CHAPTER FIVE

INDIVIDUAL CHAPTER 11

A. Lost in the Labyrinth of Individual Chapter 11 Cases? How to Find Your Way Out

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Individuals have always been eligible for relief under Chapter 11, but few have historically taken advantage of it. Instead, individuals filed under Chapter 7, as such was cheaper and simpler for individuals who had large amounts of unsecured debt. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") changed that.

First, individuals who have primarily consumer debts[1] and whose income exceeds the median for their state and household size[2] must face the dreaded means test of § 707(b). Moreover, some high-earning debtors risk that their Chapter 7 cases may be dismissed.

Next, one of the stated purposes of § 707(b) is to coerce high-earning individuals to file for Chapter 13 relief rather than Chapter 7. Congress did not, however, change the eligibility requirements for Chapter 13. It is possible that some individuals are unable to employ either Chapter 7 or Chapter 13, and are forced to consider Chapter 11 instead.

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1 *See Toibb v. Radloff*, 501 U.S. 157 (1991).

2 Individual filings for professionals and other high net-worth individuals with business debt, which are most likely to be abusive, will still be eligible for Chapter 7 because the debts are not primarily consumer debts.

Finally, perhaps in order to deal with an influx of Chapter 11 cases filed by individual debtors, BAPCPA attempted to deal with some of the shortcomings of Chapter 11.

The most important changes for individuals and pre-filing considerations[3] are as follows:

1. Credit Counseling. All individual debtors, regardless of chapter choice type of debt, must obtain a certificate that demonstrates the individual attended a group or individual briefing on credit counseling and budget analysis. § 109(h)(1). The certificate session is a necessary requirement for eligibility under Chapter 11, or any other chapter of the Bankruptcy Code. Indeed, it appears Congress believed that an individual with the sophistication to elect Chapter 11 and the wherewithal to pay the hefty expenses of Chapter 11 counsel could benefit from a 90-minute counseling session.

In addition to counseling, individual debtors must file copies of all payment advances, certain tax returns, and evidence of payment from an employer for the sixty days preceding the petition.

2. Expanded Definition of Estate Property. In an individual Chapter 11 case, as well as in a Chapter 13 case, property of the estate includes the individual debtor's postpetition personal service income, as well as all property the debtor acquires during the case. § 1115. This requirement has far-reaching implications:

a. Payment of Postpetition Expenses

i. Under § 1115, the debtor will have no property or earnings that are not property of the estate. Neither Congress nor the Bankruptcy Code provides guidance as to whether or how the debtor may retain income to pay ordinary business expenses or living expenses prior to the confirmation of a plan of reorganization. Prior to BAPCPA, one court decided that the debtor may use estate monies on such expenses. *In re Murray,* 216 B.R. 712, 713 (Bankr. W.D.N.Y. 1998.)

3 These materials do not deal with whether some changes made in Chapter 11 for individual debtors are unconstitutional under the Thirteenth Amendment. *See In re Clemente,* 409 B.R. 288 (Bankr. D.N.J. 2009); Grassgreen, Debra, *Individual Chapter 11 Cases After BAPCPA: What Happened to the "Fresh Start?,"* 2006 Ann. Surv. Bankr. Law Part I, § 12, at 324 (Sept. 2006) ("The changes to individual Chapter 11 may run afoul of the constitutional prohibition on involuntary servitude."); Keach, Robert J., *Dead Man Filing Redux: Is the New Individual Chapter Eleven Unconstitutional?,* 12 Am. Bankr. Inst. L. Rev. 483 (Winter 2005); Chemerinsky, Erwin, *Constitutional Issues Posed in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005,* 79 Am. Bankr. L.J. 571, 583-90 (Summer 2005). The constitutional issues would be particularly acute in an involuntary Chapter 11 case against an individual.

