Section 1110 is designed to ensure that airline industry financiers are assured ready access to their collateral if an airline lessee or purchaser files for bankruptcy, unless the airline is able to live up to the terms of its agreement within 60 days of filing (or within any negotiated extension). While less than ideal from an air carrier's perspective, this short time frame is intended to make it more likely that financing will be readily accessible on reasonable terms in the marketplace.

United's efforts to transform the issue from an aircraft lessor's exercise of its express statutory rights and remedies into an antitrust dispute was regarded as nothing less than an all-out assault on section 1110, and the Seventh Circuit appropriately

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WHAT'S NEW AT JONES DAY?

Paul E. Harner (Chicago), Robert W. Hamilton (Columbus), Charles M. Oellermann (Columbus) and ***Joseph M. Witalec (Columbus)*** were panelists at a continuing legal education seminar held on June 28, 2005 in Columbus concerning the significant business provisions contained in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

An article co-written by ***Paul D. Leake (New York)*** and ***Mark G. Douglas (New York)*** entitled "Testing the Limits of the Chapter 11 Transfer Tax Exemption: In Search of the Meaning of 'Under a Plan Confirmed'" appeared in the Summer 2005 edition of the *New York University Journal of Law and Business*.

An article co-written by ***Brad B. Erens (Chicago)*** and ***Scott J. Friedman (New York)*** entitled "The Chapter 11 Debtor and Section 556 of the Bankruptcy Code: Are Your Supply Contracts Safe?" was published in the June 2005 edition of the *Andrews Bankruptcy Reporter*.

Brad B. Erens (Chicago) gave a presentation concerning "Parent Issues in Subsidiary Chapter 11 Cases" on June 23, 2005 in Chicago at the Eighth Annual Conference on Corporate Reorganizations sponsored by Renaissance American Management.

An article written by ***Erica M. Ryland (New York)*** entitled "Back to the Drawing Board for Asbestos Pre-Packs" appeared in the July 2005 edition of LJN's *Product Liability Law and Strategy Newsletter*.

Richard Engman (New York), ***Veerle Roovers (New York)*** and ***Ross S. Barr (New York)*** were part of a team of Jones Day attorneys representing WHX Corporation in connection with its confirmation of a chapter 11 plan on July 21, 2005.

Carl M. Jenks (New York and Cleveland) gave a presentation on July 21, 2005 concerning the tax provisions contained in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 at a seminar in Boston jointly sponsored by the American Law Institute and the American Bar Association.

Carl E. Black (Cleveland) was among the attorneys included in "Ohio Super Lawyers — Rising Stars Edition" issued by *Cincinnati Magazine*. Ohio Rising Stars consist of the top 2.5% of the up-and-coming attorneys in Ohio who are age 40 or younger.

A two-part article co-written by ***Scott J. Friedman (New York)*** and ***Mark G. Douglas (New York)*** entitled "You Just Can't Give it Away: Senior Class Give-up to Equity Violates Absolute Priority Rule" appeared in the July and August 2005 editions of *The Bankruptcy Strategist*.

A team of Jones Day attorneys led by ***Ansgar Rempp (Munich)*** and including ***Volker Kammel (Frankfurt)***, ***Marc O. Peisert (Frankfurt)***, ***Sina Hekmat (Frankfurt)***, ***Eric Messenzehl (Frankfurt)***, ***Sandra C. Kamper (Munich)***, ***Harald Hess (Munich)*** and ***Tommaso Cefis (Milan)*** advised a consortium led by Cerberus Partners L.P. in connection with the acquisition of a loan portfolio in an aggregate nominal amount of more than € 400 million from Bayerische Landesbank, a state-owned German bank located in Munich.

Volker Kammel (Frankfurt), ***Carsten Gromotke (Frankfurt)***, ***Andreas Koester-Boeckenfoerde (Frankfurt)***, ***Markus Bauer (Frankfurt)***, ***Hanno Schultze Enden (Frankfurt)*** and ***Christian Staps (Frankfurt)*** counseled Goldman Sachs in connection with the acquisition of loans extended by nine banks to Ihr Platz in the total nominal amount of more than € 120 million. The transaction is one of the first deals in Germany involving an investor's acquisition of debt as a means of facilitating a company's successful restructuring under the German Insolvency Code.

Articles written by ***Mark G. Douglas (New York)*** entitled "Are Corporate Family Chapter 11 Filings Governed by a Different Good Faith Standard?" and "Paying Pre-Petition Critical Vendor Claims Without Relying on the Doctrine of Necessity" appeared in the June 2005 edition of *Pratt's Journal of Bankruptcy Law*.

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gave short shrift to United's "legally untenable" antitrust arguments. Moreover, the Court appropriately refocused the dispute where it belongs. Section 1110 is designed to ensure that the market determines where aircraft resources are deployed, so that a bankruptcy filing disrupts the free functioning of that market as little as possible.

Given the almost wholesale mothballing of commercial jetliners and the financial woes plaguing U.S. airlines in recent years, it remains to be seen whether repossession of leased or financed aircraft will be a desirable remedy in every case. Still, the Seventh Circuit's decisions drive home the point that Congress enacted section 1110 so that aircraft financiers and lessors, unlike many other creditors, have ready access to their aircraft if a chapter 11 debtor is unwilling or unable to comply with the terms of a loan or lease agreement.

United Airlines, Inc. v. U.S. Bank N.A., 406 F.3d 918 (7th Cir. 2005).

United Airlines, Inc. v. U.S. Bank N.A., 2005 WL 1265851 (7th Cir. May 27, 2005).

DEFAULT INTEREST PAYABLE TO OVERSECURED CREDITOR SUBJECT TO REASONABLENESS LIMITATION

Ryan T. Routh and Mark G. Douglas

It is generally well understood that an oversecured creditor is entitled to interest, and to the extent provided for under a loan agreement, related fees and charges as part of its secured claim in a bankruptcy case. Even so, certain kinds of fees and charges may be limited if the bankruptcy court decides that they are not reasonable. What qualifies as "reasonable" and, more generally, what kinds of charges are subject to this limitation, have been subjects of considerable debate in the courts, sometimes with inconsistent and confusing results. An Illinois bankruptcy court recently added to the extensive body of case law addressing these questions in *In re AE Hotel Venture*.

