Individual Chapter 11 Cases

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THE STORY OF THE DEBTOR

Mary Moore is a plastic surgeon who is in financial trouble. Demand for surgery has dropped during the recession. Additionally, the Affordable Care Act does not to cover surgeries that insurance previously paid for. Dr. Moore personally owns the building in North Hollywood where her medical office is located. There is no equity in the building and its loan is current. Her medical practice is operated through an LLC which she owns. The LLC is insolvent due to the $2,000,000 in loans it took to operate her practice for the last four years. The loans were guaranteed by Dr. Moore. The LLC has accounts receivable of $5,000,000; the collectibility of these is estimated to be $1,000,000.

Dr. Moore owns a home with $250,000 in equity and a $100,000 recorded homestead. All loans secured by the home are current. She is divorced and owes $15,000 monthly to her former husband. She is six months in arrears in support payments. She has $1,000,000 in an ERISA qualified retirement plan. In the last twelve months, she has opened and funded with $100,000 a college savings plan for her daughter. She has no other nonexempt assets.

Dr. Moore believes that her practice is worth saving. There is revolutionary new technology available to remove tattoos. Demand for tattoo removal is large and is projected to increase for the next 15 years until the cultural influence of current rappers, movie stars and NBA players wanes. She thinks her business will expand and become very profitable.

Can Dr. Moore file a Chapter 11 and confirm a plan? What are the issues?

COSTS AND BENEFITS OF FILING A CHAPTER 11

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COSTS AND BENEFITS OF FILING CHAPTER 11

Benefits

a. Keep Control

In Chapter 11, the management remains in control of the enterprise. No receiver or trustee is in place. A custodian can be ousted by the filing.

b. Stop Litigation, At Least Temporarily.

The automated stay of 11 U.S.C. Section 362 stops most civil litigations against the debtor. Most notably, it has little effect on Family Court litigation. Similarly, criminal litigation is not halted. A creditor can petition the bankruptcy court to allow frozen litigation to continue.

In light of the uncertain jurisdiction of the bankruptcy court today, it is fair to say that creditors may have better odds of having the stay lifted today, than in the past. Consider the merit of the creditors' argument that the bankruptcy court will not have the authority to render a final decision on a particular matter in litigation. Such is part of the *Stern V. Marshall*, 131 S.Ct. 2594 (2011) legacy.

c. Bind Creditors in a Confirmed Plan

The debtor, through a plan of reorganization has the prospects of binding uncooperative creditors to a treatment of the plan proposed by the debtor. The bankruptcy court can compel the creditor to live with a plan that is confirmed. Apart from bankruptcy, state law has few opportunities for a debtor to compel a creditor to treat a debt as satisfied without paying the debt in full or by its terms.

d. Address All Financial Problems at One Time

The debtor should list all creditors or potential creditors in the Chapter 11. This allows the debtor to clear out contingent claims that perhaps have not matured yet. Often the Chapter 11 provides an advantageous forum for dealing with creditors, who have few means to make threats.

Costs of Chapter 11 reorganization

a. Voluntary Servitude

The debtor is agreeing to work for the next 3-5 years or more to pay old bills. The usual reward of success, namely the capture of profits by the entrepreneur, is lost in Chapter 11 because profits are promised to the old creditors. That is, unless creditors have agreed to some significant discount as part of the plan.

Debtors in the short run do not want to depart from their current business model, even with its problems. The question is whether the current problems can be fixed or if there are better opportunities for the debtor that justify abandoning or closing the current business.

Debtors are bad at facing these questions. Also, grappling with these issues takes time, so few debtors will immediately agree to do an about face and dramatically change course. Counsel and the debtor should cover this at the first meeting, and at least once more after that. Do not be surprised if the debtor returns to the subject after reflection.

Friends and family and the spouse often have a more neutral and accurate assessment of the prospects for reorganization. Do not be shy about bringing this analysis up in front of the third parties; they may be able to carry the discussion further than counsel. In fact, often they have been advocating for Plan B already.

b. Judicial Control of The Debtor's Fate.

