Fixing Individual Chapter 11 Cases: An Absolute Priority

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Absolute Ethical Bankruptcy:[1] Recent Ethical Issues in Individual Chapter 11 Cases

As the readers of the Journal know, the challenges of representing an individual Chapter 11 debtor are many, especially after the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA").[2] Among the issues that have been recently addressed by courts are: (1) the split of authority on the issue of what impact the changes made by BAPCPA concerning the definition of what constitutes property of an individual Chapter 11 debtor's bankruptcy estate and the requirements for confirmation of an individual's Chapter 11 plan in a "cram-down;"[3] (2) whether involuntary bankruptcy cases can be filed against individuals; and (3) whether counsel who advise individual debtors pre-bankruptcy, but not in a bankruptcy, are subject to 11 U.S.C. § 329. This article addresses these issues.

A. Distilling The Absolute Priority Rule in Individual Chapter 11 Cases

The absolute priority rule of the Bankruptcy Code is codified in 11 U.S.C. § 1129(b)(2)(B) and, as noted by the Supreme Court, "The absolute priority rule provides that a dissenting class of unsecured creditors must be provided for in full before any junior class can receive or retain any property [under a reorganization] plan."[4] This rule applied in individual[5] Chapter 11 cases prior to BAPCPA.[6]

As has been discussed at length previously in the Journal, two of the most important changes made to BAPCPA were the addition of 11 U.S.C. § 1115 and the modifications made to 11 U.S.C. §§ 1123 and 1129.

11 U.S.C. § 1115 designates all of the debtor's income, earned from a job or "services performed" after a Chapter 11 is commenced, as property of the estate.[7] 11 U.S.C. §§ 1123 and 1129 establish conditions to confirmation of individual Chapter 11 plans, including a requirement that all projected dispensable income received by the debtor must be paid out under the plan.

The critical question raised by these modifications to the Bankruptcy Code was whether they eliminated or modified the absolute priority rule for property in individual Chapter 11 cases.

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[1] No, this is not an ad for a famous beverage, just another failed attempt at humor.

[2] Jennis & DiSanto, How Disposable is Your Individual Chapter 11 Debtor's Income, 30 Am Bankr Inst. J. 1 (Oct. 2011); ("Disposable Income"); Jennis & DiSanto, Application of Absolute Priority Rule and New Value Exception in Individual Chapter 11's (July/Aug. 2011) ("New Value Exception"); Jennis & DiSanto, Make Yourself "Necessary:" How to Get Paid as Debtor's Counsel in Individual Chapter 11's (June 2011) ("Necessary"). See Bowles, Ghosts of Individual Chapter 11 debtors (Part 1), 25 ABIJ 46 (Dec/Jan 2007) and Schaaf, Stosberg and Bowles, Ghosts of Individual Chapter 11 debtors (Part 2); 26 ABIJ 36 (February 2007) ("Ghosts Part II").

[3] Cram-down is used to refer to non-consensual confirmations of Chapter 11 Plan. See In re Shat, 424 B.R. 854, 858 n 7 (Bankr. D. Nev. 2010).

[4] Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 202 (1988) (internal citations omitted).

[5] See Section E of this article for a discussion whether the absolute priority rule prevented an individual Chapter 11 debtor to retain exempt property.

[6] See In re Walsh, 447 B.R. 45, 47 n. 9 (Bkrtcy. D. Mass. 2011); In re Shat, 424 B.R. 854, 858 (Bankr. S.D. Ohio 2010).

[7] See Ghost I at 98-99 addressing issues arising from this broad definition.

There are two lines of cases. One termed the "broad view"[8] holds that the modifications to 11 U.S.C. §§ 1123 and 1129 abrogate the absolute priority rule, although in a convoluted way.[9]

A larger line of cases,[10] termed the "narrow view," holds that the absolute priority rule survived the BAPCA changes intact and still applies to individual Chapter 11 debtor plans. As this split of authority is well discussed in [insert other article], this article will only address ethical issues confronting individual Chapter 11 debtor's counsel concerning the absolute priority rule.

(1) Good Faith

The initial and overriding issue is whether an attorney[11] can, in good faith, propose a plan for an individual Chapter 11 debtor that does not propose to pay all creditors in full but nevertheless proposes that debtors retain ownership interests in their property. In at least the Ninth Circuit, the answer may be no.

In the pre BAPCPA case of In re Perez,[12] the Ninth Circuit, based on the absolute priority rule, refused to affirm the confirmation of an individual debtor's Chapter 11 plan that proposed to pay all creditors in full over a 67-month period, but without interest, even though the sole creditor who voted against the plan (and caused a class to vote against the plan), never filed an objection.[13]

The Perez court further stated, *in dicta*

> [W]e are most disappointed in the estate's counsel, who is responsible for proposing and seeking confirmation of these failed plans. . .
>
> He has defended Plan 111 on appeal before the BAP and before us despite what appears to have been his clear understanding that the [absolute priority rule] was not satisfied.[14]

[8] In re Shat, 424 B.R. 854 (Bkrtcy. D. Nev. 2010); In re Ballard, 358 B.R. 541 (Bkrtcy. D. Conn. 2007).
[9] Id.
[10] See, e.g., In re Kamell, ___ B.R. ___ 2011 WL 1760282 (Bkrtcy. C.D. Cal. 2011); In re Stephens, 445 B.R. 816, 820-21 (Bkrtcy. S.D. Tx. 2011) (finding a broad reading of 11 U.S.C. § 1115 would make 11 U.S.C. § 541 mere surplusage); In re Gelin, 437 B.R. 435, 442 (Bkrtcy. M. D. Fla. 2010). The trend of courts adopting the narrow will likely continue in light of a recent, Court of Appeals decision, In re Lett, 632 F.3d 1216 (11th Cir. 2011) concerning a pre BAPCPA individual Chapter 11 case, where the Court of Appeals ruled that the absolute priority rule applied in individual Chapter 11 cases, even though this issue was not preserved on appeal.
[11] The author understands there is a great deal of controversy regarding the debtor's duty and the duty of counsel for the debtor, but thankfully, that issue is beyond the scope of this article. We will therefore assume for purposes of this article that the debtor has a fiduciary duty to the debtor's bankruptcy estate.
[12] 30 F.3d 1209 (9th Cir. 1994).
[13] Id. at 1214. See also In re Lett, 632 F.3d at 1216 (allowing absolute priority objection to first be raised on appeal).
[14] Id at 1219 n. 14. (However, please review this footnote as the assertion of the estate counsel's knowledge is somewhat weak).

Therefore, if the narrow view of 11 U.S.C. § 1115 prevails and there is no exception to the absolute priority rule,[15] counsel will have to carefully consider the impact of Perez.[16]

(2) Is there a future income problem under Ahlers?

Although not addressed directly by most courts considering the narrow or broad views on the absolute priority rule, an interesting question arises as to whether Norwest Bank Worthington v. Ahlers[17] prohibition against "sweat equity plans" has been (or could be) overruled by 11 U.S.C. §§ 1123(a)(8) and 1129(a)(15), which requires that five years of an individual debtor's projected disposable income be distributed under a plan.

Ahlers, in part, found that new value, in the form of future services, could not be new value on constitutional grounds as well as an interpretation of the absolute priority rules of the Bankruptcy Code. As Congress now requires future income be paid under a plan, could an individual Chapter 11 debtor propose a confirmable plan under the new value exception to the absolute priority rule?

