

# Bankruptcy Evolution

THE BANKRUPTCY ABUSE PREVENTION AND CONSUMER PROTECTION ACT OF 2005 WENT INTO effect on October 17, preceded by a spike in filings by consumer debtors concerned about the pending changes. Indeed, the new law does create many changes for individual and business debtors, along with their creditors, attorneys, and the U.S. bankruptcy system.

Our panelists bring a variety of perspectives to a discussion of the evolving dynamics. They are Robert Gebhard of Sedgwick, Detert, Moran and Arnold; Kyle Everett of Development Specialists Inc.; Donald Cram of Severson & Werson; Lawrence Fallon of Semperian, Inc.; Tracy Green of Wendel, Rosen, Black & Dean; and Chief Judge Randall Newsome of the U.S. Bankruptcy Court, Northern District of California. The forum was moderated by freelance legal editor Tracie L. Thompson and reported for Barkley Court Reporters by Krishanna DeRita.

**MODERATOR:** How sweeping are the changes in this new law?

**NEWSOME:** It's a much more sweeping change for consumers than it is for Chapter 11 and businesses, generally. The real difference is that in Chapter 11 the judge still has some ability to change the outcome, depending upon the facts and circumstances. The consumer provisions intend to limit that kind of discretion.

## EXECUTIVE SUMMARY

The long-awaited U.S. Bankruptcy Code changes have finally gone into effect. Our expert panel details the advantages gained by companies that extend credit to financially troubled consumers and businesses, and the new rules for creditor committees. They also explain why prebankruptcy planning has become more important for companies on the edge.

**GREEN:** With respect to the consumer aspect, the biggest change is with debtors who were previously presumed to be entitled to a fresh start, and who now are presumed to be "bankruptcy abusers."

Debtors now have to jump through various hoops, and the lawyers who are assisting the presumed abusers are being treated in a "scarlet letter" approach as well. They have to advertise in a certain way, and they have to state that they are a "debt-relief agency."

It's a punitive approach to people who are like the victims of the hurricane in New Orleans. Most of the individuals that file bankruptcy have their own personal hurricane: a medical condition, a business that went south. There isn't a huge problem with people randomly abusing the bankruptcy system, but many people will be labeled as abusers and have to overcome that.

**GEBHARD:** Regarding this idea about abuse and means testing—which is the real heart of this—the old standard under the code was not the right standard. It had the concept of substantial abuse. You had Chapter 7 debtors who had a lot of charge card debt,

but they rented their apartment, leased their car, and they didn't have a lot of assets that could be liquidated to pay creditors. However, they had income to pay creditors.

Under the old law, only the U.S. Trustee could make a motion to dismiss the bankruptcy case, but the standard was "substantial" abuse. I think that was the wrong standard, and the intent of Congress was to fix that standard. But it's fair to say they went overboard with means testing.

**EVERETT:** It will be more costly for businesses to file Chapter 11. There's a lot of uncertainty in the new bill, and there probably will be litigation about some of the new provisions that pertain to business cases. There also will be increased reporting requirements, which will increase costs.

**FALLON:** I have a different view on some of these provisions, and I don't think it's quite as draconian as the scarlet letter. If you look at it from a national perspective, the means test issue only affects those debtors who exceed the median income for their area. I was talking with a trustee in Georgia.

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Ninety percent of his current debtors are not even subject to the means test due to low incomes.

Although it may seem harsh at first, I don’t think the means test is going to capture everybody that people are afraid it’s going to capture. A lot of people who will qualify for Chapter 7 will make it work for them, even if they do exceed the median income.

There are also some problems with the means test, such as the double-dipping issue on housing allowances and things like that. You could have debtors who under the old law would have been in Chapter 13, and now they are going to file Chapter 7, pass the means test, and not pay anything back. So it may have the reverse effect as well.