Once Chapter 11 is filed, the debtor's fate is controlled by the court. The debtor can be liquidated if the court thinks this is appropriate. See 11 U.S.C. Section 1112. As long as the debtor stays out of bankruptcy, it has more freedom until, either a foreclosure or state court ruling, changes the positions of the parties.

c. Public Reporting Required.

This has two aspects. First, upon filing, the debtor must notify all creditors and parties in interest of the filing. If there are parties who do not know of the financial crisis, this notice will come as a surprise and be possibly alarming. If the debtor has acted in a way that suggests unlawful conduct, making a list of the affected parties by listing them as unsecured creditors may facilitate an investigation. If this is a high risk, not filing may be prudent.

Once the case is filed, the debtor has to file monthly operating reports and show exactly how money is being handled. This generates several consequences. First, the inability to file these reports will be fatal to the business. Chapter 11 demands a minimum of accounting capability or else it will end in conversion or dismissal. Second, no commingling will be allowed of funds from different cash collateral sources. The violation of this rule will be apparent in the reporting. Third, a lack of profits in the business will doom the Chapter 11, as there will obviously not be enough funds available to pay the old bills, unless new money or liquidation is part of the plan.

d. Distraction and Significant Legal Costs

The debtor has to learn to live with Chapter 11. This has a significant learning curve, which distracts from running the business. Little is intuitive about Chapter 11, meaning that management has to consult regularly with its counsel to learn the correct way to react or proceed in the case.

Filing the operating reports will require the accounting department, in whatever form, to become acquainted with the forms and to adapt monthly reporting and accounting to produce the information needed to fill in the forms.

PREPARING THE CHAPTER 11 CASE

Develop the Story of the Case.

Without this, no case can progress. Answer the following questions:

1. How did the debtor get in trouble?
2. What has changed so that the trouble is no longer threatening viability?
3. How long will it take to use the new profits to pay the old bills?

Every workout has to present this story to the affected creditors. If you cannot do this, you cannot prepare a disclosure statement or prepare for the initial meeting with the US Trustee or for the creditor meetings.

If you do not find the debtor's story credible, no one else will either. Initially, be skeptical and ask for proof. Everyone else will, so the debtor may as well prepare to produce some evidence.

Get Confidence that the Debtor Operates Profitably or You are Not Getting Paid.

Profits are needed to fund the plan and to pay professionals. If the business is not profitable, you might not get paid unless there are assets with equity that can be sold by a subsequent Chapter 7 trustee to pay your bills, after he or she gets paid.

Profitability is not mandatory the first month. The court will have patience and allow the debtor some time to finish adjusting operations to reach profitability. Similarly, if the business is highly seasonal, filing in the down season may reveal losses but hopefully with profits to follow.

Worry about the *Asarco* case at the US Supreme Court, being heard this term. The Supreme Court is hearing a case where the Chapter 11 Debtor turned on its counsel at the end of a case that was utterly successful for creditors. The firm was denied the fees that it incurred in defending its

fee application. Such fees are allowed in the Ninth Circuit under *In re Nucorp Energy, Inc.*, 764 F.2d 655 (9th Cir. 1985). This case may be overruled by the Supreme Court.

The pernicious dynamic is that when counsel saves the debtor, the debtor then has a personal stake in chopping down the fees of counsel because the money saved goes right to the debtor. Successful work may trigger attack instead of reward.

Get The Answers to The Critical SOFA Questions.

The Statement of Financial Affairs ("SOFA") is part of every bankruptcy filing. Not every question is equal. Some are more important. The debtor needs to both answer the Key Questions where applicable and also to have good answers. The key questions are:

No. 3c: Payments to Insiders in the last 12 months.

First, get this answer correct. Next, know why the payments were made. Learn all insider deals in the last two years. These can be very inflammatory. If you know of them, you can better disclose them or anticipate trouble. Insider manipulation is a classic cause of the appointment of a Chapter 11 trustee or of conversion.

No. 7 Gifts

What did the debtor transfer for no consideration in the last 24 months and why? Giving away junk to charity is probably OK.

No. 10 All transfers out of the ordinary course in the last 24 months.