TREATMENT OF OVERSECURED CLAIMS UNDER THE BANKRUPTCY CODE

The Bankruptcy Code classifies a debtor's obligations in terms of "claims" rather than "debts." This means that a creditor owed money based upon a transaction that took place prior to the debtor's bankruptcy filing is generally treated under the statute as the holder of either an unsecured pre-petition claim or a secured pre-petition claim. Moreover, if the face amount of a claim exceeds the value of any collateral securing it, the creditor will hold both a secured claim, to the extent of the value of the collateral, and an unsecured claim for the deficiency. Classification of claims is an essential part of the bankruptcy process. It determines, among other things, the priority of payment afforded to the claim, whether the claimant is entitled to adequate protection of its interest in the collateral, how the claim can be treated under a chapter 11 plan, and the leverage the claimant can exert in connection with the plan confirmation process.

Whether a claim is secured or unsecured is determined in accordance with section 506(a) of the Bankruptcy Code. If it turns out that a claim is "oversecured" because the creditor's collateral has a greater value than the face amount of the

claim, section 506(b) gives the creditor certain rights that are not conferred upon other kinds of creditors. Specifically, an oversecured creditor is generally entitled to receive, as part of its secured claim, "interest on [its] claim, and any reasonable fees, costs, or charges provided for under the agreement under which such claim arose."

In determining what payments an oversecured creditor is entitled to under section 506(b), a court must make a number of inquiries. *First*, does a right to payment arise under the relevant agreements? *Second*, does anything under relevant non-bankruptcy law excuse the debtor from payment? *Third*, is the payment properly considered to be "interest" or is it properly considered to be a "fee, cost or charge," such that the "reasonableness" limitation applies? *Fourth*, if it is a fee, cost or charge, is the payment of such amount reasonable? An Illinois bankruptcy court was called upon to answer these questions in *AE Hotel Venture*.

AE HOTEL VENTURE

AE Hotel Venture operated a suburban Chicago hotel that it acquired with a $7.6 million loan from a securitization trust. The loan was evidenced by a ten-year promissory note maturing in 2007. The hotel served as collateral for the loan. The note and mortgage contained a number of provisions regarding additional interest, fees and charges that could be assessed by the creditor upon the occurrence of an event of default.

After making more than six years of payments, AE defaulted on its obligations under the promissory note in 2003. The trust commenced foreclosure proceedings in May 2004. These proceedings were suspended three days later when AE filed a chapter 11 petition.

The trust asserted a secured claim against AE in the amount of more than $8.6 million, comprised of $6.8 million in principal and approximately $1.8 million in interest and charges under the note. AE objected to the amount of interest, related fees and charges claimed by the trust. AE conceded that certain attorneys' fees as well as pre- and post-petition interest at the non-default rate of 9.72% were properly payable as part of the trust's allowed secured claim under section 506(b). However, AE objected to interest and related fees claimed by the trust to the extent that the amounts in question represented default rate interest and a prepayment premium. The bankruptcy court examined each element of the trust's $1.8 million assessment in determining the appropriate amount of its secured claim under section 506(b).

One component of the amount claimed by the trust was a late charge of over $17,000. This charge was assessed by the trust in accordance with a provision in the note that called for a percentage of the unpaid balance to be charged if a note installment was not timely paid. According to the loan documents, the purpose of this charge was "to defray the expense incurred in handling and processing such delinquent payment and to compensate Mortgagee for the loss of the use of such delinquent payment." The late charge was not contested by AE, and was allowed by the court.

> Careful consideration should be employed in drafting loan documentation to create an evidentiary record adequate enough to demonstrate unequivocally what the business deal is between the parties, and to indicate the purpose for each cost, fee or charge assessed therein.

The next item considered by the court was over $120,000 in default interest. This amount represented the difference between the regular 9.72% interest rate and the 14.72% default rate provided for under the note. Even though default interest was provided for under the loan agreement and was permissible under state law, the court concluded that default interest was not properly allowable under section 506(b).

In doing so, it interpreted the language of the statute to distinguish between "interest" and "default interest," which the court ruled was not a form of interest at all, but instead, a kind of "charge" that should be subject to the "reasonableness" qualifier. In following other courts that have adopted this approach, the court explained that the purpose of "interest" is to compensate a creditor for the delay in receiving money owed, whereas the purpose of "default interest" is to reimburse a creditor for extra costs which are incurred due

to a default. Thus, the court reasoned, default interest is not interest at all, but is instead similar to other charges that are incurred upon default and are designed to reimburse creditors for the costs of default.

Next, the court concluded that the default interest requested was not reasonable. If default interest were allowed, the court emphasized, the trust would be compensated *twice* for its extra costs: first, through the imposition of late charges (which the note itself said were being assessed due to the extra costs imposed on the creditor); and, second, through the imposition of default interest. Thus, the court disallowed default interest as part of the trust's secured claim.

$1.2 million of the total amount sought by the trust represented a prepayment premium. Because the amount was clearly a "charge," two questions remained: first, whether the amount was provided for under the agreement; and second, whether the amount was otherwise permissible under applicable state law (here, Illinois law). The court noted that a third question — whether the amount was otherwise "reasonable" under federal bankruptcy law — would have been relevant, but was not raised by AE and would not be considered.

The court rejected AE's contention that the premium was not even properly payable under the terms of the documents because the debt having been accelerated upon default, any prepayment was involuntary. According to the court, the note did not make payment of the premium turn on whether the payment was voluntary; instead, it provided that the premium would be payable unless there was an actual foreclosure by the trust. Because there had been no foreclosure, the court held that the premium was "provided for under the agreement" as mandated by section 506(b).

Finally, the court considered whether the premium was an unenforceable "penalty" or an allowable liquidated damages clause under Illinois law. AE having conceded that the amount of the prepayment premium was, in fact, approximately equal to the actual damages that would be incurred by the trust, rather than a penalty, the court rejected AE's argument that the premium was an unenforceable penalty and allowed the premium as part of the trust's secured claim.

ANALYSIS

AE Hotel does not represent a significant departure from existing case law regarding the allowance of default interest as part of a secured claim under section 506(b) — several courts have previously employed the same rationale to reach a similar result. Most find that a default interest rate amounting to approximately two percent over the base rate for a loan is reasonable. However, many courts will disallow late fees if the loan documentation also entitles the lender to interest at the default rate.

The decision demonstrates how bankruptcy courts will scrutinize various components and charges commonly included in loan documentation by secured creditors. For secured creditors, this means that careful consideration should be employed in drafting loan documentation to create an evidentiary record adequate enough to demonstrate unequivocally what the business deal is between the parties, and to indicate the purpose for each cost, fee or charge assessed therein.