In In re Shat, the Court noted in passing that BAPCPA "effectively overruled Ahlers"[18] on the issue of whether the future labor could constitute value under the absolute priority rule, but only used this observation to support its determination that the broad view of 11 U.S.C. § 1115 was correct. However, the "narrow view" case of In re Lindsey[19] rejects this finding that there was no attempt to overrule Ahlers by BAPCPA. This issue will likely continue to be litigated in the future.

(3) Is a debtor's exempt property subject to the Absolute Priority Rule?

An interesting issue that presents numerous problems to debtor's counsel is whether a debtor can keep exempt property under a "cram-down" Chapter 11 plan. The case of In re Gosman[20] held that even though exempted from the claims of creditors, exempt property was estate property and covered by the absolute priority rule. This meant, among other things, that a debtor could not attempt to use a contribution of exempt property as new value.

However, a majority line of case law seems to be developing holding that exempt property is not subject to the absolute priority rule requirement that the individual debtor cannot keep any interest in property unless all senior creditors are paid in full. This position is best set forth by the narrow view court of In re Steedly,[21] where the court held:

> An individual debtor's ability to claim exemptions under § 522 exists for individual chapter 11 debtors. *In re Henderson*, 321

[15] Indeed, the Shat court discusses whether it is possible to propose or confirm a non-consensual plan that pays creditors less than the present value of their allowed claims. In re Shat, 424 B.R. at 858.
[16] In light of the problems creditors faced in Perez and Lett, it is better practice for creditors to both vote against and objects to plans to have absolute priority issue considered.
[17] 485 U.S. 197 (1988).
[18] 424 B.R. at 867.
[19] 453 B.R. 886, 901 (Bkrtcy. E.D. Tenn. 2011).
[20] 282 B.R. 45 (Bkrtcy. S.D. Fla. 2002).
[21] 2010 WL 3528599 (S.D. Ga. 2011).

> B.R. [550, 558 (Bkrtcy. M.D. Fla. 2005)] (citing 11 U.S.C. § 1123(c)). "Once [a debtor's] exemptions are allowed the [property is] no longer part of the [d]ebtor's estate, and the [d]ebtor does not retain property on account of such interest because he retains it as a matter of right by virtue of recognition of his right to exemptions." *Id*. at 559. A debtor's interest in exempt property can therefore never be junior to the interest of an unsecured creditor because unsecured creditors cannot reach exempt property. *Id*. at 560. A debtor may thus retain exempt property without violating § 1129(b)(2)(B)(ii). *Id*. at 561; *In re Ballard*, 358 B.R. 541, 544-45 (Bankr.D.Com. 2007).

B. Enjoying the Product, Involuntarily

As individual Chapter 11 cases now include all post-petition earnings of debtors, there is a question of whether an individual can be placed into an involuntary Chapter 11 case.[22] This issue arose in the context of a very nasty Chapter 11 case of In re Marciano, 459 B.R. 27 (9th Cir. BAP 2011).[23]

In Marciano, an involuntary Chapter 11 petition was filed against an individual by a group of creditors which had obtained un-stayed state court judgment against the Debtor. The judgments were entered as sanctions for the debtor's discovery abuse. As part of the debtor's objections to the involuntary petition was a constitutional challenge against 11 U.S.C. § 1115 as it would be applied in an involuntary Chapter 11 case.

The basis of the debtor's constitutional challenge to the involuntary Chapter 11 was that application of 11 U.S.C. § 1115(a)(2) in an involuntary individual Chapter 11 would violate the Thirteenth Amendment to the Constitution.[24] This challenge, however, was weakened by the debtor's declaration that he did not have any earnings from post-petition earnings.[25]

However, neither the Bankruptcy Court, nor the Bankruptcy Appellate Panel reached this constitutional issue determining the issue was not ripe. Both courts ruled that until the Debtor was placed into an involuntary bankruptcy by the entry of an order of relief against the debtor, the constitutionality of 11 U.S.C. § 1115 could not be challenged.[26] In this case, the debtor raised this argument as part of his motion to dismiss the involuntary petition and, therefore, the issue could not be reached.[27] To date, this issue has not been raised again by the debtor. While this issue was not ripe in this case, it will arise again.

C. Disclosing the Bill . . . I have to do what?

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[22] See Howard, Bankruptcy Bondage, 2009 U. III. L. Rev. 199 (2009); Chemerinsky Constitutional Issues Posed in the Bankruptcy Abuse and Consumer Protection Act of 2005, 79 Am. Bankr. L.J. 571, 586-88 (2005).

[23] See also In re Marciano, 446 B.R. 407 (Bkrtcy. C.D. Cal. 2010) (retailing the facts of the underlying litigation which led to a $260+ million dollar against _____ to the debtor.

[24] 459 B.R. at 39.

[25] Id.

[26] Id. at 40.

[27] Even the Bankruptcy Appellate Panel's dissent found this constitutional issue was not ripe.

Finally, a recent District Court case, In re Garcia,[28] addresses which attorneys are subject to the provisions of 11 U.S.C. § 329 in an individual Chapter 11 case. The facts of Garcia are fairly simple.

Prior to his individual Chapter 11 filing, the debtor retained an attorney[29] to represent him in several foreclosure actions and short sales. The attorney later advised the debtor to file bankruptcy and helped him find bankruptcy counsel and provided his counsel a list of foreclosure lawsuit for use in the debtor's schedules and statement of financial affairs.

After filing bankruptcy, the debtor filed a motion against the attorney under 11 U.S.C. § 329 seeking disgorgement of fees asserting the value of fees the debtor paid to the attorney exceeded the reasonable value of these services. The bankruptcy court dismissed the motion finding the attorney was not subject to 11 U.S.C. § 329 because the attorney was not the debtor's bankruptcy counsel.

The District Court reversed stating that representing the debtor is not the best for determining whether attorneys are subject to 11 U.S.C. § 329. Rather, the District Court held that the subjective state of mind of the debtor as to whether the debtor's counseling was the key issue in determining whether an attorney is subject to 11 U.S.C. § 329.[30] The District Court remanded for further finding to determine whether the debtor's dealing with the attorneys were for purposes of avoiding bankruptcy or were motivated for the possibility of bankruptcy. This opinion, especially in light of the current economy, should be reviewed by all attorneys representing parties who may be debtors.

D. Final Shot: The Conclusion

Representing an individual Chapter 11 debtor has always been a daunting task. The recent decisions construing the absolute priority rule, plus the dicta of Perez, may, however, move these challenges to the realm of near impossibility as always only time will tell.

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[28] 456 B.R. 361 (N.D. Ill. 2011).

[29] There is a dispute as to whether the debtor paid the attorney $7,000 or $24,000 for her work.

[30] As the Court noted:

> To determine if payments were made "in contemplation" of bankruptcy must consider whether "the underlying professional services were rendered at a time when the debtor was contemplating bankruptcy." *In re Gage*, 394 B.R. 184, 194 (Bankr.N.D.Ill.2008). Thus, a subjective test of the debtor's state of mind is used in determining if a transaction is subject to Section 329. *See Zepecki*, 277 F.3d at 1045; *In re Dixon*, 143 B.R. 671, 675 n3 (Bankr.N.D.Tex.1992) (articulating the test as "whether, in making the transfer, the debtor is influenced by the possibility or imminence of a bankruptcy proceeding"); *In re GIC Gov"t Securities, Inc.*, 92 B.R. 525, 531 (Bankr.M.D.Fla.1988) (asserting that fees paid for the purpose of avoiding bankruptcy are "clearly 'in contemplation of bankruptcy'").

