

We, The People: Planning for the High-End Individual Filer

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Doctors, Lawyers and Businessmen, Oh My! Representing High-Income Individuals in Bankruptcy

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Congress' amendments of the Bankruptcy Code through the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) seem driven to make high-income individuals more responsible for their debt and to rope them in to paying their "fair share" to creditors. Three amendments in particular seem aimed at grounding these high flyers who might otherwise have charmed their way out of paying on their debts. First, Congress added section 548(e)(1), which gives the trustee the right to pull in to the bankruptcy estate assets transferred to a self-settled trust, to discourage the use of trusts to shelter debtor assets. Next, Congress added section 1115 to include within the individual chapter 11 debtor's estate income earned for services performed after filing for bankruptcy. Finally, Congress added the means test to section 707(b) to kick a debtor into chapter 11 or chapter 13, or dismiss the case entirely, if an individual debtor with primarily consumer debts had an income above his/her state's median income. Each of these changes will be addressed in turn.

A. ASSET PROTECTION

Americans have made a trillion dollar industry out of hiding assets from the IRS and their creditors, and prior to the 1990's, they did so mainly through the use of offshore trusts. In 1997, both Alaska and Delaware decided that they wanted part of the \$2 Trillion dollar market in offshore trusts, so each state enacted a trust act authorizing self-settled spendthrift trusts.¹ Domestic Asset Protection Trusts, also referred to as Alaska or Delaware Trusts, are substantially similar to the Offshore Asset Protection Trusts used to shelter assets outside the United States. Since Alaska and Delaware led the way, similar statutes have also been enacted in Nevada, Rhode Island, and Utah. These DAP Trusts allow an individual to shelter assets and enforce spendthrift provisions against creditors provided that the individual and/or the trust and its trustee have strong ties to the state where the trust is formed. However, if a settlor of a DAP Trust files for bankruptcy outside of the state allowing the formation of the DAP Trust, the bankruptcy court will most likely not enforce the spendthrift provisions of such trust.²

Even if a debtor can show a strong relationship with the trust state, the assets of DAP Trusts are still subject to the call of creditors. Both Alaska and Delaware provide that a creditor may bring an action for invalid transfer of property to such a trust up to the later of (a) four years after the transfer or (b) one year after the transfer is or reasonably could have been discovered by the creditor.³ Under the Nevada Trust Act, the statute of limitations is cut to two years after the transfer is made or six months after the creditor "discovers or reasonably should have discovered the transfer."⁴ However, Congress did not deem these time frames sufficient when applied to the realm of bankruptcy.

¹ John K. Eason, *Home from the Islands: Domestic Asset Protection Trust Alternatives Impact Traditional Estate and Gift Tax Planning Considerations*, 52 Fla. L. Rev. 41, 42 (2000).

² David S. Kupetz, *Spendthrift Trusts: The Real (but Not Unlimited) Benefits in Bankruptcy*, ABI, October 1, 2003, citing *In re Portnov*, 201 B.R. 685 (Bankr. S.D.N.Y. 1996), *In re Brooks*, 217 B.R. 98 (Bankr. D. Conn. 1998), and *In re Lawrence*, 227 B.R. 907 (Bankr. S.D. Fla. 1998).

³ See Susan Reedy Williams, *The Use of Alaska and Delaware Trusts for Asset Protection and Wealth Transfer Planning*, at <http://www.dcba.org/brief/aprissue/1999/art20499.htm>.

⁴ Nevada Revised Statutes 166.170 (2003).

Pursuant to BAPCPA, Congress amended Bankruptcy Code Section 548(e) to provide that self-settled trusts will fail as to transfers made within ten (10) years prior to the date of the bankruptcy filing provided the debtor transferred assets into a self-settled trust with fraudulent intent. Section 548(e) now considers a fraudulent transfer to be any transfer made by a debtor to a self-settled trust where the debtor is a beneficiary AND “the debtor made such transfer with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted.”⁵ This change to the bankruptcy code should largely nullify the value of such self-settled trusts as long as the trustee can show that there was intent to defraud, but some have argued that this amendment to the code does not add anything to the existing law.⁶

At this point, the amendment to section 548(e) remains largely untested by the courts. It is likely that with advanced planning and evidence of non-fraudulent reasons to establish a self-settled trust debtors will still be able to utilize domestic asset protection trusts.

