

The New Bankruptcy Law: What Business Executives Should Know

by [Alec P. Ostrow](#) - Shareholder, Stevens & Lee

On April 20, President Bush signed into law a major overhaul of the Bankruptcy Code. This legislation has generated much controversy, almost all of which has been focused on the closing of the bankruptcy courthouse door to many poor individuals who can afford to pay something back to creditors, but would instead seek to discharge these debts without any obligation to repay. The new law establishes for individuals whose debts are primarily “consumer debts” a “means test.” The means test looks at the putative debtor’s means, income less permissible expenses, and determines whether at least \$6,000 to \$10,000 can be paid back over five years to regular creditors (those without special rights). If this kind of debtor has sufficient means, then a simple bankruptcy case to discharge debts without a pay-back plan is unavailable.

While this is indeed a major change for personal bankruptcy from the “fresh start” policy that has existed for over 100 years, there are nevertheless important changes that affect business bankruptcies as well. Many of these changes are in the nature of “nips” and “tucks.” Nevertheless, some of these changes are important for business executives to be aware of, not just in case a business by which they are employed or which owes money to them or their firm needs to consider bankruptcy relief. Executives who may have given personal guaranties or otherwise have personal liability for business debts may be thinking about bankruptcy relief for themselves. Creditors of these executives also need to be aware of these changes.

Although some changes have already gone into effect, such as a limitation on the use of homestead exemptions, most of the changes go into effect in mid-October. So, there is a window of opportunity to see whether it might make sense to file for bankruptcy under the “old” law before the new provisions make matters more difficult on the debtor’s side.

Here are some important changes applicable to most businesses in chapter 11 cases:

- **Less tolerance for failure to follow the rules.** Courts must dismiss cases, order liquidation, or appoint trustees for unexcused failures to comply with court orders, file financial reports on time, pay taxes on time, or confirm a plan within a set deadline. Severe consequences can be averted only if the court finds unusual circumstances, or if the failure can be promptly cured and a plan promptly confirmed.
- **A shorter period for the debtor to control its destiny.** The maximum amount of time the court can give a debtor the exclusive right to file a chapter 11 plan is 18 months, with two extra months to get it accepted.
- **Mandatory motion by the government to appoint a trustee, if there are reasonable grounds to believe management committed fraud.** This is already effective.
- **Real estate leases must be assumed or rejected within a maximum of 210 days after filing, unless the landlords consent to more time.** Companies with a lot of leases, such as major retailers, must do lease disposition planning well in advance of filing. Nevertheless, if a lease is rejected after it has been assumed, the maximum liability for rejection damages as an administrative expense under the new law is two years’ rent.
- **Debts incurred by fraud or with false financial statements to any governmental entity cannot be discharged.** This means such debts must be paid in full under a chapter 11 plan, whether or not they are entitled to priority over other creditors.
- **Key employee retention programs (“KERPs”) and severance payments to executives are substantially restricted.** A retention payment cannot be approved unless the executive is essential to the survival of the business and has a bona fide job offer from another firm for at least the same compensation.

Severance payments cannot be made to executives unless they are part of a policy open to all full-time employees. The amounts of KERP and severance payments are also restricted.

- **Debts for goods delivered in the ordinary course of business within 20 days of the filing have priority over most other debts.**

Here are some important changes for executives contemplating personal bankruptcy (or the personal bankruptcy of others):

- **No “means test” for business executives.** The test applies only to those individuals whose debts are primarily “consumer debts,” which are those incurred for a personal, family or household purpose. Individuals whose debts are primarily for corporate guaranties or corporate obligations are exempt. Nevertheless, an attempt to discharge debts without any repayment plan for these individuals is also subject to being blocked if it is considered an “abuse.” The criteria for such “abuse” is not specified.
- **Debts to current or former spouses or for child support have the highest priority of payment.** These debts must be paid even before the costs of the bankruptcy (except for those costs relating to the satisfaction of such debts).
- **Debts to former spouses for property settlements are no longer dischargeable.**
- **Homestead exemptions have been limited.** This is already effective. The most significant limitations are:
 1. A cap of \$125,000 in value for homesteads:
 - a. acquired in a new state within 1215 days (about 3-1/3 years) prior to the bankruptcy filing;
 - b. if the debtor is convicted of a felony that demonstrates that the bankruptcy filing was an abuse of the Bankruptcy Code; or
 - c. if the debtor owes a debt for such things as fraud, securities fraud, or willfully causing serious physical injury or death within 5 years of the bankruptcy filing.
 2. A reduction in value of such exemption for property transferred in fraud of creditors and used to acquire the homestead within 10 years of the filing.
- **Chapter 11 cases for individuals have dramatic changes:**
 1. Income for personal services is now part of the bankruptcy “estate.”
 2. Plans must devote at least five years of “disposable income” to payment to creditors, if creditors are not paid in full and a creditor objects.
 3. The discharge of debts is not granted until the payments under the plan have been completed, unless the plan can’t be modified and creditors have received at least liquidation value.

These are just some of the major changes the new bankruptcy law makes applicable to the commercial world. Other significant changes include more disclosure for “small businesses” in chapter 11 and the adoption of an international protocol to deal with cross-border insolvencies. There are also important changes concerning bankruptcies for health care businesses.

The impact of these changes for business and business executives needs to be carefully considered. For those contemplating business or personal bankruptcy the time to take advantage of the old, more liberal law is ticking away. For those who cannot imagine filing before the change-over, but may have to consider filing after, it may be prudent to start planning for the new regime.

For more information on how the new bankruptcy law may affect you, please contact [Alec P. Ostrow](#) at 212-537-0402.