Ghosts of Individual Chapter 11 Debtors: Ethical Issues in Representing Debtors in Individual Chapter 11s Under BAPCPA

Happy Holidays! This Straight and Narrows honors (or dishonors) one of Bankruptcy's greatest pieces of literature, "A Christmas Carol," by Charles Dickens.[1] Early in the story one of the most famous individual debtors in history, Jacob Marley, the former partner of Ebenezer Scrooge, is featured as a chained ghostly, forever paying for the "debts" he incurred in life. This month's article addresses the ethical and practical pitfalls in representing individual debtors in Chapter 11 cases under BAPCPA.[2]

Ghosts of Debtors Past: Credit Counseling for Individual Chapter 11 Debtors

Section 109 of the Code establishes the criteria for becoming a debtor in a bankruptcy proceeding. Each Chapter (i.e., 7, 11, 12 or 13) has different standards for eligibility. "One of the primary amendments enacted by BAPCPA, was a new eligibility requirement for individual debtors." *In re Dixon*, 338 B.R. 383, 386 (8th Cir. BAP Mo. 2006); *see* 11 U.S.C. § 109(h).

Section 109(h)(1) of the Code provides:

> Subject to paragraphs (2) and (3), and notwithstanding any other provision of this section, an individual may not be a debtor under this title unless such individual has, during the 180-day period preceding the date of filing of the petition by such individual, received from an approved nonprofit budget and credit counseling agency described in section 111(a) an individual or group briefing (including a briefing conducted by telephone or on the Internet) that outlined the opportunities for available credit counseling and assisted such individual in performing a related budget analysis.

During the one year period since BAPCPA became effective, many courts have addressed Section 109(h). *See Dixon*, 338 B.R. at 386 ("Specifically, §109(h) states that, as a general rule, all individual debtors must receive an appropriate briefing during the 180 days preceding the date of filing).[3]

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[1] Before his reformation, Ebenezer Scrooge was one of the most effective collection managers imaginable.

[2] New issues arising from the changes made to Individual Chapter 11 practice by BAPCPA have been the subject of several scholarly articles and presentations including: Keach, Deadman Filing Redux: Is The New Individual Chapter Eleven Unconstitutional?, 13 Am. Bkr. Inst. L.R. 483 (Winter 2005); Warner, Garnishment Restrictions In A Means Test World, 13 Am. Bkr. Inst. L.R. 733 (Winter 2005); Williams and Todres, Tax Consequences of Post-Petition Income as Property of The Estate in an Individual Debtor Chapter 11 Case and Tax Disclosure In Chapter 11, 13 Am. Bkr. Inst. L.R. 701 (Winter 2005).

[3] For example, *see In re Rodriguez*, 336 B.R. 462, 477 (Bankr. D. Idaho 2005) (eligibility requirements of section 109(h)(1) were not met); *In re Talib*, 335 B.R. 417 (Bankr. W.D. Mo. 2005) (same); *In re Sukmungsa*, 333 B.R. 875 (Bankr. D. Utah 2005) (same). "). S*ee also In re Burrell*, 339 B.R. 664, 666 (Bankr. W.D. Mich. 2006) ("To be a debtor under Title 11 an individual must have received credit counseling within 180 days preceding the date of filing the bankruptcy petition.")

While most of the cases address the credit counseling requirement in the context of Chapters 7 and 13 cases, Section 109(h) does not except Chapter 11 debtors from its requirements.[4] Chapter 11 and Chapter 12 cases have also been dismissed due to a debtor's failure to comply with Section 109(h).[5] The courts deciding these cases followed the same line of reasoning in the consumer cases cited *supra*, and dismissed them because the individual debtors did not obtain proper credit counseling.[6]

The failure to obtain credit counseling is a fatal flaw unless the debtor can satisfy one of two exceptions or an exemption in Section 109(h)(2), (3) and (4), respectively. *See In re Hedquist*, 342 B.R. 295 (8th Cir BAP 2006) ("[T]he requirements of Section 109(h) are mandatory; failure to meet them is a 'fatal flaw' rendering an individual debtor ineligible for bankruptcy relief." (Footnote omitted.)).

These exceptions or the exemption exist if the debtor cannot complete the credit counseling requirement because: (i) the United States Trustee has determined that the credit counseling agencies for an entire district "are not reasonably able to provide adequate services" for the district (11 U.S.C. § 109(h)(2)(A)); (2) the debtor is granted a temporary deferral by the court due to exigent circumstances (11 U.S.C. § 109(h)(3)); or (3) the debtor is incapacitated, disabled, or in active military duty in a defined combat zone (11 U.S.C. § 109(h)(4)).[7] Subsections (h)(2) and (h)(4) are objective, so courts should have little difficulty determining whether a debtor satisfies their criteria. Subsection (h)(2) requires that the Office of the United States Trustee formally determine that credit counseling is not sufficiently available throughout the district. This occurred in areas ravaged by Hurricane Katrina.[8] Under subsection (h)(4), the requirements for incapacity and disability are set out in the statute, and military duty in a war zone seems relatively easy to prove.

Therefore, the cases that address Section 109(h) discuss the exception for exigent circumstances in Section 109(h)(3). Section 109(h)(3) has two subjective prongs and one objective prong. *See Talib*, 335 B.R. at 421. "The subjective tests require that the Court

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[4] *See Dixon*, 338 B.R. at 386 ("It is the clear expectation of the statute that all individual debtors receive such a briefing *prior* to filing.") (Emphasis in original).

[5] *See In re Hedquist*, 342 B.R. 295 (8th Cir. BAP 2006); *In re Watson*, 332 B.R. 740 (Bankr. E.D. Va. 2005) ; *In re Bogedain*, 2006 WL 2471939 (E.D. Mich. Aug. 24, 2006).

[6] The problem faced by debtors whose cases are dismissed involves the application of the automatic stay. Section 362(c)(3) and (4) limit application of the automatic stay when a previous bankruptcy case was dismissed within one year of the new filing. 11 U.S.C. § 362(c)(3) and (4). To avoid the possible inequitable result the limitation on the automatic stay might impose on an unsuspecting debtor, bankruptcy courts have struck the case, rather than dismissing it. *See In re Elmendorf*, 345 B.R. 486 (Bkrtcy. S.D. N.Y. 2006). In *Elmendorf*, the bankruptcy court struck a Chapter 7 case and two Chapter 13 cases filed before the debtors sought credit counseling. The bankruptcy court determined it may decide, on case-by-case basis, whether to strike petitions filed in violation of the credit counseling requirement. *Id.* at p. 499-500. *But see In re Wilson*, 346 B.R. 59 (Bankr. N.D. N.Y. 2006) (the appropriate disposition, upon determination by bankruptcy court that debtors had not satisfied prepetition credit counseling requirement, was to dismiss, not strike, bankruptcy case).

[7] *See generally, In re DiPinto*, 336 B.R. 693 (Bankr. E.D. Pa. 2006).

