New York Law Journal
CORPORATE RESTRUCTURING AND BANKRUPTCY
Web address: http://www.nylj.com
MONDAY, MARCH 3, 2008
ALM

Bankruptcy Reforms And the High Net Worth Debtor

Amendments limit ability of individuals to obtain 'fresh start' through Chapter 11.

BY STEPHEN J. SHIMSHAK, BRIAN S. HERMANN AND REBECCA R. ZUBATY

AFTER YEARS of intense public debate over bankruptcy reform, Congress enacted the amendments to the Bankruptcy Code contained in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA)[1] aimed principally at curtailing perceived bankruptcy abuse by individual debtors. Since BAPCPA's enactment, much has been written about the difficulties that individual debtors now face in obtaining Chapter 7 relief. Far less attention has focused on a unique subset of individual debtors—those with substantial assets or earning capability—for whom Chapter 11 provides the preferred, and today, often the only means of restructuring their indebtedness.[2]

In this article we address the principal BAPCPA amendments affecting individual Chapter 11 debtors, the restrictions that these amendments impose on such debtors' ability to obtain a "fresh start" through Chapter 11, and some of the strategies that individual debtors might adopt to deal with those restrictions.

Individual Indebtedness

Through the BAPCPA amendments, Congress has generally made obtaining a discharge of individual indebtedness far more difficult, and in doing so, has limited the ability for an individual to obtain the traditional "fresh start." Congress achieved this outcome principally through the changes that restrict Chapter 7 relief for individuals with primarily "consumer" debts.[3] Specifically, post-BAPCPA, a bankruptcy court must dismiss an individual Chapter 7 case, or, with the debtor's consent, convert such a case to one under Chapter 11 or 13, if it finds that granting relief under Chapter 7 would constitute an "abuse" of that chapter.[4]

Section 707(b) prescribes a two-part test for determining "abuse"—one part quantitative and one part qualitative.[5] The first part, the so-called "means test," presumes abuse if the debtor's current monthly income (reduced by payments for certain living expenses, domestic support, priority claims, and payments to secured creditors) exceeds the lesser of $10,950 or the greater of $6,575 or 25 percent of the debtor's nonpriority unsecured claims in the case.[6] Even if a debtor qualifies for Chapter 7 relief under the means test, §707(b)(3) mandates that the bankruptcy court must consider whether the individual filed the Chapter 7 petition in bad faith and whether the totality of the circumstances making up the debtor's financial situation (including whether the debtor seeks to reject a personal services contract) results in abuse.

An individual debtor who fails the means test or, even in passing that test, otherwise evidences abuse of Chapter 7, faces one of two outcomes: (i) dismissal of the Chapter 7 case, which in turn would substantially eliminate any hope of a traditional "fresh start," or (ii) with the individual debtor's consent, conversion of the Chapter 7 case to a case under Chapter 11 or Chapter 13. Given Chapter 13's debt limitations,[7] individuals with substantial assets or a high net worth have but a single bankruptcy option: Chapter 11.[8]

Seemingly aware that the indebtedness ceilings of Chapter 13 would channel a significant number of individual debtors to Chapter 11, Congress made a handful of critical changes to the Bankruptcy Code to ensure that an individual would face rigors in Chapter 11 directionally comparable, if not equal in import, to those faced by an individual under chapters 7 and 13. Most significantly, BAPCPA for the first time includes the debtor's postpetition earnings from "services performed" among the property comprising the debtor's Chapter 11 estate.[9] In addition, the individual debtor must now contribute "all or such portion of earnings from personal services performed by the debtor after the commencement of the case or other future income of the debtor as is necessary for the execution of the plan."[10]

To enhance the rights of dissenting creditors (as distinct from a dissenting class of creditors), an amendment to §1129(a) of the Bankruptcy Code requires that if an unsecured creditor receiving less than full payment objects to the debtor's Chapter 11 plan, then the debtor must fund the plan with at least the value of his projected disposable income, including income from personal services, over the five years following plan confirmation.[11]

