

Confronting the Challenges Arising in Individual Chapter 11 Bankruptcy Cases

May 02 2014

Posted By: David I. Cisar

Practice Area: Restructuring and Insolvency & Banking and Commercial
Finance

Because of the complexity and expense of chapter 11, most reorganization cases are filed by entities rather than individuals. Nevertheless, in recent years a growing number of entrepreneurs and high net-worth individuals have used chapter 11 to restructure their personal finances and maintain control of their businesses and investments. This Update discusses some common challenges arising in individual chapter 11 bankruptcy cases, and how a creditor can respond.

General Principles: Claim Impairment and Bifurcation

In a chapter 11 case, the debtor has the right to propose a plan governing the treatment of the property in the bankruptcy estate and creditor claims for payment. The plan must classify claims according to shared features, such as claim priority, secured or unsecured status, and the nature of the collateral. Many plans have a class containing all general unsecured claims and separate classes for each secured claim. Each claim in a particular class must receive the same treatment. The members of each class whose claims are modified by the plan—or in bankruptcy terminology, “impaired”—have the right to vote to accept or reject the plan. Unsecured claims and one or more classes of secured claims are typically impaired under a chapter 11 plan.

If at least one class of impaired claims approves the plan, and the plan meets certain minimum requirements for the treatment of claims, the bankruptcy court will approve or “confirm” the plan. For this reason, a plan can be approved over a creditor’s objection if the dissenting creditor is either outvoted by other creditors in its class, or by creditors in a different impaired class.

A chapter 11 plan may also seek to “cram down” an undersecured loan by using the value of the collateral to divide (“bifurcate”) the debt into its secured and unsecured parts, with each resulting claim voting in a different class. If the plan is approved, the secured portion of the loan will be reduced to the value of the collateral, and the remaining portion will be unsecured and share *pro rata* in distributions on all unsecured claims, which can be minimal, but must be at least as much as unsecured creditors would receive in a chapter 7 liquidation. In an individual chapter 11 case, any lien other than a mortgage on the debtor’s primary residence is potentially subject to cram down.

Claim impairment and bifurcation are frequent sources of disputes in chapter 11 cases, and resolving those disputes is a fact-sensitive process. A secured creditor's ability to challenge the debtor's proposed treatment of its claim will depend on the value of collateral, the value of the debtor's other property, the debtor's ability to make payments as well as other factors. A secured creditor who acts timely also has the ability to elect to have its entire claim treated as secured, thus blocking claim bifurcation and cram down – and giving the creditor potentially significant leverage over the debtor.

Although other "fairness" requirements apply, the debtor has a great deal of flexibility in the plan to reorganize its affairs and, in many cases, negatively impact a creditor's claim.

Enforcing the Requirement for the Debtor to Contribute Disposable Income to the Plan

In an individual chapter 11 case, an unsecured creditor who will not be paid in full can object to the plan and force the debtor to contribute property to the plan equal to the value of the debtor's projected disposable income for the next five years. "Disposable income" generally means the debtor's current monthly income less reasonably necessary expenses for the support of the debtor and debtor's dependents, and the operation of the debtor's business. The debtor must establish that any expenses claimed are reasonably necessary, and must also demonstrate that the plan provides creditors with value equal to or greater than the debtor's five-year projected disposable income.

The plan should require the debtor to submit yearly post-confirmation tax returns so that post-confirmation income and expenses can be monitored. If the debtor's disposable income increases during the plan term, any creditor can file a motion to increase the debtor's plan payments. A creditor should object to any plan that attempts to limit creditors' rights to seek modification of the plan post-confirmation.

Finally, any plan that will be completed in less than five years must still make payments equal to the debtor's five-year projected disposable income. A creditor should object to any proposal to pay less.

Opposing a "Collapsed Debtor" Scheme and Preserving Single Asset Real Estate Options

Sometimes the challenge confronted by the creditor in an individual chapter 11 case arises from aggressive pre-bankruptcy actions by the debtor. A "collapsed debtor" is one such situation that arises when an individual real estate developer owns a number of entities, each holding title to a single project or property, with debts secured by mortgages against those properties and personally guaranteed by the developer. Rather than filing separate bankruptcies for each real estate entity, the developer transfers the real estate assets from the entities to himself or herself personally and possibly assumes personal liability for the debts owed by the entities, thereby collapsing the ownership structure prior to filing bankruptcy. These transfers are typically made on the eve of the bankruptcy filing and without the consent of the lenders.

A creditor facing this scenario is in danger of losing many protections. First, it may lose the bankruptcy protections provided to secured creditors of "single asset real estate" cases—which the title-holding entity would have been had it filed the bankruptcy case—including the requirements that the debtor begin making monthly interest payments and propose a plan no later than 90 days after filing for bankruptcy. The creditor's ability to exert influence against the collapsed debtor will be diluted by the numerous additional claims by parties that were not creditors of the original, single asset borrower. The undersecured creditor will likely lose the ability to control the unsecured creditor class, which might (after the collapse) be the only accepting, impaired class. The strategic option of purchasing a few small unsecured claims to control the unsecured creditor class will be lost.

Among the reforms enacted by Congress in 2005 was a provision allowing a secured creditor to seek relief from the automatic stay and proceed with remedies outside of bankruptcy court if the debtor's bankruptcy filing was part of "a scheme to delay, hinder or defraud creditors" that involved the transfer of ownership of real property without the secured creditor's consent. Case outcomes have varied based on the specific facts in each case, but creditors should be prepared to develop evidence to show that the transfer of the real estate to the individual debtor was part of a "scheme" to hinder or delay creditors.

Conclusion

A bankruptcy debtor will try to maximize its chance of successfully reorganizing, and will attempt to pay as little to creditors, as the law and facts permit. Bankruptcy Courts generally favor giving debtors a chance to reorganize so creditors need to be prepared to fight for better treatment of their claims. Creditors should be cognizant of the foregoing requirements and strategies to maximize recoveries in individual chapter 11 cases.

von Briesen & Roper Legal Update is a periodic publication of von Briesen & Roper, s.c. It is intended for general information purposes for the community and highlights recent changes and developments in the legal area. This publication does not constitute legal advice, and the reader should consult legal counsel to determine how this information applies to any specific situation.