ii. Courts have utilized two tests to determine whether a transaction occurs within the ordinary course of business under § 363(c): (i) the vertical dimension or creditor's expectation test; and (ii) the horizontal dimension test. The Ninth Circuit has determined that if both of the above-referenced tests are satisfied, the court must hold that the transaction was within the ordinary course of business. *Burlington N. R.R. Co. v. Dant & Russell Inc. (In re Dant & Russell Inc.)*, 853 F.2d 700, 705 (9th Cir. 1988).

iii . Under the vertical dimension test, the court examines the transaction from the viewpoint of a hypothetical question and asks whether the creditor is subjected to economic risks of a different nature than those accepted when the creditor initially extended credit. *Id*.

iv .The horizontal dimension test is utilized to determine whether the debtor or creditor conducted itself in a way to unfairly gain advantage over other creditors. *In re Straightline Inv., Inc.,* 2008 WL 1970560, at *6 (citations omitted). The court asks "whether the postpetition transaction is of a type that other similar businesses would engage in as ordinary business." *Id*.

v. Where is the line drawn between expenses in the ordinary course of business or out of the ordinary course of business? One court has noted that "in calculating an individual Chapter 11 debtor's projected disposable income, § 1129(a)(15)(B) must be read to allow a judicial determination of the expenses that are reasonably necessary for the [maintenance or] support of the debtor and his or her dependents." *In re Rodemeier,* 374 B.R. 264, 272-73 (Bankr. D. Kan. 2007). It appears that the court can unilaterally decide where to draw that line. Will Chapter 11 individual debtors need court permission to use postpetition income to take a family vacation to the beach, pay for their childrens' orthodontia, buy a new television, etc.? What about legal fees for divorce cases, nondischargeability litigation, and other work that benefits the debtor but does not seem to benefit the estate?

vi. Does it matter that a portion of the debtor's postpetition wages would be exempt under applicable state and federal nonbankruptcy law?

vii. Should counsel file and obtain court approval of a budget at an early stage in the case?

b. Plan Funding. Section 1123, "Contents of plan," has been amended to account for the funding of an individual's plan with postpetition earnings. The plan must "provide for the payment to creditors under the plan of all or such portion of the individual debtor's postpetition personal service earnings . . . or other future income of the debtor as is necessary for the execution of the plan." § 1123(a)(8). This section appears to provide flexibility for funding an individual debtor's plan. The following choices seem to be available:

i. Monthly payments are not required, only enough to provide for execution of the plan.

ii. All earnings are not required, only enough to provide for execution of the plan.

iii. There is no limit to secured or unsecured claims for eligibility pursuant to § 109(e).

iv. No earnings are apparently required if the plan can be funded out of "other future income." There is little indication of what this may mean, but it does provide flexibility for individuals who do not have periodic income or may be able to develop or are entitled to receive income out of an alternative source to traditional earnings. This is an important provision because it may make Chapter 11 the only available option to those individuals who do not have "regular income" and are therefore ineligible for Chapter 13 under § 109(e), as well as those individuals who fail the means test.

3. Court-Approved Attorney. In the case where the court approves an attorney to represent the debtor in possession, is the attorney's client the individual or the bankruptcy estate? *In In re Perez,* 30 F.3d 1209, 1219 (9th Cir. 1994), the Ninth Circuit held that the client was the bankruptcy estate. Specifically, the Ninth Circuit noted that "[c]ounsel for the estate must keep firmly in mind that his client is the estate and not the debtor individually. . . . Under no circumstances . . . may the lawyer for a bankruptcy estate pursue a course of action, unless . . . [the action] serves the best interests of the estate." *Id*.

4. Minimum Plan Payments. If an unsecured creditor objects to confirmation of a plan, the debtor must either pay unsecured creditors in full or distribute property of a value not less than the debtor's projected disposable income, as defined at § 1325(b)(2), for the longer of five years or the term of the plan. § 1129(a)(15).

a. Chapter 13 Distinguished. The test is different from the disposable income requirement under § 1325(b) of the Code. Section 1325(b)(1) provides that if the trustee or the holder of an allowed unsecured claim objects to the confirmation of the plan, then the court may not confirm the plan unless, as of the effective date of the plan, the present value of the plan distributions equals the amount of the claim, or "the plan provides that all of the debtor's projected disposable income to be received in the applicable commitment period beginning on the date that the first payment is due under the plan will be applied to make payments to unsecured creditors under the plan."