Interestingly, the issue commonly challenged in this context — whether a prepayment premium is reasonable under section 506(b) — was not considered by the bankruptcy court because AE either failed or neglected to raise the issue. Prepayment premiums are not disallowed *per se* in a bankruptcy case. Instead, the inquiry under section 506(b) centers on whether the amount of the premium is reasonable.

In re AE Hotel Venture, 321 B.R. 209 (Bankr. N.D. Ill. 2005).

VERGE-OF-RETIREMENT FIRINGS DO NOT NULLIFY SECTION 1114 PROTECTIONS

Mark G. Douglas

Retiree benefit plans have featured prominently in recent headlines as cash-strapped airlines such as United Airlines, US Air, Midwest Air and Delta struggle to manage skyrocketing retiree liabilities in an effort to emerge from or stave off bankruptcy. United Airlines recently became the biggest company in the nation's history to renege on its pension and employee benefit obligations, having been allowed by a bankruptcy judge to avoid paying more than $3 billion in plan contributions over the next five years to about 120,000 employees and retirees. Delta's plans are currently underfunded by $5 billion and Northwest's by $3.8 billion. Moreover, the crisis is not limited to the airlines — pension and benefit plan underfunding nationwide was recently estimated at $450 billion, nearly a quarter of which may have to be assumed by the Pension Benefit Guaranty Corp., whose current deficit already exceeds $23 billion.

These and related developments provoke questions concerning the effect of a bankruptcy filing upon a debtor employer's obligation to continue paying insurance benefits to retired employees under any pre-bankruptcy benefit program. It is widely recognized that the Bankruptcy Code can provide relief to a debtor staggering under the load of a retiree benefit plan by allowing the debtor to modify, or in some cases even terminate, the agreement. Less understood, however, are the circumstances under which a bankruptcy court can authorize these modifications.

Special protections for retiree benefits were added to the Bankruptcy Code in 1988, four years after the statute was amended to include roughly comparable safeguards applicable to current employees under collective bargaining agreements. In both cases, the changes were deemed necessary because of widespread perception among labor advocates that a higher standard than the business judgment test governing the ability of a trustee or chapter 11 debtor ("DIP") to disavow the terms of most contracts should be applied to collective bargaining agreements and retiree benefit plans. In keeping with the important policy considerations underlying these protections, courts often cast a critical eye on debtors, who by means of strategic planning attempt to circumvent the retiree benefit provisions contained in the Bankruptcy Code. This approach is exemplified by a ruling recently handed down by the Third Circuit Court of Appeals in the chapter 11 case of General DataComm Industries, Inc.

RETIREE BENEFITS IN BANKRUPTCY

Entitled "Payment of insurance benefits to retired employees," section 1114 of the Bankruptcy Code prohibits a DIP or trustee from unilaterally terminating or modifying retiree benefits unless the bankruptcy court orders the modification, or the trustee and an authorized representative of retirees agree to the modification. Section 1114's "clear purpose" is to give the bankruptcy court the ability "to resolve the competing interests of retirees, debtors and creditors, if agreement as to continuation and level of benefits cannot be reached."

"Retiree benefits" is defined in the statute to mean "payments to any entity or person for the purpose of providing or reimbursing payments for retired employees and their spouses or dependents, for medical, surgical, or hospital care benefits in the event of sickness, accident, disability, or death under any plan, fund, or program (through the purchase of insurance or otherwise)" maintained by the debtor before filing for bankruptcy. The "authorized representative" of a company's unionized retirees is generally the union, unless it elects not to serve. Where retirees are not unionized, the court may appoint a representative committee of retired employees to serve in that capacity.

Before seeking court authority to modify retiree benefit payments, the DIP is obligated to negotiate with the retiree's representative, accompanied by disclosure of the most complete and reliable information available, toward modifications "that are necessary to permit the reorganization of the debtor and assure[] that all creditors, the debtor and all of the affected parties are treated fairly and equitably." If the authorized representative rejects a modification proposal that meets these requirements "without good cause," the bankruptcy court is empowered to authorize the modification, so long as it finds that it is "necessary to permit the reorganization of the debtor and assures that all creditors, the debtor, and all affected

parties are treated fairly and equitably, and is clearly favored by the balance of the equities." The court also has the power to order temporary modifications where such relief is "essential to the continuation of the debtor's business, or in order to avoid irreparable damage to the estate."

Other protections for retirees contained in section 1114 include the ability under certain circumstances to be represented by a committee officially sanctioned by the court with the right to employ lawyers and other professionals compensated by the estate, administrative status for benefit payments required to be made during the course of the bankruptcy case, and a short time frame — generally 90 days — governing the court's determination on any request to modify benefit payments. In addition, retiree benefit claims are not subject to the restrictions placed on damage claims resulting from the termination of employment contracts. However, section 1114 expressly excludes certain retirees from its scope — it generally does not apply to retirees whose gross annual income exceeds $250,000.

The language of section 1114 gives the bankruptcy courts considerable discretion to fashion appropriate relief based upon the particular circumstances of the case. Still, not all courts are of the same view concerning the scope of that discretion. For example, courts sometimes disagree on what modifications to a benefit plan qualify as "necessary" within the meaning of the statute. Also, the statute's admonition that relief must comport with the "balance of the equities" gives a court wide latitude to grant relief according to its own subjective view of fairness.

Courts generally look to cases involving collective bargaining agreements under section 1113 when construing what qualifies as "necessary" modifications to retiree benefits under section 1114 because the relevant language of the two provisions is almost identical. Under section 1113, there are two opposing views on this issue. In *Wheeling-Pittsburgh Steel Corp. v. United Steelworkers of America*, the Third Circuit ruled that the term "necessary" includes only those minimum modifications that the debtor "is constrained to accept because they are directly related to the Company's financial condition and its reorganization," thereby ultimately holding that the terms "necessary" and "essential" are synonymous. In addition, in determining the object of the modifications, the Court of Appeals held that in keeping with section 1113's purpose, the objective of the modifications should be the short-term "goal of preventing the debtor's liquidation."

General DataComm is a testament to the practical significance of important policy considerations, particularly in a situation where a bankruptcy court, as a court of equity, is convinced that a debtor's strategic machinations will result in injustice even if technically within the letter of the law.