**CRAM:** The intent was to make it more difficult and more costly to file bankruptcy, especially Chapter 7, but there will always be a need for Chapter 7. Good debtors’ lawyers will find a way for these debtors to obtain the relief they need. Also, the actual language of the code wasn’t drafted well, and there will be a lot of unintended consequences.

Debtors who possibly have more secured debt will be able to “pass” the means test. The means test is really a fictional process where you take a fictional income and subtract fictional expenses from that income. So someone’s Schedules I and J may actually reflect substantial excess income that could go to fund a Chapter 13 plan; however, they pass the means test and may liquidate in

Chapter 7. The real issue is whether judges will entertain motions to dismiss under 707(b)(1) for abuse when there’s actual substantial excess income.

**MODERATOR:** In looking at this bill’s implications for creditors, will those with asset-based portfolios fare better?

**FALLON:** On paper it looks as if all creditors will do better, particularly creditors with asset-based portfolios, and even the unsecured creditors, although there’s some conflict between the treatment of secured and unsecured creditors, particularly in the Chapter 13 context.

The secured creditor will fare better in two ways, but it depends on the quality of the collateral in your portfolio. Are you an A-paper portfolio like GMAC, Ford Motor Credit, Daimler-Chrysler, or are you a near-prime lender whose collateral is not quite as up to snuff as someone else’s?

Changes in the law give a lot more certainty to creditors with asset-based portfolios: If the debtors don’t do certain things, they essentially lose the right to retain possession of that collateral. If I have an asset-based portfolio with a near-prime type of paper, I may not necessarily want that collateral back. So these new provisions aren’t really the best thing for me.

But if my portfolio consists of A-paper with solid collateral, I’m going to want my collateral back when the debtor fails to comply with the provisions relating to collateral retention. Generally my first loss will be my best loss, especially given the historical failure of Chapter 13 cases.

**NEWSOME:** I have heard that certain car creditors are not going to allow debtors to retain their car if they don’t sign a reaffirmation. The new law says if the debtor doesn’t file a statement of intention and perform on it within a certain period, the automatic stay lifts and you are left to your state law remedies. Will state courts enforce an ipso facto clause that says if you file a bankruptcy, you are in default on this



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## FORUM

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agreement and the entire amount of the balance is accelerated?

**FALLON:** The position of many automotive finance companies is that the state courts will give them their collateral back. What we are hearing from the debtor's side is, "So, you are going to actually repossess my client's car, even though they have ridden through a bankruptcy, they haven't redeemed, they haven't reaffirmed, they are completely current on their debt?" And the answer will often be "Yes."

When the state court judge says, "Tell me where it is in the bankruptcy code that you can do this," we explain that the debtor's discharge has converted the original obligation to a non-recourse debt and Section 521(a)(6) specifically states that debtors who have not reaffirmed or redeemed "shall not retain possession" of such collateral and then you go to Section 521(d), which specifically references ipso facto clauses giving them full force and effect.

**CRAM:** This ties into the ride-through issue. Before, in some jurisdictions, you had a conundrum between a debtor and a creditor. How do you facilitate payments on the account when you have a discharge injunction preventing you from contacting the debtor?

There were judicial decisions that allowed for that type of communication. But under the new code, you have a very specific allowance for lenders who are secured by the debtor's principal residence to make contacts despite the discharge injunction, and for those lessors of personal property to facilitate an assumption of that lease and to cure payment defaults. Those are the only specific carve-outs from the discharge injunction. So if you don't fall within one of those specific carve-outs, you can't contact the debtor.

**GEBHARD:** Also, when you look at Chapter 11 bankruptcies, certain creditors like sellers of goods, utilities, and taxing authorities get some perks from this bill. They may get higher priority of claim and better assurance of payment, and that will affect the debtor's cash flow. But other types of trade creditors—

providers of services, for example—there are no added benefits for them.

**NEWSOME:** Is there much buzz in the banking community about all of the securitization of credit card debt and what may happen with all of the derivative instruments that are built on that?