i. There is a raging dispute in the case law about whether the reference to the "applicable commitment period" creates a temporal requirement (the duration of the plan payments) or a dollar amount requirement. Interestingly, there is no comparable language in § 1129(a)(15).

b. Allowable Expenses. Section 1129(a)(15)(B) states that projected disposable income of the debtor is "defined in § 1325(b)(2)." Section 1325(b)(2) states that "disposable income" means current monthly income received by the debtor, less amounts reasonably necessary to be expended for the maintenance or support of the debtor or a dependant of the debtor. Note, however, that *projected* disposable income is nowhere defined in the section. Section 1325(b)(3) goes on to provide that, if the debtor's income exceeds the applicable median for the debtor's state of residence and family size, the debtor's expenses are determined in accordance with the mechanical means test of § 707(b)(2)(A) and (B). But § 1129(a)(15)(B) incorporates only § 1325(b)(2), not § 1325(b)(3). At least two courts have held that a Chapter 11 debtor's expenses are determined based upon judicially determined standards, as opposed to the Chapter 7 means test deductions specified by § 1325(b)(3). *See In re Roedemeier,* 374 B.R. 264 (Bankr. D. Kan. 2007); *In re Gray,* 2009 WL 2475017 (Bankr. N.D. W.Va. 2009).

i. The mechanical test may actually favor some debtors. Under the judge-made standard, courts have frequently held that the debtor's secured debt service was excessive, and consequently required debtors to dispose of extravagant homes, vehicles, and the like rather than continue to make the payments. Under § 707(b)(2)(A)(iii), all payments on secured debts are deductible for purposes of computing projected disposable income. Debtors with high secured debt service may face lower plan payments, and may find it easier to retain extravagant and heavily encumbered property, under the mechanical test.

c. Mechanical or Forward-Looking Test. In *Hamilton v. Lanning (In re Lanning)*, 130 S.Ct. 2464 (2010), the Supreme Court resolved a controversial issue in Chapter 13 cases under BAPCPA: Whether "projected" disposable income, which is not defined in BAPCPA, allows a "forward-looking approach based on a debtor's historical earnings and expenses" or only a "mechanical approach." The Court resolved a split in the circuits. In *Lanning*, the Tenth Circuit adopted the "forward-looking approach," as did the Fifth, Seventh and Eighth Circuits. *In re Nowlin*, 576 F.3d 258 (5th Cir. 2009); *In re Turner,* 574 F.3d 349 (7th Cir. 2009); *Coop v. Frederickson (In re Frederickson),* 545 F.3d 652 (8th Cir. 2008). The Ninth Circuit had previously adopted the "mechanical approach." *Maney v. Kagenveama (In re Kagenveama),* 541 F.3d 868 (9th Cir. 2008). The Supreme Court selected the forward-looking approach, under which a Chapter 13 debtor's six-month, prepetition "disposable income," as defined by statute, is presumed to be the debtor's "projected disposable income," but that the plan payments can be adjusted to reflect changes in the debtor's income or expenses that are "known or virtually certain at the time of confirmation." The forward-looking approach allows courts to consider the debtor's actual financial circumstances at the time of plan confirmation in determining any required contribution of earnings. The forward-looking approach gives individual Chapter 11 debtors substantially more latitude in their plans.

d. Responding to Objections. If there is an objection based on § 1129(a)(15), several responses may be available:

i. If the objecting creditor holds a disputed claim, the debtor could object to the claim and attempt to obtain a hearing on the objection within the

time frame required for confirmation of a plan. This may be difficult in certain cases.

ii. While case law concerning § 1325(b)(1), the Chapter 13 corollary, may be of assistance, can the debtor buy off the objection by simply paying the objecting creditor's claim in full, without running afoul of §§ 1122 and 1123(a)(4)?