The Second Circuit rejected this approach in *Truck Drivers Local 807 v. Carey Transportation, Inc.* There, the Court of Appeals held that, in determining the degree and purpose of "necessary" modifications, "the necessity requirement places on the debtor the burden of proving that its proposal is made in good faith, and that it contains necessary, but not absolutely minimum, changes that will enable the debtor to complete the reorganization process successfully." In adopting this approach, the court focused on the long-term goal of reorganization, rather than the short-term goal of preventing liquidation. This approach was adopted by the Tenth Circuit in *In re Mile Hi Metal System, Inc.* Lower courts have lined up on both sides of the issue.

Another controversial aspect of section 1114 concerns whether a debtor-employer is obligated to comply with the procedures delineated in the statute even if a pre-bankruptcy benefit plan gives the debtor the right to terminate the plan unilaterally. A related issue — whether the debtor can circumvent section 1114 by dismissing employees before they retire — was the subject of the Third Circuit's decision in *General DataComm*.

GENERAL DATACOMM

Four years before General DataComm Industries, Inc. ("DataComm") sought chapter 11 protection in 2001, the company's board approved a benefit agreement for senior executives and employees providing for the payment of long-term

care insurance coverage and health insurance benefits. The plan listed certain actions that would lead to discharge and the forfeiture of all benefits, including violation of confidentiality, disclosure of proprietary information, refusal to cooperate in litigation brought by DataComm, employment by a competitor, and suing DataComm for matters unrelated to the plan. Dismissal without cause was not among the events triggering forfeiture.

Shortly after filing its chapter 11 petition, DataComm notified four of its executives that they (and the benefit plan) would be terminated in approximately ten days. It then sought court authority to reject the benefit plan under section 365 of the Bankruptcy Code. DataComm acknowledged that the terminations were without cause. At the time, the executives were all over 65 years of age.

The executives objected to DataComm's request to reject the benefit plan, claiming that it was subject to the strictures of section 1114. The bankruptcy court agreed, denying DataComm's rejection motion. That determination was upheld on appeal by the district court, which ruled that the executives were retirees within the scope of section 1114 because DataComm's action in firing them the day after it purported to reject the benefit plan constituted "forced retirement." DataComm appealed to the Third Circuit.

It fared no better with the Court of Appeals. After explaining that retiree benefit plan modifications are governed by different rules than those applicable to other kinds of executory contracts under section 365, the Third Circuit observed that "the overarching question . . . is whether the [executives] constitute 'retired employees' for purposes of invoking the precautions of the statute." The Court concluded that the executives were retired employees even though they were dismissed before retiring.

The Third Circuit rejected DataComm's contention that section 1114 does not apply because the executives never retired, having been terminated, albeit without cause. Remarking that "this contention elevated form over substance" and that DataComm's deliberate actions were "designed to thwart the purposes of § 1114," the Court of Appeals ruled that DataComm's termination of employees on the verge of retirement in an effort to nullify section 1114 was illegitimate. The Court was careful, however, to emphasize that its decision was motivated by the particular circumstances of the case before it, which it characterized as "compelling enough to warrant" expansion of section 1114 to embrace employees forced into retirement by termination without cause. According to the Court, the "deliberate and involuntary termination of an employee on the verge of retirement, where the employee has otherwise met all qualifications for retirement, cannot deprive such an employee of the procedural protections of § 1114."

OUTLOOK

The protections to retirees and retiree benefits built into the Bankruptcy Code are premised on important policy considerations. *General DataComm* is a testament to the practical significance of those considerations, particularly in a situation where a bankruptcy court, as a court of equity, is convinced that a debtor's strategic machinations will result in injustice even if technically within the letter of the law. Under less compelling circumstances, another court might well conclude differently. In fact, a Pennsylvania district court previously did so in *Hourly Employees/Retirees of Debtor v. Erie Forge & Steel, Inc.*, dismissing as a "novel legal argument" without any support the contention that dismissed employees qualify for section 1114 protection as "constructive retirees."

The problem is that section 1114 by its terms only applies to "plan, fund or program" payments to "retired employees and their spouses and dependents." Although employees dismissed with or without cause prior to retirement may have other avenues of redress, they are not technically protected by section 1114. This leaves the door open to strategic planning — a company considering a chapter 11 filing may want to consider downsizing its workforce prior to filing for bankruptcy, or even afterward, to avoid having to comply with section 1114. Even the Third Circuit refused to categorically prohibit such conduct in *General DataComm*, observing that "[t]he contours of such a concept as 'forced retirement' may receive appropriate interpretation, when it occurs, by a case-by-case development."

Interestingly, in a concurring opinion, District Judge Louis H. Pollak, sitting by designation on the Third Circuit, agreed with the result reached by the majority, but for a different reason. According to him, DataComm's motion to terminate the benefit plan should not be denied because it improperly abridged the executives' rights as retirees because they were fired prior to retiring. Rather, Judge Pollak explained, the benefit plan was not an executory contract capable of being rejected under section 365, due, among other things, to the absence of any material ongoing obligations remaining unperformed at the time that DataComm filed for bankruptcy. This approach would appear to misconstrue the relationship between sections 365 and 1114. DataComm clearly had a benefit plan in force at the time it filed for chapter 11, executory or otherwise. That plan provided for payments to retirees, even if it did not apply to the executives. Thus, any attempt by DataComm to modify payments under the plan (termination being a form of modification) was governed by section 1114. Section 365 simply does not apply.

General DataComm illustrates that the issue of retiree benefits is a sensitive one in the realm of bankruptcy, as elsewhere. Moreover, the landmark bankruptcy legislation enacted on April 20, 2005 will make the rules regarding retiree and employee benefits even more stringent. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "Act") amends the Code to provide that if a debtor was a plan administrator of an employee benefit plan prior to filing for bankruptcy, it is obligated to continue to serve in that capacity during the bankruptcy case, unless a trustee is serving in the case. As a result, the debtor will be required to continue to perform various statutory duties imposed on an administrator by ERISA. It is unclear whether an administrator that also has fiduciary duties to the plan under ERISA must continue to perform those fiduciary duties notwithstanding the bankruptcy filing. This could subject the debtor, and potentially the officers and directors through whom the debtor acts, to conflicting or at least competing loyalties in exercising their duties as a debtor-in-possession, or the representatives thereof, in a chapter 11 case and as plan fiduciaries.