B. PEONAGE

The BAPCPA added Section 1115 to the Code to bring in to the bankruptcy estate of an individual chapter 11 debtor “earnings from services performed by the debtor after the commencement of the case but before the case is closed, dismissed, or converted to a case under chapter 7, 12, or 13, whichever occurs first.”⁷ By adding such a provision, the BAPCPA attempts to impose on an individual chapter 11 debtor the same obligations such debtor would face under a chapter 13 filing, which is an obligation to pay all disposable income to his or her creditors for the life of the plan. In emphasis of this goal, the BAPCPA also amended Section 1129(a) to provide that for an individual chapter 11 debtor, all unsecured creditors must approve the plan or the debtor must show that:

the value of the property to be distributed under the plan is not less than the projected disposable income of the debtor (as defined in section 1325(b)(2)) to be received during the 5-year period beginning on the date that the first payment is due under the plan, or during the period for which the plan provides payments, whichever is longer.⁸

Based on these amendments, an individual chapter 11 debtor’s income must generally be pledged to the plan for a minimum of five years, raising the question of whether an involuntary chapter 11 filing amounts to little more than involuntary servitude.

Unlike a chapter 13 filing, which these amendments are designed to emulate, an individual can be involuntarily forced into a chapter 11 filing by his/her creditors.⁹ Once placed in chapter 11, an individual debtor will have difficulty escaping since he does not have the right

⁵ 11 U.S.C. § 548 (e)(1)(D).

⁶ See Lawrence R. Ahern, III, *Homestead and other Exemptions under the Bankruptcy Abuse Prevention and Consumer Protection Act: Observations on “Asset Protection” after 2005*, 13 Am. Bankr. Inst. L. Rev. 585, 609 (2005) (“the new provision in section 548(e) is largely duplicative of existing law. It does not dramatically change the ground rules for asset protection planning, although it does enlarge the window through which a trustee may reach to set aside transfers without being required to find an actual unsecured creditor as to whom a particular transfer was voidable under UFTA and section 544(b) of the Bankruptcy Code.”)

⁷ 11 U.S.C. § 1115(a)(2).

⁸ 11 U.S.C. § 1129(a)(15)(B).

⁹ 11 U.S.C. § 303(a).

to dismiss the case or convert it to chapter 7.¹⁰ Because chapter 11 lacks the escape hatch provided to chapter 13 debtors but includes the provision that a debtor may be forced into a chapter 11 case, there are general concerns that individual chapter 11 debtors will be compelled to work to serve their creditors, making these amendments run afoul of the Thirteenth Amendment.

In addition to compelling individual chapter 11 debtors to work for their creditors, the modification to section 1115 to include post-petition income in the bankruptcy estate also required modification of the Absolute Priority Rule as stated in section 1129. The Absolute Priority Rule provides that a debtor may force a plan onto a disapproving unsecured creditor provided that the creditor either receives the full value of its claim or no junior claim holder receives anything.¹¹ The BAPCPA amended section 1129(b)(2)(B)(ii) by adding language that an individual debtor's retention of estate property will not violate the prohibition against a junior claim holder holding more than an unsecured creditor. Courts have interpreted this modification of the code to abolish the Absolute Priority Rule in individual chapter 11 cases.¹²

The court in *In re Tegeder* held that “the absolute priority rule no longer applies to individual debtors who retain property of the estate under § 1115.”¹³ The debtors in *In re Tegeder* were a married couple with primarily business debts who filed for chapter 11 “protection”. In the end, the Bankruptcy Court for the District of Nebraska confirmed their 10 year plan, which plan paid out unsecured claims during the last three years of the plan. In confirming the plan, the court considered that its payments to unsecured creditors was fair and equitable since the plan would repay approximately 95% of the unsecured debt. Based on the amendment to section 1129(b)(2)(B)(ii), the court also found that the debtors had the right to retain post-petition income even though one class of unsecured creditors had not approved the plan. However, the court did not mention the reasonableness of the plan's 10 year length.

C. APPLICATION OF THE MEANS TEST

Finally, in an effort to stem what Congress saw as abuse of the bankruptcy system Congress amended 11 U.S.C. § 707(b) to provide:

the court on its own motion or on a motion by the United States trustee, trustee (or bankruptcy administrator, if any), or any party in interest, may dismiss a case filed by an individual debtor under this chapter whose debts are primarily consumer debts, or, with the debtor's consent, convert such a case to a case under chapter 11 or 13 of this title, if it finds that the granting of relief would be an abuse of the provisions of this chapter.