iii. Can the debtor defer the first payment due under the plan in order to increase or decrease the amount required to be paid to creditors or to meet the best interest test, since funding with disposable income is for five years from the date the first payment is due under the plan, not the effective or confirmation date?

iv. What if the debtor has little or no "disposable income" as defined? Note that "disposable income" means "current monthly income" minus specified expenses. Section 1325(b)(2)(B) allows debtors engaged in business to deduct "expenditures necessary for the continuation, preservation, and operation of such business." This appears to be a case where Congress has borrowed from Chapter 13 without adjusting for the fact that Chapter 13 is only available for individuals with "regular" income, which is not the case in Chapter 11 cases.

v. Note that neither a creditors' committee nor the U.S. Trustee may raise this issue. Only a creditor holding an allowed unsecured claim may object to plan confirmation on this basis. However, a creditor can probably object even if the creditor's class has accepted the plan.

5. Absolute Priority and Cramdown for Individual Debtors.

a. Prior to BAPCPA, § 1129(b)(2) provided that the court could confirm a plan over the objection of a dissenting class of unsecured creditors if the plan was "fair and equitable" with respect to the dissenting class. One component of the "fair and equitable" test is the "absolute priority" rule; unless the plan provides for full payment to the dissenting class, no junior class - including equity holders - can receive or retain anything under the plan. The absolute priority rule posed obvious problems where the debtor is an individual.

b. BAPCPA modified the absolute priority rule in cases involving individual debtors. Section 1129(b)(2)(B)(ii) allows the debtor to "retain property included in the estate under section 1115" subject to the required payment of postpetition domestic support obligations. There are at least three ways to read this section:

i. Some courts hold that Congress intended to exempt individual Chapter 11 debtors from the absolute priority rule altogether. *See In re Johnson,* 402 B.R. 851, 852-53 (Bankr. N.D. Ind. 2009); *In re Roedemeier,* 374 B.R. 264 (Bankr. D. Kan. 2007); *In re Tegeder*, 369 B.R. 477, 480-81 (Bankr. D. Neb. 2007). According to these courts, a Chapter 11 debtor may retain prepetition and postpetition property and still cram down a plan of reorganization over the objection of a creditor.

ii. One court has held that an individual debtor may not satisfy the absolute priority rule while retaining exempt property. *In re Gosman*, 282 B.R. 45, 49-52 (Bankr. S.D. Fla. 2002). Despite the amendment to § 1129, the *Gosman* case may still be good law. *But see In re Bullard,* 358 B.R. 541, 545 (Bankr. D. Conn.) (holding that a plan can be confirmed notwithstanding that the debtor retains exempt property of the estate). The rationale is that § 1129 only permits the Chapter 11 debtor to retain property included in the estate under § 1115 and that exempt property is not property of the estate - at least once the deadline for objecting to exemptions has run without objection (or the exemptions have otherwise been fully litigated.

iii. Another interpretation holds that individual debtors can retain any property included in the estate only by virtue of § 1115, and not property included in the estate under § 541. In other words, the debtor can retain postpetition personal services income without violating the absolute priority rule, but not other property. This view is hard to reconcile with § 1115's inclusion of the phrase "in addition to the property specified in section 541."

6. Domestic Support Obligations. Section 1129(a)(14) provides that a debtor who is required to pay a domestic support obligation by virtue of a judicial or administrative order or statute must have paid all postpetition payments required to be paid before the plan may be confirmed. This provision is new verbiage, but in real-

ity the requirement always existed. A postpetition domestic support obligation is an administrative expense claim which always had to be paid on the effective date of the plan. § 1129(a)(9).

