Focus On: Bankruptcy

by Hon. Craig Gargotta

Where is Bankruptcy's Next Innovation?

Bankruptcy cases have for years received widespread news coverage. The average citizen is probably familiar with some of the companies that have filed bankruptcy, such as General Motors, Chrysler, Lehman Brothers, Enron, and Texaco. Some may even know that these companies went through Chapter 11 bankruptcies. Those same citizens may be aware that the companies were facing huge debt burdens, the possibility of a complete business shutdown, and the limited prospect of paying their debts in full. Further, each company faced the prospect of reducing its labor force and not retaining equity.

Lesser known to these same citizens may be the administrative costs of bankruptcy; the lawyers, accountants, turnaround specialists, unsecured creditor committee, restructuring officers that are paid ahead of other creditor constituencies such as the unsecured creditors and equity holders. These citizens may even grumble at the notion that in a number of Chapter 11 cases the only parties who get paid are administrative claimholders, secured parties and maybe tax claimholders.

Unfortunately, the chances are better that many of these citizens know someone who has filed personal bankruptcy—Chapter 7 or 13 usually—and faced the prospect of losing a home or car. These consumer debtors are facing the prospect of job loss or reduced hours, mounting medical bills, divorce, or business failure. For them, bankruptcy hovers over their heads for years and stays on their credit report for as long as a decade. Moreover, their ability to obtain favorable credit, if at all, is severely limited.

Regrettably, this is the unknown cost (literally) of bankruptcy. So much attention is focused on the magnitude of the case, the number of dollars discharged, and/or the lawyers that are involved. On a business level, more headlines are devoted to executive pay or bonuses than are devoted to how much debt is paid or the number of employees retained.

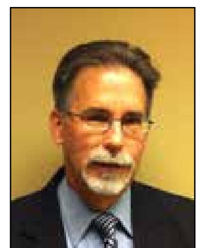
In consumer cases, the cost to some creditors is significant. Unsecured debts for credit cards or unsecured loans rarely get paid in full. Conversely, car loans that were negotiated within 910 days of filing must be paid in full. Income taxes due within three years of the date of filing of the petition, unfiled tax returns and business taxes cannot be discharged; nor can most student loans. Further, under the premise of public policy, other debts such as alimony and child support, fraud, damages related to deaths caused by drunken driving, and certain securities violations are also deemed non-dischargeable. In that regard, the inability to discharge debt is significant.

These revelations are well known and represent common considerations as they relate to the debt discharge versus debt repayment rubric. These types of issues are determined daily in court. With all this "regularity" in the bankruptcy system, has the bankruptcy system lost some of its innovation when it comes to debt relief and the restructure of business entities?

Historically, bankruptcy law and the courts have been on the forefront of innovation. When the original version of the Bankruptcy Code went into effect in 1979, the U.S. Congress and the constituencies who structured the Code envisioned a system that would achieve a meaningful discharge for honest consumer debtors and allow businesses a means to "restructure" secured debt, pay delinquent taxes, and retain equity. While the contours of reorganization were defined, business debtors had wide latitude in dealing with a number of issues particular to their businesses. For example, airlines filed bankruptcy to restructure collective bargaining agreements that dealt with employee wages and pensions. Asbestos manufacturers used bankruptcy to deal with medical claims filed against them and created mechanisms to deal with class actions and settlement of claims. Texaco filed bankruptcy to reach a settlement of the judgment owed to Pennzoil. Large department stores rejected leases for nonperforming stores or leases that no longer made economic sense. Companies cited for environmental violations attempted to discharge fines through bankruptcy and avoid future liability through discharge. Even sport organizations, such as the Pittsburgh Penguins, sought protection under Title 11.

Bankruptcy even became mainstream for celebrities. Sports stars and actors such as Michael Vick, Lenny Dykstra, Wesley Snipes, Nicolas Cage, Mike Tyson, Marvin Gaye, Burt Reynolds and Jerry Lee Lewis all sought refuge in bankruptcy for poor investments, financial mismanagement or embezzlement, or excessive gambling and lifestyles. Moreover, millions of average citizens filed

Hon. Craig Gargotta is a bankruptcy judge in Austin, Texas, and former editor in chief of The Federal Lawyer.



to save their homes, cars, and small businesses. Tax debt was paid over time without the accrual of penalties and interest and secured claims on car debt could be crammed down to the value of the vehicle.

In addition, bankruptcy courts became leaders in innovation when it came to electronic filing, paperless dockets, electronic exhibits, and the use of televideo hearings. Litigants could file pleadings from anywhere with their computers and receive instant notification of filing and electronic notice of hearings. Bankruptcy courts can now "publish" audio recordings of court hearings for parties to hear simply by accessing the court's electronic docket. Moreover, litigants can access court orders and opinions on the court's website.

The code was amended significantly in 2005 to curtail perceived abuses in primarily consumer cases. Under the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) of 2005, Congress required debtors to opt for Chapter 13 over Chapter 7. As a result, debtors with a certain threshold level of disposable income are required to file Chapter 13 and make some distribution to unsecured creditors. Chapter 7 cases can be dismissed for "abuse" if it appears that the debtor is attempting to avoid payment of consumer debt if the debtor has the ability to pay. Fraud is no longer a basis for discharge. The "super" discharge for consumer cases has been weakened significantly by the addition of more categories of nondischargeable debt. Consequently, consumers' lawyers lament the limited means in which they may file bankruptcy and discharge debt.

Business cases have changed as well. In a soft economy with banks reluctant to lend capital, business debtors are having difficulty obtaining credit or restructuring debt. Further, many business debtors have resorted to selling property through court-approved sales and then either dismissing or converting their case to Chapter 7, thus avoiding the necessity and expense of the Chapter 11 process. The rate at which these types of cases have been filed has reached the point that several business type groups are studying whether Chapter 11 reorganization is still a viable option.