In addition to requiring that an individual's postpetition and, in some cases, post-confirmation earnings go toward funding a Chapter 11 plan, BAPCPA contains two additional provisions designed to put some teeth in these requirements. The first amends Chapter 11's "discharge" provision to postpone the individual debtor's discharge until the debtor has made all plan payments.[12] The second provides for modification of a plan upon the request of any unsecured creditor with an allowed claim; such modification could, among other things, increase the amount of payments to a particular class of creditors or reduce or extend the period for plan payments, with no maximum term.[13] By delaying the grant of an individual's discharge and providing creditors with the ability to make post-confirmation changes to the plan, Congress appears to have sought to minimize, if not eliminate, any ability of an individual debtor to shortchange its creditors by paying too little under a Chapter 11 plan.

What Lies Ahead?

What impact will these changes have on the individual debtor's resort to Chapter 11? We next consider some of the challenges that lie ahead as individual debtors, creditors and the bankruptcy courts grapple with the BAPCPA amendments affecting individual Chapter 11 debtors. These challenges have the potential to blunt some of the impact of the BAPCPA amendments.

Stephen J. Shimshak *and* **Brian S. Hermann** *are partners, and* **Rebecca R. Zubaty** *is an associate (bar admission pending) in the bankruptcy department of Paul, Weiss, Rifkind, Wharton & Garrison LLP.*

Constitutionality. A number of commentators have questioned the constitutionality of the BAPCPA reforms affecting an individual Chapter 11 debtor, seeing in them violations of the Thirteenth Amendment's prohibition on involuntary servitude.[14] Specifically, the argument goes, the addition of sections 1115 (including postpetition earnings as property of the Chapter 11 estate) and 1129(a)(15) (requiring an objecting creditor(s) to receive value at least equal to the debtor's projected disposable income for the five years following confirmation) puts the debtor to work for his or her creditors; this prospect may raise a Thirteenth Amendment issue, particularly where an individual's creditors have the remedy of an involuntary Chapter 11 case.[15]

Similarly, an individual ending up in Chapter 11 due to means testing under Chapter 7 or the unavailability of Chapter 13, will have no choice (short of forgoing bankruptcy relief altogether) but to work for creditors under the terms of a Chapter 11 plan.[16] Other involuntary aspects of Chapter 11 contribute to the constitutional argument: As noted, creditors can seek to modify a substantially consummated plan without the debtor's consent,[17] and creditors can move to convert an individual debtor's Chapter 7 case to one under Chapter 11.[18]

The 'High Net Worth' Debtor. Some individual debtors have the good fortune to possess substantial and diversified assets or other sources of income upon filing. Despite the congressional effort aimed at comprehensive reform, BAPCPA's amendments do not provide an airtight solution to the potential for perceived abuse in these circumstances. Take, for example, the new exception to the absolute priority rule applicable only to individuals, which clarifies that an individual debtor may retain property of the estate even if senior classes of secured or unsecured creditors do not receive full payment.[19] Faced with an unsecured creditor's objection, the debtor must either pay its unsecured creditors in full or demonstrate that the value of property distributed under the plan to unsecured creditors at least equals the projected disposable income (as defined by reference to §1325(b)(2))[20] that the debtor will receive during the longer of the five years from the date of the first payment under the plan, or the period for which the plan provides payments.[21]

A disagreement exists as to how to determine "projected disposable income to be received"; consistent with customary methods of calculating reorganization value for business debtors in Chapter 11,[22] Congress probably intended a forward-looking definition.[23] A minority of bankruptcy courts (albeit an increasing minority) have rejected a forward-looking calculation of "projected income" in Chapter 13, opting instead to take the debtor's "current monthly income" (defined in 11 USC §101(10A) as the debtor's average monthly taxable income over the six months prior to filing) and then to deduct projected expenses.[24] Given that the Bankruptcy Code defines "projected disposable income" by reference to the definition of "disposable income" contained in §1325(b)(2), the potential exists for courts to take a similar approach under Chapter 11.