7. Tax Provisions.

a. In Chapter 11 cases, a new estate is created which can be taxed as a separate entity pursuant to 26 U.S.C. § 1398. This provision may be advantageous to the Chapter 11 debtor who incurs capital gains pursuant to the sale of an asset, as the estate will pay for the tax liability.

b. Section 1129(a)(9)(C), which applies to all Chapter 11 cases, has clarified the payment of priority tax payments under a plan. The claimholder must receive regular cash payment installments: "(i) of a total value, as of the effective date of the plan, equal to the allowed amount of such claim; ii) over a period ending not later than 5 years after the date of the order for relief . . . and (iii) in a manner not less favorable than the most favored nonpriority unsecured claim provided for by the plan. . . ."; Accordingly, no longer will the debtor and counsel have to puzzle over the six-year from the date of assessment provision and the differing payment terms it created for taxes assessed in different years. Moreover, given the likely treatment of unsecured creditors, this should not be a hard test to meet.

8. Small Business Cases. In certain cases, an individual Chapter 11 debtor may be considered a small business debtor. The Bankruptcy Code defines a small business debtor as a person engaged in commercial or business activities with total debt under $2,190,000, exclusive of debt to insiders, and for which there is no active committee. § 101(51D). Section 1129(e) requires that in a small business case, the court "shall confirm a plan" that complies with all the applicable confirmation requirements within 45 days of the date on which the plan is filed, unless the time for confirmation is extended under § 1121(e)(3).

a. Section 1121(e)(1) is the "exclusivity period" for small business cases. It provides that only the debtor may file a plan for the first 180 days of the case, unless extended or the court orders otherwise. Section 1121(e)(2) further provides that the plan and a disclosure statement, if any, shall be filed not later than 300 days following the entry of the order for relief. These provisions appear to mean that while the debtor may enjoy the exclusivity period for the first 180 days of the case, a plan does not have to be filed within this period.

b. Does the 300-day limit apply only to the debtor's plan or also to a creditor's plan? One court has held that there is no statutory deadline to file a plan for any party in interest other than the debtor. *In re Florida Coastal Airlines, Inc.*, 361 B.R. 286, 290-91 (Bankr. S.D. Fla. 2007).

   i. The issue of a creditor's competing plans raises constitutional issues, including violation of the 13th Amendment. Theoretically, a creditor could propose a plan which subjects the debtor's disposable income to distribution in favor of creditors against the debtor's will for a minimum of five years. Query, however, whether the debtor would remain income-producing through employment or otherwise during the term of the plan.

c. Failure to comply with the time periods may constitute "cause" for conversion or dismissal. §§ 1112(b)(4)(F); 1112(b)(4)(J).

d. These time periods may only be extended if the debtor demonstrates, following notice to parties in interest, that "it is more likely than not" that the court will confirm "a plan" within a reasonable period of time. The debtor must prove this point by a preponderance of the evidence. The order extending time must be entered before the existing deadline expires, and the court must set a new deadline when the order is signed. § 1121(e)(3).

e. Timing is everything in these cases. The plan confirmation hearing must occur within 45 days of the date on which the plan is filed. The disclosure statement may be conditionally approved, and final approval may occur at the confirmation hearing. However, a conditionally approved disclosure statement must be mailed to creditors no later than 25 days before the confirmation hearing. Assuming the plan and disclosure statement are filed on the same day, the disclosure statement must be conditionally approved and mailed within twenty days. Creativity may get you around this problem. One might try filing the disclosure statement with the plan attached as an exhibit. This would enable you to argue that the plan has not been "filed," and that the 45-day period has not begun to run. You would file the plan only after conditional or final approval of the disclosure statement is granted.

9. Discharge Issues. BAPCPA added special provisions to § 1141 that govern the discharge of individuals under Chapter 11.

a. **Full Payment Before Discharge.** An individual will not receive a discharge until all plan payments are completed "unless after notice and a hearing the court orders otherwise for cause." § 1141(d)(5)(A). This will generally take five years, although it is easy to contemplate plans extending beyond this time frame. This is a substantial change from prior law, under which all Chapter 11 debtors, including individuals, received a discharge upon plan confirmation. The statute gives no hints about what might constitute cause for an earlier discharge.