**CRAM:** You are seeing a lot of banking institutions that are buying asset-based portfolios to try to hedge against that. But I don't think you are hearing that openly discussed.

**MODERATOR:** How about when businesses are considering Chapter 11 under the new law? What changes are they looking at?

**GREEN:** A couple of things come into play there. It used to be that as soon as a Chapter 11 was filed, the debtor would race in and say, "We have to pay this group of people these astronomical bonuses just for showing up to work tomorrow"—the same people that got the debtor in the position that they are in—and the judge is faced with this unknowing situation. Are these people really going to walk? And it's distasteful when these poor unsecured creditors are going to get 10 cents on the dollar and these executives are asking for huge bonuses.

So the law has limited the ability of these executives to come in and ask for bonuses for just sticking around. They have to show bona fide evidence that they do have another job they could go to, and the debtor has to show that these people are, in fact, critical to the debtor's operations.

**NEWSOME:** So are we going to replace key employee-retention programs with incentive bonuses because they aren't covered by this new provision?

**EVERETT:** I'm hoping that what you are going to see is a lot of performance metrics, bonuses that truly are performance based. I'm sure that there will be severance packages disguised as incentive packages, and it

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will be up to the judge to decide what’s really, truly an incentive.

**NEWSOME:** The last time I had one of these cases, they wanted the money just for hanging around, and I said, “No, you get the money when creditors get *X* percent on whatever the plan promises.” They were shocked I would make that requirement. But if that’s the kind of incentive bonus they are talking about, that doesn’t sound so bad.

**EVERETT:** This is a good provision, and one good thing is that it is on the judges to really decide what the performance measures will be and whether they are appropriate or not.

**FALLON:** Unless the judges have specific knowledge about the industry, how will they be able to determine the appropriate performance measures tied to the key employee’s incentive bonus?

**NEWSOME:** Unless somebody wants to put on some evidence to tell me why any kind of a bonus is appropriate, I’m not willing to give anything. I’m not qualified to tell them whether a million dollars or two cents is what they ought to get in retention plans. Maybe they shouldn’t be retained at all. Maybe the best thing is for them to be thrown out, since they rode the thing into Chapter 11.

**GREEN:** Another change is that the exclusivity periods—where only the debtor can file a plan of reorganization—have also been cut

down. Debtors would sometimes aggressively continue the exclusivity period because otherwise a creditor would come in and propose a liquidation plan or something that the debtor wasn’t interested in. Now the code sets limits on how long the exclusivity periods can be extended. What’s the impact? Maybe not much, because not many creditor plans are filed. But they are filed on some occasions, and it can affect the outcome of the case.

**GEBHARD:** For most cases the exclusivity limit is not going to make a difference. But for larger cases, particularly mass tort bankruptcies such as W.R. Grace, where they need to be in bankruptcy much longer to work through their tort liabilities, I’m not so sure they can get it done in 18 months.

**EVERETT:** You have a problem with real cases with complex constituencies, too, like airlines.

**GEBHARD:** And does this really affect plan-negotiating leverage? If you are now on the creditor’s side and you know there’s an end in sight—the debtor can’t just wear you down—you may be more inclined to hold out for a better deal or threaten to propose a creditors’ plan.

The other thing people are talking about is the DIP [debtor-in-possession] financing. A lot of companies can’t reorganize without restructuring their existing secured debt or getting a new lender to come in to provide exit financing. If you negotiate with the lender—“I need \$10 million to exit the bankruptcy. I can lay out a clear term sheet for you. Let’s negotiate something, and then we’ll approach our creditors to put it in a plan to implement”—that kind of conversation was happening before. But now the lender knows it may be a creditor’s plan that actually wins the day in the bankruptcy.

**NEWSOME:** Why couldn’t the lenders put into the lending agreements, in essence, a poison pill to prevent that? For example, “If any creditor proposes a plan in this case, the entire amount of the indebtedness is



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immediately due and owed.” They build so many things into these agreements as it is, there’s no reason why they can’t build that in there, too.