These developments beg the question, where will the next innovative filings occur? Consumer debtors have few options under the current code in reducing debt. Some debtors have resorted to filing Chapter 20s, a Chapter 7 case to discharge unsecured debt and then a subsequent Chapter 13 to get current on mortgage arrears debt, car delinquencies, or tax debt. *See Johnson v. Home State*.[1] This approach has been available for years but has been limited somewhat by a debtor's ability to qualify first for Chapter 7 before filing a Chapter 13. Moreover, the benefit of a subsequent Chapter 13 is limited because the debtor is not eligible for a Chapter 13 discharge.[2] Additionally, some courts have been receptive to allowing debtors to "strip off" junior liens on real property where the collateral has a value less than the amount of the first lien. There is even the possibility of lien stripping extending to liens on residential homesteads. *See Woolsey v. Citibank N.A. (In re Woolsey)*[3] and *In re McNeal*.[4] As noted, Chapter 11 debtors have limited options

INNOVATION continued on page 68

Summary

Preference cases are relatively straightforward. The foregoing should provide you and your client with the basic information regarding preferential payments and, with just a little precaution, a defense or two. ⊙

Endnotes

[1]It is said that the bankrupt debtor prefers one creditor over another since there are insufficient funds to pay all creditors.

[2]11 U.S.C. § 547(b).

[3]*Id.* § 547(c)(1).

[4]*See Jones Truck Lines, Inc. v. Central States SE & SW Areas Pension Funds (In re Jones Truck Lines, Inc.)*, 130 F.3d 323, 326 (8th Cir. 1997).

[5]11 U.S.C. § 547(c)(2).

[6]*Payne v. Clarendon Nat'l Ins. Co. (In re Sunset Sales, Inc.)*, 220 B.R. 1005 (B.A.P. 10th Cir. 1998).

[7]*Gasmark Ltd. Liquidating Trust v. Louis Dreyfus Natural Gas Corp.*, 158 F.3d 312, 317 (5th Cir. 1998).

[8]11 U.S.C. § 547(c)(4).

[9]*New York City Shoes, Inc. v. Bentley Int'l Inc.*, 880 F.2d 679 (3d Cir. 1989).

INNOVATION continued from page 65

in restructuring debt. The Supreme Court determined earlier this year that a Chapter 11 debtor cannot sell property free and clear of liens without allowing a secured lender to credit bid its debt against competing bids to purchase the property.[5] Further, individuals have resorted to filing Chapter 11, but because of the amount of debt may have difficulty in getting a plan confirmed because some courts believe that the absolute priority rule applies to individual Chapter 11 debtors.[6] As such, if there is any area in bankruptcy that has received much attention, it is in the context of Chapter 9 for municipalities. State legislatures and Congress have debated the impact of municipalities resorting to bankruptcy relief. Viewed as a panacea by some, many city leaders are considering filing for bankruptcy as a way to alleviate debt and coerce city unions into modifying collective bargaining agreements with public unions. Such an approach might avoid the prospect of city councils making budget cuts that would reduce city services and restrict city employee pay and benefits. Although it is questionable whether municipalities can alter union contracts, the mere threat of filing Chapter 9 pits city officials and taxpayers against city employees. Although Chapter 9 has been in existence since the 1938 depression, it has not been utilized often.

The reasons for filing Chapter 9 and the limitations thereto dictate how Chapter 9 may be utilized. For example, the debtor must be a municipality. The state in which the municipality is located must authorize under state law that it may do so (roughly half of the states allow municipalities to file for Chapter 9). The municipality must be insolvent and desire to effect a plan or debt adjustment with no prospect of liquidation. The filing must be the last option available. As a result, while Chapter 9 may be viewed as a substitute or alternative for budget cutting, it requires a great deal of negotiation and agreement. While municipal filings appear to be the next frontier in bankruptcy, it is difficult to assess how viable the filings will be. Until then, bankruptcy will remain relatively unchanged and will operate as it has for the past 33 years.

While bankruptcy practice may not change much in the upcoming years, bankruptcy courts will have to conduct operations with reduced staff and funding. The challenge will be to provide exemplary service in the wake of budget reductions. This will require a re-emphasis on technology and shared services. It is in the environment of "more with less" that the courts must be innovative. ⊙

Endnotes

[1]501 U.S. 78 (1991).

[2]11 U.S.C. § 1328(f)(1).

[3]___ F.3d ___, 2012 WL 3797696 (10th Cir. 2012) (court denied debtors' request to strip off second lien on their home because they failed to make an argument under § 1322(b)(2) that would have allowed the court to consider strip-off of second lien).

[4]2012 WL 1649853 (11th Cir May 11, 2012) (Chapter 7 debtor could strip off wholly unsecured lien).

[5]*See RadLAX Gateway Hotel v. Amalgamated Bank*, 566 U.S. ___, 132 S. Ct. 2065 (2012).

[6]*See In re Maharaj*, 681 F.3d 558 (4th Cir. 2012) (absolute priority rule does apply to individual Chapter 11 debtors); *see also In re Friedman*, 466 B.R. 471 (B.A.P. 9th Cir. 2012) (absolute priority rule does not apply in individual Chapter 11 cases).

2013 Washington, D.C./Baltimore Public Service Career Fair

Presented by the Federal Bar Association Federal Career Service Division

Friday, February 1, 2013 • 9:00 a.m.–5:00 p.m.

George Mason School of Law

There is no fee to participate in the career fair! For more information, visit www.fedbar.org/2013CareerFair.