Really important, even if the debtor does not want to talk about the transfers. What has gone missing? Why? If the transfer was for fair value, especially to a third party, likely no problem as long as the motive was a business or profit motive. Giving a lien applies here, not just sales. Of course, what "ordinary course" means is not clear. But if you are not going to disclose a transfer

based on the fact that it was "ordinary," better have a chronological history of similar events to support the case.

No. 23 Withdrawals by Insiders in the Last 12 Months.

Everyone wants to know and is suspicious of what the insiders have received in the last year. So as with question 3c, have good detail on this answer. Debtors often act guilty about having been paid by their insolvent business. That is inappropriate. It is OK to get paid.

Educate the Debtor About Cash Collateral.

The debtor-to-be likely has no idea what cash collateral is. Commingling and segregation may not be terms familiar in the fiscal content. It is critical to instruct the debtor on the allowed use of funds and the need to segregate cash collateral before the case commences.

Outside bankruptcy, there is a duty to segregate cash collateral. In fact that formed the basis for the argument that the lender had waived the right to segregate the money in the early 1980s. Debtors put all the income into whatever bank account and spent the money paying bills, and more importantly, paying themselves. The filing has to end that practice and initiate a more structured treatment of revenues.

Note that segregating cash may reveal which assets do not generate sufficient revenue to justify retention. Or it may reveal that the enterprise cannot afford to pay management's salary. Better to know this before a filing than to learn it while a) wasting management's time on a futile case and b) investing $20,000 in legal fees which won't ever be paid because there is no profit from which to pay them.

Collect Important Documents.

This includes promissary notes, contracts, leases, deeds, security agreements. Many of these will need to be given to the US Trustee or introduced in the case.

Review The Documents; Collect Key Dates And Data.

See if what the client says and what the documents say is correct. It might not be. Figure out when the big deadlines are. Leases, options and maturity dates can have a huge effect on the case and on the claims. The operator of Park City Ski Resort lost its lease by not renewing it in a timely manner. Entirely. No compensation.

See That All Secured Claims Are Really Secured.

This is a key factor, as secured claims are entitled to more favorable treatment than general unsecured claims. For all UCC filings, see that the lien is current and has not expired. See what the lien encumbers; maybe there are assets not encumbered.

See Who the Debtor Really Is.

Individuals with small LLCs or corporations have debt in a variety of structures. Loans with guarantees. Direct obligations. Entity debt with no guarantee. Third party guarantees of personal or entity debt. Figure out who is on the hook so the plan will accurately address the liability.

Sometimes the entity can be jettisoned and does not need a Chapter 11. The individual may have accumulated the key assets in a way that lets you abandon the entity and thus save the cost of dual cases.

See If the Debtor Has the Necessary Licenses or Billing Numbers.

This is particularly applicable in businesses where insurance billing provides revenue. The only way for many medical providers to be paid is to bill an insurance company or governmental entity. If the producer does not have a billing account, billing is not possible.

If the plan is to reorganize into a new entity, it may serve to get a new license before the bankruptcy commences so that billing can be submitted in the name of the entity that will pay the claims.

Make Sure the Debtor Can Fill Out Operating Reports.

Without these, the case will be converted in short order. And you cannot show the profits to fund the plan.

Keep Some Friendly Creditors.

It is a common urge to pay off all the friendly creditors before filing the Chapter 11. Besides the risk of avoidance litigation, this is a bad idea because the debtor will benefit from having friendly creditors who will vote for the plan. Stripping out all the allies from the case will make it more difficult for the debtor to meet the requirements of confirmation under 11 U.S.C. Section 1129.

Similarly, do not pay off all the friendly creditors during the case. This should not happen but it does, sometimes involuntarily, as a result of a markup in the price of post-petition goods. The plan will need some affirmative votes.

Consider a Short Year Tax Election.

Particularly in individual bankruptcy cases, counsel has to consider if there have been or should be taxable events in the year before the bankruptcy filing that should be addressed by a short year election. The debtor can divide its tax year into two components: the months before the bankruptcy filing and the initial months in the case ending with the end of the standard tax year. The debtor can then file a return for the pre bankruptcy period and one for the post-bankruptcy period.