**GREEN:** Another change in the new law impacts landlords. It used to be if the debtor needed additional time to consider whether or not they were going to assume and assign leases, they would ask the court for an extension, and the courts were generally generous with giving debtors the benefit of the doubt. Now the code has limited the judge’s discretion in this, and the debtors get an initial 120 days to decide whether they want to assume and assign the lease, and one 90-day extension. If they want additional extensions, they have to negotiate with the landlord. That’s going to hurt the unsecured creditors because the debtor may be compelled to reject the lease.

**FALLON:** Don’t you think the large retailer that’s contemplating bankruptcy is going to do a lot more planning and analysis of their business needs—especially with respect to the real estate and the leasehold interest—before they go into bankruptcy, given these shorter timelines?

**GREEN:** Debtors ideally come to you a year before they need to file bankruptcy, and it’s better for the business in most cases. However, the reality is that many times debtors simply do not consult their attorneys early enough.

**EVERETT:** For a whole host of reasons it’s an opportunity for some of us to actually do some prebankruptcy work with people. Either workouts or prebankruptcy planning, I think, will be really, really key.

**MODERATOR:** The law also includes new requirements of creditors committees, correct?

**EVERETT:** Yes. The committee is now required to share information with all of the constituents and all creditors, and it’s not clear what that information is. There’s also a requirement

to solicit their comments, but it’s not clear what comments or in what context. Some people are concerned that if claims traders have more information, it is only going to enable them and perhaps cause more abuses. I think that’s probable.

**NEWSOME:** The hand-wringing I’ve seen over this has surprised me, because I always thought that’s what creditors committees are supposed to do anyway. They aren’t supposed to be there just to represent themselves; you are supposed to disseminate information to your creditor body and solicit their views.



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Apparently, the biggest worries are that people are going to find out stuff they shouldn’t. Well, there’s already section 107(b), which says that the court can protect an entity with respect to a trade secret, confidential research, development, or commercial information. So if you need to get something sealed, you can.

As to other kinds of information, like plan negotiations, if you think this is something people ought not have ready access to, then come in and make a showing as to why they shouldn’t. But otherwise, why not set up a website? Periodically post reports of committee meetings, discussions of how the debtor is progressing toward a Chapter 11 plan, and solicit comments and suggestions from the creditor body.

**EVERETT:** Originally I was thinking that this could open the floodgates for requests for

information that would be very, very costly, but the idea of a website is a good one.

**GEBHARD:** The concern is that when you are in negotiations on a plan, for instance, the debtors’ lawyers want you to sign a nondisclosure agreement. They will want to talk about potentially sensitive things: where they are headed with this business and where they are now. They don’t want competitors to know about their key customers or trade secrets. Unless you can assure debtor’s counsel that there will be some confidentiality, you will not necessarily get enough information to negotiate a plan with the debtor company.

In a case where you anticipate a lot of creditor activity and an active committee, you might even see a motion where the committee comes in and says, “We have some protocols we want to adopt about how we are going to communicate with the creditor body, how we are going to protect some information with the debtor, so we don’t get into a lot of needless disputes and can focus our energies on the task at hand.”

**NEWSOME:** Committees traditionally have had bylaws anyway, and this could be incorporated into the bylaws.

**GREEN:** My concern is that there are so many anti-dissemination provisions in the code with respect to a plan, some people won’t want to sit on the committee because they might not want to run afoul of those provisions, which restrict the disclosure of information.

**NEWSOME:** That’s only if you are soliciting votes. There’s nothing that says you can’t disclose what the debtor’s operations are all about.

**GREEN:** But if you are soliciting comments like “We are thinking of putting together this type of plan,” the committee people would have to be careful about how they phrase everything so it’s absolutely clear that they are not soliciting votes, that they are not soliciting approval of a term taken out of context of a plan. ●