The Act also adds subsection 1114(l) to the Bankruptcy Code, which provides that if a debtor modifies retiree benefits in the 180 days before a bankruptcy filing while it was insolvent, the bankruptcy court must reinstate such benefits as they existed before modification and retroactive to such date unless it finds that the "balance of equities" clearly favors the prior modification. This amendment creates a significant risk that courts will retroactively reinstate modified retiree health benefits, causing the estate to incur both a substantial lump-sum obligation as well as additional ongoing costs. Unlike most of the rest of the Act, which has a delayed effective date, this amendment applies to any case filed on or after April 20, 2005.

The amendment leaves several questions unanswered. For instance, what exactly are the "balance of equities," and at what time should they be viewed — when the modifications were made or when the court is making its decision? Also, how does the provision interact with a debtor's general ability to modify retiree health benefits under section 1114 of the Code? Finally, what role does section 1114 play if the contract itself provides that benefits may be modified unilaterally?

General DataComm Industries, Inc. v. Arcara (In re General DataComm Industries, Inc.), 407 F.3d 616 (3d Cir. 2005).

In re Ormet Corp., 2005 WL 775448 (Bkrtcy. S.D. Ohio Mar. 24 2005).

In re Horsehead Industries, Inc., 300 B.R. 573 (Bankr. S.D.N.Y. 2003).

In re Horizon Natural Resources Co., 316 B.R. 268 (Bankr. E.D. Ky. 2004).

In re Farmland Industries, Inc., 294 B.R. 903 (Bankr. W.D. Mo. 2003).

Hourly Employees/Retirees of Debtor v. Erie Forge & Steel, Inc., 2004 WL 385023 (W.D. Pa. Feb. 2, 2004).

FINANCIAL CONTRACT PROVISIONS OF NEW BANKRUPTCY LEGISLATION

Mark G. Douglas

INTRODUCTION

President George W. Bush gave his imprimatur to the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "Act") on April 20, 2005, thereby effecting the most sweeping changes to U.S. bankruptcy law in more than a quarter century. Although a significant part of the legislation is devoted to curbing alleged consumer bankruptcy abuse, the Act also contains important changes to the laws, rules and procedures governing business bankruptcy cases. Prominent among these modifications are provisions intended to clarify, expand and add provisions to title 11 of the United States Code (the "Bankruptcy Code") dealing with financial transactions. What's more, the additional and modified financial contract provisions will apply to cross-border bankruptcy and insolvency cases filed under the new chapter 15 of the Bankruptcy Code after the amendments become effective in cases filed on or after Monday, October 17, 2005.

These provisions are briefly summarized and explained below.

OVERVIEW OF CODE PROVISIONS AFFECTING FINANCIAL MARKETS

Sections 555, 556, 559 and 560 of the Bankruptcy Code currently provide special protections to transactions involving financial markets. Without them, sections 362 and 365(e)(1) of the Bankruptcy Code would prevent a non-debtor party to a financial contract from taking immediate action to limit exposure occasioned by a bankruptcy filing by or against the counterparty. Lawmakers, however, recognized that financial markets can change significantly almost overnight, and that non-debtor parties to certain types of complex financial transactions may incur heavy losses unless the transactions are promptly and finally closed out and resolved. In a series of measures enacted ending in 1990, Congress exempted most kinds of financial contracts from these prohibitions. It also amended the Bankruptcy Code to insulate these transactions from avoidance (*i.e.*, revocation or unwinding) as preferential or fraudulent transfers unless the transaction was made with actual intent to hinder, delay or defraud creditors of the debtor.

IMPETUS FOR CHANGE

Since the 1990s, it has been widely perceived that existing provisions governing financial transactions fail to account for certain kinds of transactions and participants in a rapidly expanding industry. These new parties and transactions are currently subject to uncertainty regarding what rights and obligations apply if a counterparty files for bankruptcy. The financial provisions of the Act are designed, in part, to dispel such uncertainty by facilitating the closeout, setoff and netting of a broader array of financial contracts. The Act amends sections 555, 556, 559 and 560 of the Bankruptcy Code to expand and clarify the protections afforded to "securities contracts," "forward contracts," "repurchase agreements" and "swap agreements" under the Bankruptcy Code. It also adds sections 561 and 562 to the Bankruptcy Code to protect master netting agreements and to define the timing of the measure of damages under such agreements.

BROAD APPLICATION TO FINANCIAL PARTICIPANTS

The Act broadens the class of parties protected by the financial transaction provisions in the Bankruptcy Code. Protected parties now include all "financial participants." These include most clearing organizations as well as any entity which, on any day during the 15 months immediately preceding the commencement of a bankruptcy case, has had securities contracts, commodity contracts, forward contracts, repurchase agreements, swap agreements or master netting agreements involving non-affiliates with a total gross dollar value of not less than $1 billion in principal amount outstanding or had gross mark-to-market positions of not less than $100 million (aggregated across counterparties).

TERMINATION AND ACCELERATION OF QUALIFYING FINANCIAL CONTRACTS

The Act also provides that neither the filing of a stockbroker liquidation case under the Securities Investor Protection Act of 1970 ("SIPA") nor the issuance, at the behest of the Securities Investor Protection Corporation, of a court order

may act as a stay of any contractual right to "liquidate, terminate, or accelerate a securities contract, commodity contract, forward contract, repurchase agreement, swap agreement, or master netting agreement," to offset or net termination payments or other obligations arising under such agreements, or to foreclose on cash collateral. However, a SIPA application or court order may still prevent foreclosure or other disposition of securities pledged by a debtor as collateral.

The Act clarifies sections 555, 556, 559 and 560 by providing that the liquidation of a qualifying securities contract also encompasses termination and acceleration. The Act broadens the definition of "contractual right" to include:

(a) rights set forth in a bylaw of a derivative clearing organization, a multilateral clearing organization, a national securities exchange, a national securities association, a contract market designated under the Commodity Exchange Act, a derivatives transaction execution facility registered under the Commodity Exchange Act or a board of trade, or in a resolution of the governing board thereof; and

(b) rights arising under common law, merchant law, or by reason of normal business practice.

EXPANDED FINANCIAL CONTRACT DEFINITIONS

The Act expands the definitions of sections 555 (securities contracts), 556 (commodity or forward contracts), 559 (repurchase agreements) and 560 (swap agreements) of the Bankruptcy Code.