Obviously, for those debtors with substantial earning potential but little current income (consider a new recording artist or a young professional athlete), whether the measure of projected income looks forward or not will factor directly in determining the debtor's repayment obligations and, thus, creditor recoveries. However, even with a prospective measure, an individual might shield future income from creditors in any of the following ways.

First, some bankruptcy courts have held that the five-year period does not prescribe a minimum duration for plan payments, but instead only provides a measure of the total value of property available for distribution under a Chapter 11 plan.[25] Under this literal reading of the statute, an individual debtor with other assets to contribute toward a Chapter 11 reorganization has a greater chance to preserve income upon a showing that the value of such contributed assets at least equals projected income.

Second, BAPCPA limits the total amount available for repayment to "income to be received" by the debtor in the five years following plan confirmation; this limitation provides an opportunity for some individual debtors to defer income beyond this period. For instance, an individual debtor who owns a business could conceivably get by on a modest salary for five years, leaving the difference in the business, and realizing the enhanced equity through dividends and other payments in the sixth year after confirmation of the plan and beyond. An individual debtor could also structure a "back-end" loaded employment or other personal services contract, putting the bulk of compensation in the sixth year and beyond.

Third, because the projection of future income often mixes art with prediction (as business reorganizations have shown), a debtor could produce highly conservative or unduly pessimistic projections. With projected income playing a crucial role in individual cases, the presentation of projected income and the assumptions underlying it will require careful analysis by creditors and bankruptcy courts alike.

The foregoing offers but three examples of the ways that an individual might deal with §1129(a)(15)'s projected income requirement. As at least one bankruptcy judge has noted, "[t]his will provide a playground for creative lawyers."[26]

Checks on gamesmanship exist, of course. Section 1129(a)(3) provides one: that provision requires the proposal of a Chapter 11 in "good faith." A bankruptcy court could find that an individual debtor who attempts to impair creditor recoveries by deferring income beyond §1129(a)(15)'s five-year measuring period has acted in bad faith.[27] On the other hand, legitimate business reasons often justify deferred compensation arrangements, so the mere existence of such an arrangement should not constitute per se abuse.

As noted, the new §1127(e), which permits creditors to seek modification of Chapter 11 plans any time before completion of plan payments, operates as another check. If, post-plan confirmation, an individual debtor's actual income greatly exceeds plan projections,[28] then a creditor may try to modify the Chapter 11 plan to increase creditor recoveries.[29]

Conclusion

Congress' reforms through BAPCPA have certainly complicated the lives of individuals seeking to reorganize under Chapter 11. Whether these BAPCPA reforms have strayed into the area of the constitutionally impermissible remains to be seen. If the BAPCPA reforms withstand constitutional scrutiny, then individual debtors in Chapter 11 will no doubt test the limits of the BAPCPA reforms.

1. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), Pub. L. No. 109-8, 119 Stat. 23 (codified as amended in scattered sections of 11 USC).

2. See, e.g., David Gray Carlson, "Means Testing: The Failed Bankruptcy Revolution of 2005," 15 AM. BANKR. INST. L. REV. 223, 234-35, 307-08 (2007) (challenging perceived inequities in the BAPCPA amendments); Debra Grassgreen, "Individual Chapter 11 Cases After BAPCPA: What Happened to the 'Fresh Start?'" 1 NORTON 2006 ANN. SURV. OF BANKR. L., §12, at 326 (discussing why certain individuals would opt for Chapter 11).

3. "The term 'consumer debt' means debt incurred by an individual primarily for a personal, family, or household purpose." 11 USC §101(8).

4. Id. §707(b)(1).

5. Insofar as §707(b) concerns cases "filed by an individual debtor" under Chapter 7, id., it appears that the tests for determining abuse are inapplicable to involuntary cases filed pursuant to 11 USC §303.

6. Id. §707(b)(2)(A), as periodically adjusted by the Judicial Conference of the United States.

7. Individual debtors with unsecured debts exceeding $336,900 and secured debts exceeding $1,010,650 may not file under Chapter 13. Id. §109(e).

8. For certain individuals with substantial assets or a high net worth, who wanted to avoid losing their assets, Chapter 7 never presented a viable alternative.