[8] Section 109(h)(2) requires a review of the exception at least once a year. Based on information from the Office of the United States Trustee, it is understood this exception was not extended for areas affected by Hurricane Katrina when it came up for review.

find that there are exigent circumstances that 'merit a waiver' … and that the Certification is 'satisfactory to the Court.'" *Id*.; *see also* 11 U.S.C. § 109(h)(3)(A). "The objective requirement is that the Certification allege that the debtor requested credit counseling prior to the filing of the petition from an approved agency but was told that the services would not be available for more than five days subsequent to the date of the request."[9]

Most cases addressing 109(h)(3) were filed to prevent some imminent harm, such as a foreclosure sale. This argument is persuasive in some jurisdictions, but not others. *See, e.g, In re Hedquist* , 342 B.R. 295 (8th Cir. (BAP) (insufficient); *In re Burrell*, 339 B.R. 664 (Bankr. W. D. Mich. 2006)(sufficient); *In re Dixon*, 338 B.R. 383 (8th Circuit BAP) (insufficient); *In re DiPinto*, 336 B.R. 693 (Bankr. E.D. Pa. 2006)(insufficient).

A further requirement is that the Court must accept the arguments in the certification. 11 U.S.C. § 109(h)(3)(C). Although this section seems to mimic the requirement that the exigent circumstances "merit waiver" in subsection (h)(3)(A), one court recognized that under general rules of statutory construction, the court must give it meaning if possible.[10] The court, therefore, concluded that this subsection indicated Congress intended for the bankruptcy court to use its discretion when deciding issues under Section 109(h)(3).

It is also important to recognize that the exigency exception is only a temporary solution for the debtor. Unlike the subsection (h)(4) permanent exemption, a subsection (h)(3) exception requires credit counseling within thirty days, with one 15 day extension if allowed by the court. In *Burrell*, the debtor's failure to "cure" his or her lack of credit counseling within this period appeared to have some relevance in the court's refusal to recognize the exception. *Burrell*, 339 B.R. 666-67.

Recognizing that the statute makes pre-bankruptcy counseling mandatory except in the very restrictive circumstances discussed previously, the individual Chapter 11 debtors in *Hedquist* and *Watson* argued that the statute violated their constitutional right to equal protection and due process.[11] These arguments were rejected because the credit counseling obligation did not violate any fundamental right and was not devoid of a rational justification. *Id*. In fact, the court found the requirement "was well within the policy judgment of the legislature." *Hedquist*, 342 B.R. 300; *Watson*, 332 B.R. at 747.

Another debtor failed attempt to avoid dismissal for lack of credit counseling involved an argument of excusable neglect.[12] The bankruptcy court discussed the requirements for excusable neglect, but would not grant relief from the dismissal order because the debtors could not prove they could satisfy the criteria of Section 109(h)(3). *Id*. at 880.

The conclusion of the court in *In re Cleaver*[13] accurately describes the conclusions of the courts addressing Section 109(h): "Pursuant to the newly enacted changes to the

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9 *Talib*, 335 B.R. at 421; *see also* 11 U.S.C. § 109(h)(3)(B).
10 *Dixon*, 338 B.R. at 387.
11 *Hedquist*, 342 B.R. 299-300; *Watson*, 332 B.R. at 746-47.
12 *See In re Sukmungsa*, 333 B.R. 875 (Bankr. D. Utah 2005).
13 333 B.R. 430 (Bankr. S.D. Ohio 2005).

Bankruptcy Code, an individual must receive credit briefing prior to filing for bankruptcy protection, or he must submit a certification to the court describing exigent circumstances and detailing the unavailability of the credit briefing during the five days after requesting it."[14] Therefore, Chapter 11 attorneys must ensure compliance with these provisions to ensure that Chapter 11 will not "die" shortly after its inception.

Ghosts of Debtors Present: Ethical Issues in Representing

As debtors attorneys know, or should know, the vast majority of courts have held that counsel for Chapter 11 Debtors represent the bankruptcy estate[15] and not the principals of the Debtor.[16] While representing your actual client in a corporate Chapter 11 case is difficult, representing a debtor's bankruptcy estate in an individual Chapter 11 is almost an out of body experience. As noted by one of the leading scholars in Bankruptcy ethics, Nancy Rapoport:

> Representing a corporation can present numerous problems for Estate Counsel, but representing individual Debtors in chapter 11 is even trickier: "The complex fiduciary duties of a chapter 11 debtor-in-possession and its counsel can become even more confused when the debtor(s)-in-possession are individuals." Obviously, there is the metaphysical challenge of realizing that the human who hired you to file his chapter 11 petition is not your client in the bankruptcy case. Even though it's fairly easy, at least in theory, to understand that the president of a corporation or the managing partner of a partnership is not your client when you are representing the business entity itself, it stretches the bounds of legal fiction to comprehend the difference between the Bankruptcy Estate of an individual (your client) and the individual himself (not your client).

Rapoport and Bowles at 70-71.

Two key issues: (1) the individual debtor's fiduciary duty to creditors and (2) new 11 U.S.C. § 1115 make the challenges facing debtors counsel and the individual chapter 11debtors themselves especially challenging.[17]

A. What Am To Do Spirit?: An Individual Debtor's Duties.

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[14] *Id*.

[15] *See generally, Everett v. Perez*, 30 F.3d 1209 (9th Cir. 1994); *In re Cenargo International PLC*, 294 B.R. 571 (Bkrtcy. S.D. N.Y. 2003); *In re ICM Notes, Ltd.*, 278 B.R. 117 (S.D. Tx. 2002); *In re Harp*, 166 B.R. 740 (Bkrtcy N.D. Ala. 1993); *In re Rusty Jones, Inc.*, 134 B.R. 321 (Bkrtcy. N.D. Ill. 1991); *In re Grabill, Corp.*, 113 B.R. 966 (Bkrtcy. N.D. Ill. 1990); *In re Storms*, 101 B.R. 645 (Bkrtcy. S.D. Cal. 1989). *See also*, Rapoport and Bowles, Has the DIP's Attorney Become the Ultimate Creditor's Lawyer in Bankruptcy Reorganization Cases?, 5 Am. Bkr. Inst. L. Rev. 47 (Spring 1997) (hereinafter "Rapoport & Bowles").

[16] However at least two cases, *Hansen Jones & Lela P.C. v. Segal*, 220 B.R. 434 (D. Utah 1998) and *In re Sidco, Inc.*, 173 B.R. 194 (E.D. Col. 1994) have held that counsel owe duties to the Debtors-in-possession, not the estate.

[17] There are numerous other problems with individual Chapter 11 debtors, including attorney-client privilege issues, which are beyond the scope of this article. *See generally In re Bame*, 251 B.R. 367 Bankr. D. Minn. 2000).

One of the most difficult concepts chapter 11 debtors have to grasp, when they file their bankruptcy is that they owe a fiduciary duty to their creditors[18] to act in the best interests of their bankruptcy estate.[19] Courts have universally held that individual chapter 11 debtors owe these duties just like other debtors-in-possession.[20]

This means the individual Chapter 11 debtor must generally put the interests of his creditors ahead of his or her own interests and must actively work to benefit a bankruptcy estate even when that would disadvantage the individual himself. Two cases demonstrate the issues found in this standard.