SECURITIES CONTRACTS

"Securities contract" now includes any contract for the purchase, sale or loan of a mortgage loan or interest in a mortgage loan and options on any of the foregoing, including repurchase or reverse repurchase transactions. The revised definition of "securities contract" expressly includes, among other things:

(a) a contract for the purchase, sale, or loan of a security, a certificate of deposit, a mortgage loan or any interest in a mortgage loan, a group of index of securities, certificates of deposit or mortgage loans or interests therein or options on any of the foregoing;

(b) the guarantee by or to any securities clearing agency of a settlement of cash, securities, certificates of deposit, mortgage loans, or interests therein, group or index of securities, or mortgage loans or interests therein or option of any of the foregoing;

(c) any margin loan; and

(d) (i) any other agreement or transaction that is similar to an agreement or transaction described above, (ii) any combination of agreements or transactions referred to above, (iii) any option to enter into any agreement or transaction referred to above, (iv) a master agreement that provides for an agreement or transaction referred to above, and (v) a security agreement or arrangement, or other credit enhancement related to any agreement or transaction referred to therein but not to exceed the damages in connection with any such agreement or transaction measured in accordance with section 562.

However, the definition of "securities contract" explicitly excludes any purchase, sale, or repurchase obligation under a participation in a commercial mortgage loan.

COMMODITIES CONTRACTS

Section 761(4) of the Bankruptcy Code formerly defined a "commodity contract" as:

(a) with respect to a futures commission merchant, a contract for the purchase or sale of a commodity for future delivery on, or subject to the rules of, a contract market or board of trade;

(b) with respect to a foreign futures commission merchant, a foreign future;

(c) with respect to a leverage transaction merchant, a leverage transaction;

(d) with respect to a clearing organization, a contract for the purchase or sale of a commodity for future delivery on, or subject to the rules of, a contract market or board of trade that is cleared by such clearing organization, or commodity option traded on, or subject to the rules of, a contract market or board of trade that is cleared by such clearing organization; or

(e) with respect to a commodity options dealer, a commodity option.

The Act expands the definition of a "commodity contract" to include, among other things, (i) any other agreement or transaction that is similar to those described above, (ii) any combination of the foregoing, (iii) any option to enter into any of the foregoing, (iv) any master agreement providing for any of the foregoing, and (v) a security agreement or arrangement, or other credit enhancement related to any of the foregoing, but not to exceed the damages in connection with any such agreement or transaction measured in accordance with section 562.

FORWARD CONTRACTS

Section 101(25) of the Bankruptcy Code formerly defined a "forward contract" as a contract (other than a commodity contract) for the purchase, sale or transfer of a commodity or any similar good, article, service, right, or interest which is presently or in the future becomes the subject of dealing in the forward contract trade, or product or byproduct thereof, with a maturity date more than two days after the date the contract is entered into, including, but not limited to, a repurchase transaction, reverse repurchase transaction, consignment, lease, swap, hedge transaction, deposit, loan, option, allocated transaction, unallocated transaction, or any combination thereof or option thereon.

The Act deletes the ambiguous reference to "any combination thereof or option thereon" and replaces it with "any other similar agreement." It also adds to the definition: (i) any combination of agreements or transactions referred to above; (ii) any option to enter into an agreement or transaction referred to above; (iii) a master agreement to the extent that it provides for an agreement or transaction referred to above; and (iv) a security agreement or arrangement, or other credit enhancement related to any covered agreement or transaction, but not to exceed the damages in connection with any such agreement or transaction measured in accordance with section 562.

REPURCHASE CONTRACTS

Formerly, section 101(47) of the Bankruptcy Code narrowly defined repurchase agreements as agreements that provide "for the transfer of certificates of deposit, eligible bankers' acceptances, or securities that are direct obligations of, or that are fully guaranteed as to principal and interest by, the United States" or any agency thereof with a simultaneous agreement by the transferee to transfer to the original transferor a certificate of deposit or other similar obligation either on demand or at a date not later than one year after the transfer.

The Act expands the definitions of "repurchase agreement" and "reverse repurchase agreement" to include mortgage-related securities (as defined in the Securities Exchange Act of 1934), mortgage loans, interests in mortgage-related securities or mortgage loans and qualified foreign government securities. Excluded from the definition is a repurchase obligation under a participation in a commercial mortgage loan (such as recourse obligations). However, a repurchase transaction involving the transfer of participations in commercial mortgage loans with a simultaneous agreement to repurchase the participation on demand or within one year of the transfer would constitute a "repurchase obligation."

SWAP AGREEMENTS

The Act amends section 101(53B) of the Bankruptcy Code to define in greater detail various types of swap agreements, including:

(a) a rate floor, rate cap, rate collar, cross-currency rate swap and basis swap;

(b) spot, same day-tomorrow, tomorrow-next, forward, or other foreign exchange or precious metal agreement;

(c) currency swap;

(d) equity index or equity swap;

(e) debt index or debt swap;

(f) total return, credit spread or credit swap;

(g) commodity index or commodity swap; and

(h) weather swap, weather derivative or weather option.

Moreover, the Act definition contains an open-ended provision that would include as a "swap agreement" any agreement that is similar to any other agreement or transaction referred to in the expanded definition and that is "presently, or in the future becomes, the subject of recurrent dealings in the swap market and is a forward, swap, future or option on one or more rates, currencies, commodities, equity securities, or other equity instruments, debt securities or other debt instruments, or economic indices or measures of economic risk or value." However, a "rule of construction" in the Act provides that an arrangement covered by the Bankruptcy Code definition of "swap agreement" does not necessarily constitute a swap agreement under other federal statutes, rules and regulations.

NEW PROVISIONS CONCERNING MASTER NETTING AGREEMENTS AND CALCULATION OF DAMAGES

The Act adds section 561 to the Bankruptcy Code to protect contractual rights to terminate, liquidate, accelerate or offset under a master netting agreement and across contracts. The new section 561 defines a "master netting agreement" as an agreement "providing for the exercise of rights, including rights of netting, setoff, liquidation, termination, acceleration or closeout," or any security agreement or arrangement or other credit enhancement related to one or more of the foregoing. It also defines "master netting agreement participant" as an "entity that, at any time before the date of the filing of the petition, is a party to an outstanding master netting agreement with the debtor."

Section 561 provides a general prohibition against staying, avoiding, or otherwise limiting a non-debtor counterparty's ability to exercise rights under the various types of financial contracts covered by master netting agreements. Corresponding amendments were made to the definitions of forward contract, repurchase agreement, swap agreement, securities contract and commodity contract to include master agreements within the scope of each cross-product, but only if transactions or agreements under the master agreement otherwise meet the applicable definition. "Netting" refers to the aggregate payments due to a swap participant when the agreement is terminated, for instance, by a counterparty filing for bankruptcy. Upon termination, the non-defaulting party has the right to set off and liquidate the amount owed by the other party under a master netting agreement, regardless of whether or not the various transactions under the master netting agreement involve the same type of financial product.