This revision of section 707(b) allows any party in interest to bring a motion to dismiss or convert a chapter 7 case if granting of relief would be an abuse of the system. Abuse of the system is presumed if the individual debtor fails the means test described in section 707(b)(2). A court may also find abuse under section 707(b)(3) if the debtor filed the chapter 7 petition in bad faith or if the totality of the circumstances suggest abuse. In the event a debtor fails the means test, i.e., he has sufficient means to make valuable payments to his creditors, or he filed for

¹⁰ See Robert J. Keach, *Dead Man Filing Redux: Is the New Individual Chapter Eleven Unconstitutional?*, 13 ABI L. Rev. 483, 499 (2005) and G. Ray Warner, *Garnishment Restrictions and the Involuntary Chapter 11: Rethinking Kokoszka in a Means Test World*, 13 ABI L. Rev. 733, 737 (2005).

¹¹ 11 U.S.C. 1129(b)(2)(B).

¹² See *In re Bullard*, 358 B.R. 541, 544 (2007) (Court holds that individual chapter 11 debtor's retention of post-petition income “is not an impediment to Plan confirmation under Section 1129 (b)(2)(B)(ii).”)

¹³ --- B.R. ---, 2007 WL 1549067, *3 (May 23, 2007).

chapter 7 in bad faith, the case may be dismissed or converted into a chapter 11 or chapter 13 proceeding.

So, what happens when a debtor starts out in chapter 11 or chapter 13 and then converts to a chapter 7; does such a debtor still need to satisfy the means test? The two courts that have addressed this question are split as to the result. The United States Bankruptcy Court for the District of Rhode Island first addressed this question in *In re Perfetto*.¹⁴ Judge Votolato held that where a debtor filed for chapter 13 and then converted the case to chapter 7 two weeks later, the debtor was required to satisfy the means test of section 707(b)(1). The court held that:

regardless of the low esteem in which this Court holds BAPCPA in general, it was clearly the intent of the drafters that the Form B22A be required upon conversion, so that a review of the Debtor's financial condition could be conducted within the renewed filing period for motions under 707(b).¹⁵

To reach this conclusion, the court first stated that there were two schools of thought on how to interpret the BAPCPA: (1) the "literalist" school, which interprets the Act strictly according to its language, and (2) the "common sense" school, "which accepts the fact that the BAPCPA in many instances makes no sense whatsoever, but that it must be construed against the background of what it is *presumed* the drafters intended to change from the prior law."¹⁶ Adopting the common sense approach, the court found that a case is deemed to have been filed in whatever chapter it ends up in and that the language of section 707(b) requiring that the case be "filed under" chapter 7 before the means test be applied should not be read narrowly to exclude converted cases.

In contrast, in *In re Fox* the Bankruptcy Court for the District of New Jersey declined to adopt the approach taken in *Perfetto* and interpreted the language of section 707(b)(1) literally to only require the means test where a case is initially filed under chapter 7.¹⁷ Interpreting just the language in section 707(b)(1), the court found that "[n]ever does the language make reference to a debtor's conversion of a case under another chapter to chapter 7 or subject the debtor to the means test if the debtor is 'in' a chapter 7 case."¹⁸ In reaching its decision the court found that it was counterintuitive to think that a case converted from chapter 13 to chapter 7 would be subject to the means test, and if the case failed, converted back to chapter 13. While the United States Trustee argued that Interim Bankruptcy Rule 1007(b)(4), requiring a debtor "in a chapter 7 case" to file income information supported the interpretation that even converted cases were subject to the means test, the court refused to apply the rule to contradict the clear language of the statute. In declining to follow *Perfetto*, the court stated that it "will not divine Congressional intent from a rule as it is satisfied that the plain language of the statute trumps an ambiguous Interim Rule."¹⁹

Scholarly sources also support the literal reading of section 707(b)(1) to make the means test inapplicable to converted cases.²⁰ Similar to the rationale used in *In re Fox*, Eric Brunstad argues that a case converted from chapter 11 or chapter 13 cannot be deemed to have been filed in chapter 7, thereby making converted cases outside the reach of the means test. In reaching such conclusion, Brunstad looks to section 348 to find that "the conversion of a case constitutes

¹⁴ 361 B.R. 27 (Bankr.D.R.I. 2007).

¹⁵ *Id.* at 31.

¹⁶ *Id.* at 30 (emphasis in original).

¹⁷ ---B.R.--, 2007 WL 1576140 (June 1, 2007).