In the case of *In re Bowman*,[21] a Chapter 7 debtor objected to the Chapter of Trustee's settlement of a lawsuit for an amount which would pay the debtor's creditors in full but not produce any distribution to the Debtor.[22] The Debtor exercised her right[23] to convert her case to a Chapter 11 proceeding. The Court granted the debtors' motion but immediately reconverted the case to a Chapter 7 proceeding finding the debtor's insistence on further litigation of her claim was a violation of her fiduciary duty as a Chapter 11 debtor in possession. The *Bowman* court held:

> Likewise, in this case when Debtor must weigh whether to accept a prompt settlement that would substantially pay her creditors or to wait and gamble on a potential to receive a greater recovery, her creditors' interests have a higher priority than the Debtor's own; and they must take precedence. Debtor's own statement that she "intends to proceed with litigation, through trial," indicates her unwillingness to examine other interests above hers. But there is more to the conflict than mere unwillingness, it is an inherent conflict of interest between her duty as a fiduciary to the estate and her desire to maximize the amount of money she may recover for herself.[24]

In a similar fashion, the Court in *In re Tel-Net Hawaii, Inc.*[25] removed the debtor in possession who was the corporation's controlling shareholder due to it failure to pursue preference actions which would have increased its exposure on guaranteed debts.[26] The

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[18] *Id*. at 53-55. *See also, Commodity Futures Trading Commission v. Wentraub*, 471 U.S. 343, 355 (1985).

[19] *See* Rapoport & Bowles at 53-58 for a full discussion of the exact nature of these duties.

[20] *See* generally *In re Hardy*, 319 B.R. 5 (Bankry. N.D. Fla. 2004) (Full disclosure of assets and of business transactions required); *In re Robino*, 243 B.R. 472 (Bankr. N.D. Ala. 1999) (compliance with Court orders); *In re Tornheim*, 181 B.R. 161 (Bankr. S.D. N.Y. 1995) (duty to pay fees and file required reports); *In re Bownan*, 181 B.R. 836 (Bankr. D. Md. 1995) (duty to put creditor interests first in settlement of a lawsuit); *In re Harp*, 166 B.R. 740 (Bankr. N.D. Ala. 1993) (duty to properly account for estate property and to properly use estate funds).

[21] 181 B.R. at 836.

[22] *Id*. at 841.

[23] *Id. citing In re Finney*, 992 F.2d 43, 45 (4th Cir. 1993).

[24] *Id.* at 845. However, courts do not automatically require trustees to settle claim where an offer is made to pay creditors' claims. *See generally, In re Central Ice Cream Co.*, 836 F.2d 1068 (7th Cir. 1987) (discussing settlement which included payments to equity owners and insiders).

[25] 105 B.R. 594 (Bankr. D. Haw. 1989).

[26] *Id.* at 595.

Court found that in light of the conflicting interests of its controlling shareholder, an independent trustee had to be appointed.

Therefore, attorneys must be careful to advise potential Chapter 11 debtors of the full ramifications of a Chapter 11 filing. Further they must do this while being unable to give the individual (not in his role as debtor-in-possession)advice as to how he or she could improve their financial condition at the expense of the estate.[27]

B. If you're Quick I Will Give You Half A Crown (With Court Approval), 11 U.S.C. § 1115.

Section 1115[28] of the Bankruptcy Code, added by BAPCPA, radically changes the definition of what constitutes property of the estate. Its most important provision is that an individual's "earnings from services preferred" after the commencement of the case, but before the case is closed, constitute property of the estate.

Prior to the enactment of 11 U.S.C. § 1115, Courts were bitterly divided as to what portion, if any, of an individual debtor's post-petition earnings were property of the estate under 11 U.S.C. § 541. A majority of Courts held that under the earnings exception of 11 U.S.C. § 541(c), post-petition earnings of a debtor were not property of the estate.[29] However, a sizeable minority of Courts found that at least a portion of post post-petition profits generated by professionals and sole proprietors were not earnings subject to

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[27] *See In re Harp*, 166 B.R. at 747-48;

> It is not easy for a debtor-in-possession, corporate or individual, to serve two masters-juggling the personal needs and desires of the debtor itself, with its clear fiduciary responsibilities to unsecured creditors, other parties in interest and the court. Nor is the role any easier for the attorney who represents the debtor-in-possession.

[28] 11 U.S.C.A. § 1115 provides:

(a) In a case in which the debtor is an individual, property of the estate includes, in addition to the property specified in section 541--

(1) all property of the kind specified in section 541 that the debtor acquires 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; and
(2) 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.

(b) Except as provided in section 1104 or a confirmed plan or order confirming a plan, the debtor shall remain in possession of all property of the estate.

[29] *See, e.g., In re Habe*, 2006 WL262116 (6th Cir. 2006); *Roland v. UNUM Life Ins. Co. of Am.*, 223 B.R. 499 (W.D.N.Y. 1998); *In re Powell*, 187 B.R. 642 (Bankr. D. Minn. 1995).

541(a)(6) exception[30] and therefore were property of the individual chapter 11's bankruptcy estate.

While 11 U.S.C. § 1115 resolves this split of authority, it leaves unanswered several practical questions of how does an individual chapter 11 debtor obtain a final authority to pay his or her personal living expenses and the expenses of his family during the bankruptcy.

The initial question confronting both attorney and individual chapter 11 debtors is whether an individual debtor's "living expenses" can be paid as ordinary course of business expenses under 11 U.S.C. § 363(c)(1)[31] and 11 U.S.C. § 1108[32] or notice and a hearing under 11 U.S.C. § 363(b)(1)?[33]

Prior to the enactment of 11 U.S.C. § 1115 few cases addressed the issue of whether a debtor had to get court approval for the payment of living expenses. Some courts which considered the question held that normal living expenses of an individual chapter 11 debtor did not need court approval,[34] while others indicated that some form of court approval would be necessary at least in cases of significant expenses.[35] Indeed one early decision *In re Vincent*[36] held there was no authority for the payment of living expenses for a chapter 11 individual debtor under the Bankruptcy Code. Given 11 U.S.C. § 1115 and chapter 11 debtors' fiduciary duty to creditors, individual debtors should give serious thought to having a budget for living expenses approved by their Court in order to avoid challenges to the spending later in the case.[37]

A second problem concerns what constitutes "reasonable" living expenses for purposes of 11 U.S.C. § 363? For example will Judges take into account the debtor's standard of living in determining what constitutes reasonable living expenses.[38] Should Courts adopt

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[30] *See, e.g., In re Harp*, 166 B.R. 740 (Bankr. N.D. Ala. 1993) (noting Chapter 11 Debtors spent $206772.45 on personal expenses in seven months in bankruptcy); *In re Heberman*, 122 B.R. 273 (Bankr. W.D. Tx. 1990); *In re Cooley*, 87 B.R. 432 (Bankr. S.D. Tx. 1984).

[31] 11 U.S.C. § 363(c)(1) provides: If the business of the debtor is authorized to be operated under section 721, 1108, 1203, 1204, or 1304 of this title and unless the court orders otherwise, the trustee may enter into transactions, including the sale or lease of property of the estate, in the ordinary course of business, without notice or a hearing, and may use property of the estate in the ordinary course of business without notice or a hearing.

[32] 11 U.S.C. § 1108 provides: Unless the court, on request of a party in interest and after notice and a hearing, orders otherwise, the trustee may operate the debtor's business.