As a consequence of the amendments, the Bankruptcy Code will permit multiple-transaction, multiple-contract and cross-product netting. As such, the broad netting that the International Swaps and Derivatives Association 1992 and 2002 Master Agreement forms permit if the parties elect "Multiple Transaction Payment Netting" would become enforceable in a U.S. bankruptcy case. Section 561 and the relevant corresponding amendments would appear to permit the full implementation of early termination for bankruptcy or insolvency and closeout netting under the ISDA 1992 and 2002 Master Agreement forms.

The Act also amends section 362(b) of the Bankruptcy Code to provide that setoff by a master netting agreement participant excepted from the scope of the automatic stay. Section 546, which limits a trustee's avoiding powers under certain circumstances, is also amended to add subsection 546(j), which provides that in the absence of actual intent to defraud creditors, the trustee may not avoid a transfer made within two years of the commencement of the case by or to a master netting agreement participant under or in connection with any master netting agreement or any individual contract covered thereby. These changes will permit a party to a financial contract to realize the benefits and control its exposure even though its counterparty is on the verge of bankruptcy

without worrying that the transactions occurring during the period immediately preceding a bankruptcy filing will later be undone by a bankruptcy trustee in the absence of actual intent to defraud.

The new legislation significantly augments and clarifies setoff, netting, termination and closeout rights under financial contracts in the event that one or more parties to the contract become embroiled in a bankruptcy case.

The Act adds section 562 to the Bankruptcy Code, which provides that damages under a swap agreement, securities contract, forward contract, commodity contract, repurchase agreement, or master netting agreement will be measured as of the earlier of the date of (a) rejection by the trustee or (b) liquidation, termination or acceleration of such contract or agreement by a forward contract merchant, stockbroker, financial institution, securities clearing agency, repo participant, financial participant, master netting agreement participant, or swap participant. A corresponding change was made to section 502(g) to provide that claims for damages under section 562 will be pre-petition claims.

APPLICATION TO CROSS-BORDER INSOLVENCY CASES

Unlike most other provisions of the Bankruptcy Code, the Act expressly makes the financial contract provisions applicable to cross-border bankruptcy and insolvency cases commenced under the new chapter 15 of the statute, which supersedes former section 304. Thus, if the accredited representative of a debtor in a non-U.S. bankruptcy or insolvency proceeding files a chapter 15 case in the U.S., the special protections for financial contracts contained in sections 555, 556, and 559 through 562 will apply in the case. An article discussing the new chapter 15 appeared in the May/June 2005 edition of the *Business Restructuring Review* (vol. 4, no. 3).

CONCLUSION

The new legislation significantly augments and clarifies setoff, netting, termination and closeout rights under financial contracts in the event that one or more parties to the contract become embroiled in a bankruptcy case. The amendments provide a greater degree of certainty concerning the kinds of financial contracts that are entitled to safe-harbor protection. This, in turn, should promote greater confidence among players in the market, whether in the U.S. or abroad, when structuring these transactions.

EXTENDING THE CONTEMPORANEOUS EXCHANGE FOR NEW VALUE PREFERENCE DEFENSE

Sean P. Byrne and Mark G. Douglas

The ability of a bankruptcy trustee or chapter 11 debtor-in-possession ("DIP") to invalidate asset transfers made during the period immediately preceding a bankruptcy filing that unfairly prefer one or more creditors over the rest of the creditor body is one of the most important powers created by the Bankruptcy Code. It promotes the fundamental goal of achieving equality of distribution among similarly situated creditors. However, not every payment made by a debtor on the eve of a bankruptcy filing can be successfully challenged on the grounds that it is preferential. One important exception to a DIP or trustee's avoidance powers was the subject of a decision recently handed down by the United States Court of Appeals for the Eighth Circuit. In *In re Payless Cashways, Inc.*, the recipient of pre-petition payments made for goods shipped to the debtor under a "destination contract" successfully defended a preference action by asserting that the payments constituted "contemporaneous exchanges for new value" under section 547(c)(1) of the Bankruptcy Code.

EQUALITY OF DISTRIBUTION AND AVOIDANCE OF PREFERENTIAL TRANSFERS

One of the fundamental goals underlying U.S. bankruptcy law is the equitable distribution of assets. To that end, the automatic stay generally prevents an individual creditor from pursuing its claim against a debtor after the initiation of a bankruptcy case, in part, to prevent one creditor from recovering a greater proportion of its claim relative to other similarly situated creditors. In addition, the Bankruptcy Code recognizes that the goal of providing equal treatment to similarly situated creditors would be thwarted if debtors, voluntarily or otherwise, had an unfettered ability to pay certain favored creditors more than they would otherwise receive in a bankruptcy case. Accordingly, Bankruptcy Code section 547 provides that a transfer made by an insolvent debtor within 90 days of a bankruptcy filing (or up to one year, if the transferee is an insider) to a creditor who, by reason of the transfer, receives more than it would have received if, assuming the transfer had not been made, the debtor were liquidated in chapter 7, may be "avoided" (invalidated and recovered) by a bankruptcy trustee or DIP.

Whether a transfer satisfies these basic elements, however, does not end the inquiry. While some transfers may be preferential in the literal sense, not all transfers are avoidable and recoverable. Section 547(c) contains eight distinct exceptions (nine, when the newly enacted bankruptcy legislation becomes effective in October of 2005) to the trustee's ability to avoid a transfer that is otherwise preferential. Of these, the three defenses most commonly invoked by creditors are the ordinary course payment defense, the subsequent new value defense and the contemporaneous exchange defense. The first shields from avoidance payments that are made on ordinary business terms and in accordance with the ordinary business practice of the debtor and the creditor. The second protects payments to the extent that, after the transfer, the creditor gave new value to the debtor that is not secured by an otherwise unavoidable security interest, and on account of which the debtor did not make an otherwise unavoidable transfer to the creditor.

THE CONTEMPORANEOUS EXCHANGE FOR NEW VALUE DEFENSE

The "contemporaneous exchange for new value" defense permits creditors to continue to do business with troubled counterparties by excepting from avoidance transactions involving exchanges of valuable consideration. To successfully assert the defense, the recipient of a challenged transfer must demonstrate that: (i) the parties intended the transfer to be a contemporaneous exchange; (ii) the exchange was actually contemporaneous; and (iii) the exchange was for new value.