The compelling reason to look at the short year is that upon the filing of the case, all the favorable tax attributes, in fact all the attributes, pass to the individual's bankruptcy estate. In other words, all net operating losses and tax factors that reduce or minimize tax liability ARE NOT AVAILABLE TO THE INDIVIDUAL DEBTOR TO REDUCE TAX ON PREPETITION TAXABLE EVENTS. Combined with the fact that events that occur before filing are not reported

until the end of the tax year, this can mean that the debtor personally could have a tax to pay after filing the bankruptcy, but not have any write offs to use to reduce the tax.

Look for situation where the debt encumbering an asset exceeds the basis in the asset or simply at long time assets which have been refinanced to extend the life of the business. Ask about the tax consequences of any repossessions or foreclosure that happened in the year that the bankruptcy is contemplated. Even consider making a transfer to trigger the tax so that it can be written down by losses prior to the bankruptcy filing, accompanied by full and vigorous disclosure of the transfer, its purpose and the net effect to creditors.

Is Any Inheritance or Bequest Likely?

11 U.S.C. Section 541 provides that an inheritance received in the 180 days after the filing becomes property of the estate. 11 U.S.C. Section 1115(a) extends the time frame for this to the end of the case. If the debtor does not want an inheritance to come into the bankruptcy estate, the debtor might tell the person who planned such a gift of the financial crisis and allow that person to rewrite her will or trust.

LEARNING TO LIVE IN A FISH BOWL

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"Learning to Live In the Fish Bowl"

A. The Bankruptcy Estate and the U.S. Trustee

At the moment of filing the petition, the debtor is essentially no longer the owner of its assets. Rather, at that moment a "bankruptcy estate" is created, which becomes the owner of all assets and is charged with the proper distribution of assets to creditors.

Property is very broadly defined under the Bankruptcy Code, and as a result, the estate created consists of "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a). *See also Chartschlaa v. Nationwide Mut. Ins. Co.*, 538 F.3d 116, 122 (2d Cir. Conn. 2008) (citing 4 *Collier on Bankruptcy* P 541.01 (15th ed. 2001)) ("It would be hard to imagine language that would be more encompassing than this broad definition... Every conceivable interest of the debtor, future, non-possessory, contingent, speculative, and derivative, is within the reach of § 541.")

Additionally, in both chapter 11 and 13, post-petition earnings are also property of the estate. *See* § 1306, § 1115 (estate includes substantially all property debtor obtains after filing case until the case is closed, dismissed or converted to a chapter 7 case). Personal disposable income must also be available to fund the plan, in each chapter.

In chapter 7, the debtor's estate is managed by a case trustee appointed by the Office of the U.S. Trustee. The trustee will liquidate non-exempt assets of the estate to pay creditors. Unsecured creditors generally will not receive much, if anything, of what they are owed. Filing under chapter 13 also appoints a trustee.

In chapter 11, the Trustee initially does not administer the estate. Rather, the debtor also acts as the debtor in possession, and administers the estate as a fiduciary of the creditors. This "debtor in possession" ("DIP") status is how a chapter 11 business debtor is permitted to

continue operating the business in bankruptcy, as the DIP is given the same powers as a trustee. A chapter 11 trustee may be appointed by the court in a chapter 11 case for cause however, including mismanagement of the estate. A DIP is still required to obtain court permission for use of secured creditors' cash collateral, to employ professionals (including attorneys), to borrow money, and to conduct business (especially sales) outside of the ordinary course.

a. Exemptions & Residency Requirements

Certain assets of a debtor are not subject to administration by the Trustee or DIP as part of the estate. This is one area of bankruptcy law where state law is very important: state law operates to define the property rights of the debtor. *See Butner v. United States*, 440 U.S. 48 (1979) with regard to exemptions, discussed below

On its "Schedule C," the individual debtor can claim certain property "exempt" from bankruptcy. As this varies by state to state, what follows is only a very general treatment.