[33] 11 U.S.C. § 363 (b)(1) provides in pertinent part that: "The Trustee, after notice and a hearing, may use, sell or lease, other than in the ordinary course of business, property of the estate."8

[34] *See In re Murra*y, 216 B.R. 712 (Bankr. W.D. N.Y. 1998); *In re Keenan*, 195 B.R. 236 (Bankr. W.D. N.Y. 1996); *In re Bradley*, 185 B.R. 7 (Bankr. W.D. N.Y. 1995).

[35] *See generally In re Harp*, 166 B.R. at 755 – 756 (discussing violation of fiduciary duties by paying for rental of vacation homes, sponsoring a large pre-game Alabama-Auburn brunch and taking a vacation to an exclusive resort in the Netherland Antilles).

[36] 4 B.R. 21 (Bankr. M.D. Tenn. 1979).

[37] *See In re Harp*, 166 B.R. at 755; *see also In re Roland*, 223 B.R. at 506; *In re Weber*, 209 B.R. 793 (Bankr. D. Mass. 1997) (discussing expenditures of non-estate property in connection with determination of debtors' good faith).

[38] While isolated cases have approved indirectly expenditures of an affluent nature, *see In re Bradley*, 18 B.R. at 11 (refusing to impose a budget on individual Chapter 11 debtor; *In re Rodriquez*, 41 B.R. 774

a disposable income test similar to 11 U.S.C. § 1325(b) or 1129(a)(15)[39] or will they impose the "minimal" standard of living tests imposed on parties seeking to discharge student loans.[40]

While none of these questions have clear answers it seems apparent that individual Chapter 11 debtors who are accustomed to leading affluent lifestyles will no longer be able to maintain such standards of living during the pendency of their Chapter 11s.[41]

A third area of possible confusion is whether an individual chapter 11 debtor can exempt a portion of his post petition earnings from services performed under applicable state exemption law. For example under Kentucky law[42] a significant portion of "disposable earnings" (which include earnings from services) are exempt from garnishment by creditors. While Kentucky law provides that this exemption does not apply to "[a]ny order of any court of bankruptcy under Chapter 13 of the Bankruptcy Code", it apparently still applies in Chapter 11 cases. The question which may shortly confront Courts and debtors is whether an individual Chapter 11 debtor can use state law to exempt from estate property, post petition wages. In addition, since most such laws are time period based, can those exemptions be asserted for each applicable post petition time period.

Finally, there is the question of whether individual chapter 11 debtors can pay reasonable living expenses for their family. While this question almost seems to be the paranoid fears of a madman,[43] consider whether a bankruptcy court would permit a corporate chapter 11 debtor to pay the living expenses of a president's son, brother-in-law or other relative, if they provided no value to the debtor's estate?

Further, while spouses, former spouses, children of the debtor and other designated parties are entitled to first priority payments for their domestic support obligations[44] and chapter 13 debtors are expressly authorized to pay for the support of their dependents[45] in their cases, there appears to be no similar direct and expenses authorization in Chapter 11 of the Bankruptcy Code permitting an individual chapter 11 debtor to pay for his or her family's support from estate funds.[46] Indeed in a pre 11 U.S.C. § 1115 individual chapter

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(Bankr. S.D. Fla. 1984) (approving personal expenses of $7,000 per month), most Courts have refused to consider status or lifestyle in determining what constitutes reasonable living expenses. *See generally In re Cardillo*, 170 B.R. 490 (Bankr. 1994); *In re Jones*, 55 B.R. 462 (Bankr. D. Minn. 1985).

[39] *See generally In re Watson*, 403 F.3d 1 (1st Cir. 2005) (private school tuition not a reasonably necessary expense); *In re Gleason*, 267 B.R. 630 (Bankr. N.D. Iowa 2001) (recreation and gift expenses not reasonably necessary); *In re Dick*, 222 B.R. 189 (Bankr. D. Mass. 1998) (payment on non-income producing vacation home not a reasonably necessary expense).

[40] *See generally In re Hornsby*, 144 F.3d 433 (6th Cir. 1998); *In re Clark*, 34 B.R. 238 B.R. 238 (Bankr. N.D. Ill. 2006); *In re Southard*, 337 B.R. 416 (Bankr. M.D. Fla. 2006).

[41] *See generally In re Wood*, 68 B.R. 613 (Bankr. D. Hawaii 1986) (large expenditures on pet care demonstrated mismanagement of debtor's business affairs).

[42] KRS 427.010.

[43] Consider the author, this just might be true.

[44] *See* 11 U.S.C. §§ 101(14A); 507(a)(1) and 1112(b)(4)(P).

[45] *See* 11 U.S.C. § 1325(b)(2).

[46] *See U.S. v. Sutton*, 786 F.2d 1305 (5th Cir. 1986) (holding that an incarcerated individual Chapter 11 debtor was not permitted to have his estate pay living expenses of his wife and minor children).

11 case, *U.S. v. Sutton*, the Fifth Circuit overruled a lower court decision which allowed living expenses of the individual chapter 11 debtor's spouse and minor children to be paid from estate funds. While Courts should be able to distinguish *Sutton* on its unique facts, it does illustrate the problems with new 11 U.S.C. § 1115.

C. **Bonus Material** What Secrets Do the Ghosts Know?: Attorney Client Privilege in Individual Chapter 11 Cases

Another problem which often arises in individual chapter 11 cases, concerns the control of an individual's attorney client privilege. The issue of who holds a Chapter 11 debtor's attorney/client privilege has been often litigated[47] and has been largely resolved in the area of business entities by the Supreme Court's decision in Commodity Futures Trading Commission v. Weintraub[48]. However, while the Weintraub Court held that the debtor in possession or trustee held a Chapter 11 **corporate** debtors' attorney/client privilege[49] and could waive it even over the objection of the debtors' pre-bankruptcy management, the Weintraub Court refused to extend its reasoning to individual debtors' attorney/client privilege ruling:

> [O]ur holding today has no bearing on the problem of individual bankruptcy, which we have no reason to address in this case. As we have stated, a corporation, as an inanimate entity, must act through agents. When the corporation is solvent, the agent that controls the corporate attorney-client privilege is the corporation's management. Under our holding today, the power passes to the trustee because the trustee's functions are more closely analogous to those of management outside of bankruptcy than are the functions of the debtor's directors. An individual, in contrast, can act for himself; there is no "management" that controls a solvent individual's **attorney-client privilege**. If control over that privilege passes to a trustee, it must be under some theory different from the one that we embrace in this case.[emphasis added][50]

Lower courts have taken three general positions[51] with regard to who holds an individual Chapter 11 debtor's attorney/client privilege. One line of mainly older cases has held that an individual Chapter 11 debtor's attorney/client privilege (for both pre and post-bankruptcy periods) remains with the individual debtor and does not pass to the bankruptcy estate or a subsequently appointed trustee.[52] These courts have generally held that due to the greater privacy concerns that arise when an individual holds an

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[47] See generally In re O.P.M. Leasing Services, Inc., 670 F.2d 383 (2d Cir. 1982); Citibank N.A. v. Andros, 666 F.2d 1192 (8th Cir. 1981).
[48] 471 U.S. 343 (1985).
[49] Id. at 354.
[50] Id. at 356-357.
[51] In re Bame, 251 B.R. 367, 377-378 (Bkrtcy. D.Minn. 2000).
[52] See In re Hunt, 153 B.R. 445 (Bkrtcy. N.D.Tx. 1992) (Trustee under confirmed plan not entitled to waive the attorney/client privilege); In re Silvio De Lindegg Ocean Dev. Of America, Inc., 27 B.R. 28 (Bankr. S.D. Fla. 1982) (same)

attorney/client privilege, there is no justification for the transfer of attorney/client privilege to either the bankruptcy estate or the individual debtor's trustee.[53]

Another group of cases, led by In re Williams[54], has held that the right to who holds the attorney/client privilege does not change merely because a debtor is an individual and not a business entity.[55] These cases have generally held that an individual debtor in possession must exercise its attorney/client privilege in a manner consistent with its fiduciary duty to creditors and that includes the transfer or waiver of its attorney/client privilege for the benefit of the estate.[56] These courts have found that the individual Chapter 11 Debtor's attorney client privilege passes to his or her bankruptcy estate and does not remain in the hands of the individual.