¹⁸ *Id.* at *4.

¹⁹ *Id.* at *7.

²⁰ G. Eric Brunstad Jr., *The Inapplicability of "Means Testing" to Cases Converted to Chapter 7*, ABI, November 1, 2005.

‘an order for relief under the new chapter’ but it “does not provide that the conversion of a case constitutes a ‘filing of the petition’ under the new chapter.”²¹ Brunstad further argues that Congress did not alter the provisions of chapter 11 and chapter 13 to apply the means test requirements to such chapters by changing the definition of who may be a debtor under such chapters to include the means test. Brunstad concluded that debtors who start in chapters 11 or 13 and convert to chapter 7 should not be subjected to the means test because it could in essence eliminate the efficacy of filing for bankruptcy.²²

According to the terms of the statute, the means test only applies where the individual debtor’s debts are primarily consumer debts. The question then arises as to when and how a court determines that a debtor does not have primarily consumer debts. Section 101(8) defines consumer debt as “debt incurred by an individual primarily for a personal, family, or household purpose.” Courts have further interpreted this language to mean that debt incurred “for a business venture or with a profit motive does not fall into the category of debt incurred for ‘personal, family, or household purposes.’”²³ While the Code does not define how to determine whether debts are *primarily* consumer debts, courts have generally looked at the dollar ratio between non-consumer and consumer debts and found that 51% of the total dollar amount in non-consumer debts puts an individual chapter 7 debtor outside the reach of section 707(b).²⁴

In terms of procedure, the Bankruptcy Court for the Southern District of Texas found in *In re Beacher* that it would be unreasonable for individual debtors to either (1) file Form B22A in all cases, (2) require a judicial determination of their debts within 45 days of filing, or (3) not do anything and then run the risk of a determination that their debts were primarily consumer debts but because they had failed to file Form B22A the case must be automatically dismissed.²⁵ The court reasoned that “[f]iling the form as a mere precaution, or seeking judicial determination in all cases, wastes precious resources of debtors, of the U.S. Trustee, and of the Court.”²⁶ As a solution, the court held that an individual chapter 7 debtor with primarily non-consumer debts must file a sworn statement that his/her debts are non-consumer debts. The court will then enter an order provisionally excusing the filing of Form B22A for 90 days and notifying interested parties that the order becomes final 90 days after filing unless they object. In the event a party in interest objects, a hearing will be held, and if the court finds that the debts are primarily consumer debts, it will set a deadline for the debtor’s filing of Form B22A.²⁷

D. CONCLUSION

While the BAPCPA had lofty goals of correcting perceived abuses of the bankruptcy system, it is more likely to raise constitutional concerns in the bankruptcy courts than change actual practices. The changes to section 548 may allow the trustee a greater look back period to

²¹ *Id.*

²² *Id.* (“If debtors who fail to succeed in chapter 13 cannot obtain relief through conversion to chapter 7 because of §707(b)(1), then bankruptcy would become a cruel lure that holds out the appearance of relief without actually providing any.”)

²³ *In re Runski*, 102 F.3d 744, 747 (4th Cir. 1996).

²⁴ *In re Sudderth*, No. 06-10660, 2007 WL 119141, Jan. 9, 2007 (Bankr.M.D.N.C) (“the ratio of the dollar amount of consumer debt to non-consumer debt should be controlling in determining whether the indebtedness is primarily consumer debt for purposes of section 707(b).”); *In re Beacher*, 358 B.R. 917, 920 (Bankr.S.D.Tex. 2007) (“‘primarily consumer debt’ means that more than 50% of the *amount* of debt is consumer debt, without regard to whether more than 50% of the *number* of debts is consumer debt.”) (emphasis in original).

²⁵ *Supra*, n. 21, at 921.

²⁶ *Id.* at 922.

²⁷ *Id.* at 923.

recapture assets transferred to self-settled trusts, but the trustee still has to show that the transfer was made with fraudulent intent. As long as debtors can show that they transferred assets to self-settled trusts with reasonable planning in mind, they should be able to avoid the reach of the trustee. The changes to section 707(b) will also not likely change the number of debtors receiving relief under chapter 7 since debtors can still seek a liquidation after first trying a reorganization. In contrast, however, the changes to chapter 11 requiring individual debtors to include post-petition wages in the bankruptcy estate does raise constitutional concerns where creditors can force such individuals into chapter 11. In the end, the above changes to the Bankruptcy Code may cause more trouble than they are worth.