"New value" is defined by the Bankruptcy Code as "money or money's worth in goods, services, or new credit, or release by a transferee of property previously transferred to such transferee in a transaction that is neither void nor voidable by the debtor or the trustee under any applicable law, including proceeds of such property, but does not include an obligation substituted for an existing obligation." Most courts require that "new value" confer a "material benefit" upon the debtor and thus enhance the bankruptcy estate. A transferee

invoking the protection of the defense bears the burden of proving by a preponderance of the evidence that each part of the exception applies. Whether the recipient of an allegedly preferential transfer satisfied that burden was the subject of the Eighth Circuit's ruling in *Payless Cashways*.

If destination contracts are not treated as credit transactions, contract parties may have an opportunity to use these kinds of contracts strategically to extend payment terms while maintaining a contemporaneous exchange for new value preference defense.

PAYLESS CASHWAYS

Payless Cashways, Inc. was a home improvement product retailer. Before filing for chapter 11 protection for the second time in less than five years on June 4, 2001, Payless purchased lumber from Canfor Corporation, the largest producer of lumber in Canada. At the inception of its relation with Payless, Canfor had required prepayment for orders by electronic fund transfer ("EFT") and by check, but over time the parties negotiated less stringent payment terms.

The contracts between Canfor and Payless provided for the shipment of lumber to Payless by truck and by rail. Lumber sent by rail took on average 12-14 days following shipment, and lumber sent by truck took on average 3-5 days following shipment to arrive at Payless's facilities. Canfor generally gave Payless terms which would correlate the due date for payment with the delivery date. However, at times Canfor was exposed to a credit risk because lumber would arrive before payment was made.

On January 24, 2001 — less than six months before Payless filed for bankruptcy — Canfor's concern about its credit exposure led it to convene a meeting with Payless executives to negotiate terms for continued lumber shipments. The parties agreed to terms designed to correlate delivery dates with payments. For rail shipments expected to arrive in 12-14 days, payment was due in 12 days. For truck deliveries expected to arrive in 3-5 days, payment was due in 3 days. The parties also agreed that all payments would be made by EFT. Canfor prepared the invoices at the time the shipment was made and then calculated the due dates by working from the shipment date.

Between May 14, 2001 and May 18, 2001, Payless made four payments to Canfor totaling over $800,000 and involving 25 shipments. Of these, 22 shipments were by rail, all of which were paid for between 11 days and 15 days of shipment. The remainder were by truck, all of which were paid for in either five or six days of shipment. Payless may have received some of the truck-shipped lumber prior to paying for it, but Payless and Canfor considered truck shipments to be the same as cash transactions because of the short payment terms. Payment for at least eight of the 22 rail shipments was made by EFT prior to delivery of the lumber.

After Payless filed for bankruptcy, the chapter 11 trustee appointed in the case sought to avoid the $800,000 in payments. Canfor argued, among other things, that the transfers were insulated from avoidance because they involved contemporaneous exchanges for new value. The bankruptcy court ruled that the four transfers were not avoidable under section 547(c)(1) of the Bankruptcy Code. The trustee appealed that determination to the bankruptcy appellate panel.

The appellate panel prefaced its analysis by explaining that, in accordance with established precedent in the circuit, a preference defendant can successfully rely on a defense under section 547(a)(1) only if it establishes by a preponderance of the evidence that: (i) the parties intended the transfer to be a contemporaneous exchange; (ii) the exchange was actually contemporaneous; and (iii) the exchange was for new value. Addressing the first element, the appellate panel noted that the bankruptcy court made the following findings on the issue of intent: (1) the January 24, 2001 meeting changed the nature of the parties' transactions; (2) Canfor sought new terms to reduce its credit risk by assuring that it would be paid prior to delivery; (3) each of the contracts gave Canfor the right to refuse to complete delivery if payment was not made; and (4) Canfor received payment on the documented rail shipments between 7 and 21 days prior to delivery. The appellate panel agreed with the bankruptcy court's conclusion, based upon these findings, that the parties intended the transfers to be contemporaneous exchanges.

Next, the appellate panel considered whether the exchange of lumber for the transfers was in fact substantially contemporaneous. It concluded that they were, explaining that the agreement between Payless and Canfor structured shipments, deliveries and payments in such a way that the exchanges would be contemporaneous, and that the EFT payments were in fact made prior to delivery of the lumber.

Finally, the appellate panel concluded that Canfor gave "new value" to Payless in exchange for the payments. The governing agreements, the court explained, did not create a credit transaction even though the kind of contracts involved — a "destination contract" — is ordinarily viewed as creating a debt at the time of shipment rather than delivery of goods. Here, the appellate panel noted, under both the express terms of the contracts and applicable non-bankruptcy law, a right to payment for the lumber did not arise until delivery, and therefore, value was given when the lumber was delivered rather than when the lumber was shipped. According to the appellate panel, the dealings between Payless and Canfor were essentially cash on delivery transactions that qualified as exchanges for new value under section 547(c)(1).

The trustee appealed again. However, it fared no better before the Eighth Circuit. The Court of Appeals affirmed in a brief opinion adopting the reasoning articulated in the bankruptcy appellate panel's ruling below.

ANALYSIS

Vendors dealing with a customer they know is financially troubled commonly revise or restructure the terms of payment or credit in an effort to limit their exposure in the event of a meltdown. *Payless Cashways* illustrates one approach to the problem — ensuring that payment is received contemporaneous with or prior to delivery of goods. In effect, the parties restructured their course of dealing to establish a series of pre-paid transactions at a discount.

The ruling may create opportunities for savvy creditors. Even though Payless and Canfor recorded the transaction at the time of shipment, leading the bankruptcy appellate panel to conclude that an antecedent debt was created at the time of shipment, the transfers were not treated as credit transactions. If destination contracts are not treated as credit transactions, contract parties may have an opportunity to use these kinds of contracts strategically to extend payment terms while maintaining a contemporaneous exchange for new value preference defense. Creditors could incorporate credit terms into such contracts by measuring the "contemporaneous exchange for new value" from delivery when title is transferred and not from the time of shipment.

Silverman Consulting, Inc. v. Canfor Wood Products Marketing et al. (In re Payless Cashways, Inc.), 394 F.3d 1082 (8th Cir. 2005), *affirming* 306 B.R. 243 (B.A.P. 8th Cir. 2004).

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