The final[57] and largest line of authority concerning individual Chapter 11 debtor's attorney/client privilege has stated that courts must determine who holds the attorney/client privilege on a case by case basis by balancing the policies underlying the attorney/client privilege and the potential term of disclosure to the individual against the trustee's duty to maximize the value of the estate.[58]

Under this line of reasoning, courts have generally determined that an individual debtor has no attorney/client privilege for any **post-petition discussions** the individual has with the estate counsel, holding that the estate counsel generally cannot give individuals legal advice, in their capacity as an individual, while acting as the estate's counsel.[59]

Under all of these lines of cases, the estate's counsel should carefully advise the individual as to who they represent in the chapter 11 (the bankruptcy estate generally)and the issues that may arise related to the individual attorney/client privilege (or lack thereof) when filing a Chapter 11 case.

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[53] In re Hunt, 153 B.R. at 454. But See In re Fairbanks, 135 B.R. 717 (Bkrtcy. D.N.H. 1991) (Finding "other theory" to hold that trustee controlled debtor's attorney/client privilege).
[54] 152 B.R. 123 (Bkrtcy N.D.Tx. 1992); See also In re Smith, 24 B.R. 3 (Bkrtcy. S.D. Fla. 1982) (Pre Weintraub)
[55] In re Williams, 152 B.R. at 128 (noting that under Toibbv Radloff, 501 U.S. 157 (1991) (Individual Debtor had fiduciary responsibilities of a corporate debtor in possession).
[56] Id.
[57] There is also a group of cases involving the waiver of an individual debtor's attorney/client privilege in the context of legal malpractice claims against a debtor's attorney. In these cases bankruptcy courts have generally held that the trustee holds and has the right to waive the attorney/client privilege for the purpose of investigating the malpractice action. See In re Bazemore, 216 B.R. 1020 (Bkrtcy. S.D. Ga. 1998), In re Tomarolo, 205 B.R. 10 (Bkrtcy. D. Mass. 1997) But see McClarty v. Gudenau, 166 B.R. 101 (E.D. Mich. 1994) (Individual Chapter 7 debtor holds attorney/client privilege as to file involved in malpractice action).
[58] See generally In re Foster, 188 F.3d 1259 (10th Cir. 1999); In re Benum, 339 B.R. 115 (Bkrtcy. D.N.J. 2006); In re Eddy, 304 B.R. 591 (Bkrtcy. D. Mass. 2004); In re Miller, 247 B.R. 704 (Bkrtcy. N.D. Ohio, 2000).
[59] See In re Bame, 251 B.R. 367, 375-376 (Setting forth a 5 part test to see if individual received individual legal advice from estate counsel [which would be subject to the individual's attorney client privilege] or advice as debtor in possession [which would not be subject to the individual attorney client privilege, but to the bankruptcy estate's privilege]).

Ghost Of Individual Chapter 11 Debtors Yet To Come: Confirming An Individual Debtor's Chapter 11 Plan Under BAPCPA.

BAPCPA also introduced significant changes to the Chapter 11 confirmation requirements for individual debtors.

1. 11 U.S.C. § 1129(a)(14).

Section 1129(a)(14) provides:

> The courts shall confirm a plan only if all of the following requirements are met:
>
> . . .
>
> (14) If the debtor is required by a judicial or administrative order, or by statute, to pay a domestic support obligation, the debtor has paid all amounts payable under such order or such statute for such obligation that first become payable after the date of the filing of the petition.

Based on subsection (a)(14), a Chapter 11 individual debtor is not entitled to confirm a plan unless it is current on all post-petition domestic support obligations. This change is consistent with other BAPCPA changes that make it more difficult to avoid domestic support obligations. For example, Section 101(14)(A) provides a definition of "domestic support obligations" and domestic support obligations are now a first priority claim ahead of allowed administrative expenses.[60]

2. 11 U.S.C. § 1129(a)(15).

Another creditor friendly charge made by BAPCPA is the addition of section 1129(a)(15) is certainly creditor friendly. Section 1129(b)(15) provides:

> The courts shall confirm a plan only if all of the following requirements are met:
>
> . . .
>
> (15) In a case in which the debtor is an individual and in which the holder of an allowed unsecured claim objects to the confirmation of the plan -
>
> (A) the value, as of the effective date of the plan, of the property to be distributed under the plan on account of such claim is not less than the amount of such claim; or
>
> (B) 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

[60] *See* 11 U.S.C. §§ 101(14)(A) and 507(a)(1)(A).

> 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.

Section 1129(a)(15) provides creditors another source of leverage to force a debtor to pay as much as possible in its reorganization. Only one disgruntled creditor need object to the plan and reference subsection (a)(15) to force the debtor to comply.

If a creditor objects, the debtor must prove that the property distributed under the plan is not less than the projected disposable income of the debtor as defined in Chapter 13. Oddly, even though unsecured creditors may object, Subsection (a)(15)(B) requires a review of all property distributed under the plan (i.e., it includes payments on secured debt and possibly property returned to the individual), not just property distributed to holders of allowed unsecured claims. Although Section 1129(a)(15) seems to be an effort by Congress to impose Chapter 13 obligations on Chapter 11 individual debtors, projected disposable income generally goes to pay general unsecured claims under Chapter 13.

Of course, if no creditor holding an allowed unsecured claim objects, this section does not apply.[61] Also, the debtor can avoid an objection under subsection (a)(15) if it is a 100% payment plan. 11 U.S.C. § 1129(a)(15)(B).

There is one other criteria in subsection (a)(15) that might raise questions; the objection must come from a holder of an allowed general unsecured claim. Query, if a creditor is partially secured, may a debtor argue it is not a general unsecured claim?[62] Or, may a debtor object to a claim the day before a confirmation hearing so it is not deemed allowed when the objection is considered?[63]

One final point on subsection (a)(15). Like Chapter 13 debtors under BAPCPA, individual Chapter 11 debtors have a five-year standard for plan payments (although the period is extended if the repayment term is longer in the plan).

In the end, the squeaky wheel may get the grease. If a creditor can force a higher recovery simply by objecting, it seems an easy course of action. Query, could a debtor affirm an unsecured claim in full to avoid an objection by that creditor?

3. 11 U.S.C. § 1325(b)(2).

As indicated, Section 1129(a)(15) calculates disposable income by reference to 11 U.S.C. § 1325(b)(2). The Section 1325(b)(2)[64] calculation of disposable income starts with the

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[61] *See, e.g.*, 11 U.S.C. § 1129(a)(6) (if there is no regulatory control, there is no obligation to comply with this subsection).