9. 11 USC §1115(a)(2).

10. Id. §1123(a)(8). Before BAPCPA, many courts considered contribution of the debtor's postpetition earnings relevant to the determination of feasibility and good faith, but not a statutory condition for confirmation. Robert J. Landry, III, "Individual Chapter 11 Reorganizations: Big Problems With the New 'Big' Chapter 13," 29 U. ARK. LITTLE ROCK L. REV. 251, 264-65 (2007).

11. 11 USC §1129(a)(15)(B).

12. Id. §1141(d)(5)(A).

13. Id. §1127(e)(1)-(2). The statute, however, prescribes no guidelines for granting or denying a request to modify an individual Chapter 11 plan under §1127(e). See Grassgreen, supra note 2, at 323.

14. See, e.g., Erwin Chemerinsky, "Constitutional Issues Posed in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005," 79 AM. BANKR. L.J. 571 (2005); Grassgreen, supra note 2, at 324; Robert J. Keach, "Dead Man Filing Redux: Is the New Individual Chapter Eleven Unconstitutional?" 13 AM. BANKR. INST. L. REV. 483 (2005).

15. 11 USC §303(a), discussed in Chemerinsky, supra note 14, at 584.

16. Even though §707(b)(1) requires the debtor's "consent" to convert a case from Chapter 7 to Chapter 11, given that the alternative to conversion where the debtor does not satisfy the means test is outright dismissal, such consent is likely illusory.

17. 11 USC §1127(e).

18. Id. §707(b)(1).

19. Id. §1129(b)(2)(B)(ii).

20. 11 USC §1325(b)(2) defines "disposable income" as the "current monthly income received by the debtor," less amounts reasonably necessary for the debtor's maintenance or domestic support obligations, for charitable contributions, or for necessary business expenses.

21. Id. §1129(a)(15)(B).

22. Cf. *In re Exide Techs.*, 303 B.R. 48, 65 (Bankr. D. Del. 2003) ("[A] reorganized debtor's value should be based upon earning capacity." (citing *Consol. Rock Prods. Co. v. Du Bois*, 312 U.S. 510, 526 (1941))).

23. *In re Devilliers*, 358 B.R. 849, 857 (Bankr. E.D. La. 2007) (citing cases).

24. See, e.g., *In re Berger*, 376 B.R. 42, 46 (Bankr. M.D. Ga. 2007) (citing cases); *In re Pak*, 378 B.R. 257 (B.A.P. 9th Cir. 2007); see also Kenneth N. Klee & Laura N. Buchanan, "Bankruptcy Practice After the Bankruptcy Act of 2005," ALI-ABI Course of Study (Dec. 8-9, 2006).

25. *In re Roedemeier*, 374 B.R. 264, 273 (Bankr. D. Kan. 2007); *In re Frederickson*, 375 B.R. 829, 835 (B.A.P. 8th Cir. 2007) (same, under Chapter 13); see also Grassgreen, supra note 2, at 322; Bruce A. Markell, "The Sub Rosa Subchapter: Individual Debtors in Chapter 11 After BAPCPA," 2007 U. ILL. L. REV. 67, 76-78 (2006).

26. Markell, supra note 25, at 87.

27. Cf. *In re Weber*, 209 B.R. 793, 798 (Bankr. D. Mass. 1997) (holding that debtor must make full use of its resources to pay creditors), cited in Grassgreen, supra note 2, at 313, n. 17.

28. For non-debtor parties to know when modification would be warranted on account of, for example, a debtor's changed circumstances, a statutory or plan-imposed post-confirmation reporting requirement is needed. Landry, supra note 10, at 278.

29. Interestingly, a key creditor protection, the so-called "best interests" test of 11 USC §1129(a)(7), which requires that a dissenting creditor not receive less under a Chapter 11 plan than it would under a Chapter 7 liquidation, will not prevent gamesmanship over an individual debtor's projected income: Because Chapter 7 does not make an individual debtor's postpetition earnings available to all creditors, the inclusion of less than all of the debtor's income under a Chapter 11 plan will not create a "best interests" problem for the debtor.