b. **Closing the Case.** Must the debtor leave the case open, and continue to pay quarterly fees to the U.S. Trustee for the five years, or can the debtor close the case following plan confirmation with the right to reopen at the end of five years in order to obtain the discharge? If the case is closed, who would monitor the debtor's compliance and bring defaults to the attention of the court? At least four courts have considered this issue, with varying results. The Northern District of West Virginia, in *In re Ball,* 2008 WL 2223865 (Bankr. N.D. W.Va. 2008), rejected the debtor's request for a discharge and to close the plan prior to the completion of all payments under the plan. Similarly, in *In re Belcher,* 410 B.R. 206 (Bankr. W.D. Va. 2009), the Western District of Virginia denied an individual debtor's motion for an early discharge and simultaneously found that it was inappropriate to close the case prior to the completion of all payments. Compare these cases to *In re Sheridan,* 391 B.R. 287 (Bankr. E.D. N.C. 2008) and *In re Johnson,* 402 B.R. 851 (Bankr. N.D. Ind. 2009), in which the *Sheridan* court granted a discharge upon confirmation, and the *Johnson* court closed the case prior to the completion of plan payments, thereby eliminating the requirement of quarterly payments to the U.S. Trustee.

c. **Early Discharge.** The debtor may apply for a discharge, on notice and hearing, before all payments are made under the plan if several elements are met: (a) the value of property already distributed to unsecured creditors is equal to what they would have received in a Chapter 7 case, as of such date; (b) modification of the plan is not practicable; and (c) the court finds, after notice and a hearing 10 days before discharge, § 522(q) provisions relating to securities law crimes are not applicable. Note that the debtor does not require conviction. § 1141(d)(5)(B). The test is less stringent than the Chapter 13 test, which additionally requires the debtor to demonstrate that the failure to complete payments is due to circumstances beyond the debtor's control. §1328(b).

d. Section 523 Exceptions to Discharge Applicable. Chapter 11 does not discharge an individual debtor from any debt excepted from discharge under § 523. § 1141(d)(2). An individual debtor in Chapter 11 gets a narrower discharge than a Chapter 13 debtor. § 1328(a).

e. Extra Credit Question. What, if anything, does § 1141(a)(5)(C) mean?

10. Plan Modification. The plan may be modified at any time after confirmation but before payments are completed. § 1127(e). In a nonindividual case, modification is not allowed after the plan is "substantially consummated," which usually occurs long before the plan payments are completed. §1127(b). As in a Chapter 13 case, the modifications may increase or reduce payments to creditor classes or alter the time period for plan payments. §1127(e). Adequate disclosure of an amendment is required. § 1127(c). The debtor, the U.S. Trustee or a creditor holding an allowed unsecured claim may request a modification.

a. Fed. R. Bankr. P. 3019(b) governs the notice and hearing procedure for post-confirmation amendments.

b. There is tension between § 1129(a)(15) and § 1127(e). Under § 1129, the plan payments are based on "projected" income as of the confirmation date. Does a creditor then have the right to seek modification of a plan to recover actual income received in excess of projections? This excess is allowed to be retained by the debtor under § 1129(b)(2).

11. Dismissal. The grounds for dismissal or conversion of a Chapter 11 case are found at § 1112. Many of the grounds for dismissal or conversion could apply to an individual case. These selected grounds include: (a) the failure of the debtor to maintain appropriate insurance that poses a risk to the estate or to the public; (b) unexcused failure to timely satisfy any filing or reporting requirement established under Title 11 of the Bankruptcy Rules; (c) failure to attend a 341 meeting or Rule 2004 examination, without good cause shown by the debtor; (d) failure to timely provide information or attend meetings reasonably requested by the U.S. Trustee; (e) failure to timely pay postpetition taxes or file postpetition tax returns; and (f) failure to pay any domestic support obligation that first becomes payable after the date of the filing of the petition.

a. Section 1112(b)(1) and (2) appear to make it clear that conversion or dismissal is not required if, due to unusual circumstances specifically identified by the court, conversion or dismissal is not in the best interests of creditors and the estates. The debtor may be able to avoid conversion or dismissal by establishing that there is a reasonable likelihood that a plan will be confirmed within the time frames established under §§ 1121(e) and 1129(e) or, if these time periods do not apply, within a reasonable time.