[62] *Norwest Bank Wortington v. Ahlers*, 485 U.S. 197 (1988).

[63] *See 11 U.S.C. § 502(a)* (a claim is deemed allowed unless a party in interest objects).

[64] 11 U.S.C. § 1325(2) provides:

> (2) For purposes of this subsection, the term 'disposable income' means current monthly income received by the debtor (other than child support payments, foster care payments, or disability payments

current monthly income of the debtors other than child support, foster care or disability payments for dependent children. From this "net" income, the debtor may deduct maintenance and support obligations of the debtor or a dependant and domestic support obligations accruing post petition. The debtor is also allowed a charitable contribution deduction up to 15% of gross income for the year. Further, if the debtor is a business debtor, there is a deduction for expenses necessary to preserve the business.

Section 1325(b)(2) requires that any exclusion from income be "reasonably necessary". Section 1325(b)(3) provides that amounts reasonably necessary under paragraph (2) are determined in accordance with Section 707(b)(2)(A) and (B) of the Code. But, Section 1129(b)(15) did not reference to Section 1325(b)(3); only Section 1325(b)(2). Query, does this omission allow an argument that the bankruptcy court should determine what is "reasonably necessary" under Chapter 11 without resort to the Chapter 7 definition, even though what is "reasonably necessary" under Chapter 13 is calculated pursuant on subsection 1325(b)(3)?

Overall, these changes plan will make it more difficult for an individual Chapter 11 debtor to confirm a reorganization plan. Another impediment to confirmation for the individual Chapter 11 debtor involves the absolute priority rule.

4. Absolute Priority and the Individual Debtor.

An individual debtor's Chapter 11 filing creates a new taxable entity.[65] Notwithstanding this, BAPCPA now provides that an individual debtor's post petition salary or other earnings become property of the estate until "the estate is closed, dismissed or converted . . . , whichever occurs first . . . ." 11 U.S.C. § 1115(a)(2); *see also* the discussion of Section 1115 *supra*.

If earnings are property of the estate, an individual debtor may not retain any portion of its salary in a less than 100% payment plan because the plan would violate the absolute priority rule. The absolute priority rule provides that a class of interests cannot receive payment under a plan until higher priority claims are paid in full. *See* 11 U.S.C.

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for a dependent child made in accordance with applicable nonbankruptcy law to the extent reasonably necessary to be expended for such child) less amounts reasonably necessary to be expended –

(A)(i) for the maintenance or support of the debtor or a dependent of the debtor, or for a domestic support obligation, that first becomes payable after the date the petition is filed; and

(ii) for the charitable contributions (that meet the definition of 'charitable contribution' under section 548(d)(3) to a qualified religious or charitable entity or organization (as defined in section 548(d)(4)) in an amount not to exceed 15 percent of gross income of the debtor for the year in which the contributions are made; and

(B) if the debtor is engaged in business, for the payment of expenditures necessary for the continuation, preservation, and operation of such business.

[65] *See generally* Williams and Todres, Tax Consequences, 13 Am. Bkr. Inst. L. R. at 712-715.

§ 1129(b).[66] Any creditor receiving less than 100% payment may object even if the plan only leaves a debtor with enough money to survive.

The usual ways around the absolute priority rule do not seem to help an individual Chapter 11 debtor. Previously, an individual debtor would propose to pay creditors some amount of money saved from post petition earnings and perhaps from his or her future earnings, which would give creditors more than they could otherwise expect to receive in a liquidation or through a Chapter 13 plan. Now that future earnings are estate property under Section 1115, future income is not something the debtor can "contribute" to a plan.[67]

Although the earnings themselves are property of the estate, the debtor may try to argue its promise to work to earn the income has value. After all, if the individual debtor does not work (or at least work hard), there is no future income and creditors are worse off. This argument probably will not succeed, however under the *Ahlers* decision.

In *Ahlers*, the individual Chapter 11 debtors filed a plan that proposed that they retain their farm and use the proceeds of operations to make plan payments. Although the appellate court approved the plan, the Supreme Court determined the debtors plan violated the absolute priority rule. *Ahlers*, 485 U.S. at 202. "Viewed from the time of approval of the plan, respondents' promise of future services is intangible, inalienable, and, in all likelihood unenforceable."[68]

Individual debtors also will likely have no success arguing that any money assets retained for necessities in a plan is de minimis. The debtors in *Ahlers* tried to argue that the property retained, their farm, had had no value. The Supreme Court rejected this argument holding: "Even where debts far exceed the current value of assets, a debtor who retains his equity interest in the enterprise retains 'property.'" *Id.* at 207-08.

This complication is probably something that was not contemplated by the drafters of the BAPCPA Code amendments. New Section 1129(a)(15) seems intended to require that a Chapter 11 individual debtor pay at least as much as he or she would pay in a Chapter 13 reorganization. Therefore, the protections afforded a creditor by the absolute priority rule in an individual Chapter 11 are substantially or totally addressed. Also, it seems

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[66] With respect to a class of unsecured claims –

> (i) . . .
>
> (ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property, except that in a case in which the debtor is an individual, the debtor may retain property included in the estate under section 1115, subject to the requirements of subsection (1)(14) of this section.

11 U.S.C. § 1129(b)(2)(B).

[67] *See also* Keach, Dead Man Filing, 13 Am. Bkr. Inst. L. R. at 489-498.

[68] *Id*. at 204. *See also Matter of Stegall*, 865 F.2d 140, 141-142 (7th Cir. 1989) (noting the 13th amendment prohibition against involuntary servitude prevents enforcement of a plan based on future work).

unreasonable to conclude that Congress would leave an individual debtor without the ability to maintain at least enough of his or her earnings to live on.

Therefore, can the courts fashion an equitable solution to allow an individual to confirm a Chapter 11 plan? The answer may be no. The individual debtors in *Ahlers*, were farmers, the most favored and sympathetic of debtors, who did not qualify for Chapter 12.[69] Even though the Supreme Court understood the Debtor's plight under their interpretation of the Bankruptcy Code left consideration of the impact of the absolute priority rule and property of the estate questions to Congress. *Id.* At 209.

These changes leaves an individual that exceeds the Chapter 13 debtor criteria and fails the Chapter 7 means test without a viable reorganization or liquidation option under the Bankruptcy Code. It seems the best option is to hope there is no objection to a proposed Chapter 11 plan. *See id.* ("Consequently, we think that the interest respondents would retain under any reorganization must be considered 'property' under § 1129(b)(2)(B)(ii), and therefore can only be retained pursuant to a plan accepted by their creditors or formulated in compliance with the absolute priority rule.").

God Bless Us, Everyone: Conclusion

Unlike the muse for this article, Charles Dickens' "A Christmas Carol," there is no happy ending at the present time for individual Chapter 11 debtors. While some debtors may have access to sufficient exempt assets to live on while in bankruptcy and to fund a Chapter 11, most individual Chapter 11 debtors do not have such convenient resources. BAPCPA has made the already difficult lives of individual Chapter 11 debtors and their lawyers much more challenging, without offering many solutions to these difficulties. However, unless the new provisions concerning BAPCPA are either revised by Congress or ruled unconstitutional by the Supreme Court, (topics far outside the scope of this article) these "shadows" will remain unchanged. Therefore, like Tiny Tim, we will have to press on and make the best of a bad situation.

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[69] *Ahlers*, 485 U.S. at 209, fn. 9.