The state in which a debtor files for bankruptcy protection is significant because it will bear on what exemptions exist. There is also a federal list of exemptions. Some states permit debtors to choose between using the state or federal exemptions. In California, state exemption laws offer an option between 2 different lists of exemptions. California is included among the majority of states, which don't permit the federal exemptions (i.e. states that "opt out" of the Federal exemptions): Alabama, Arizona, California, Colorado, Delaware, Florida, Georgia, Idaho, Illinois, Indiana, Iowa, Kansas, Louisiana, Maine, Maryland, Mississippi, Missouri, Montana, Nebraska, Nevada, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, South Carolina, South Dakota, Tennessee, Utah, Virginia, West Virginia and Wyoming. *See* 4-522 Collier on Bankruptcy P 522.01.

The 2005 BAPCPA revisions to the Bankruptcy Code created new residency requirements for debtors. Congress wanted to discourage people from moving to states with more liberal exemptions and then filing for bankruptcy. You must, therefore, have lived in a state for 730 days (two years) before you can use that state's exemptions. If the debtor's domicile has been located in more than a single state during the 730 day time period, the law now requires that the governing exemption law will be the state in which the debtor's domicile was located for 180 days immediately *preceding* the 730 day period "or for a longer portion of such 180 day period than in any other place." This precludes a debtor moving from one state to another to take advantage of that state's more favorable exemption rules. *See* 11 U.S.C. § 522(b)(3)(A).

b. Discharge

The ultimate goal of an individual debtor is discharge, or the legal elimination of debt. Not all debts are entitled to discharge; certain debts that will remain after bankruptcy include: student loan payments, domestic support obligations, certain taxes, debts stemming from criminal fines, or debts due to death or personal injury caused while driving under the influence. *See generally* 11 U.S.C. § 523.

In addition, certain debts are non-dischargeable under chapters 7 and 11 that are dischargeable under chapter 13, such as those stemming from injury to property, and debts arising from settlements in divorce.

Non-exempted assets generally remain liable to satisfy pre-petition debts. 11 U.S.C. § 507(a) lays out the priority for payment of expenses and claims.

The chapter 11 plan essentially creates new contracts between the debtor and the creditors, and is overseen by the bankruptcy court throughout the life of the plan. A chapter 11 or 13 discharge does not officially take place until an individual debtor has completed making

payments under the plan of reorganization. *See, e.g.*, 11 U.S.C. § 1141(d)(5). While a debtor may file a plan for liquidation under chapter 11 or 13, the plan proposed is usually one of reorganization, and may take many years to "fully administer." Generally, a chapter 13 discharge releases the debtor from all debts provided for under the chapter 13 plan with the exception of certain debts referenced in §1328. Examples include but are not limited to certain long term obligations, such as a home mortgage, debts for alimony or child support, certain taxes and student loans.

B. U.S. Trustee Requirements

A chapter 11 DIP has myriad requirements to maintain vis-à-vis the Office of the U.S. Trustee. While a duty of compliance and good faith appears in any chapter, a chapter 11 DIP must go further and make initial and regular reports (some of which are filed directly with the U.S. Trustee, and some of which are filed with the Bankruptcy Court).

Information is available at http://www.justice.gov/ust/r16/.

On the petition date, a debtor must take certain actions, including the following:

- Close existing pre-petition accounts and sets of books
- Open new set of books and new bank accounts with an approved depository institution, designated as "debtor in possession" on the account (business cases require at least three separate accounts, for "general," "payroll" and "taxes"), which may require separate accounts for cash collateral (see below)
- Obtain appropriate insurance coverage, naming the U.S. Trustee as an additional insured party

Additionally, within 7 days of filing, the debtor must provide the Trustee's office with a "7 Day Package" of materials that confirms these requirements were met, and in addition the 7 Day Package includes:

- A "Real Property Questionnaire" for every parcel of real property owned(which includes information such property description and transfer history)
- Proof of required certificates and licenses
- A projected cash flow statement for the first 90 days of the case
- A statement of major issues and projected timetable
- An employee benefit plan questionnaire
- List of insiders
- Copies of any trust agreements
- Pre-Petition financial statements, and (in a separate submission) tax returns

The 7 Day Package is not filed with the Court, but submitted directly to the UST.

Additionally, the UST may conduct on-site audits and inspections (even unannounced) to verify information.

a. Meeting of Creditors

Per 11 U.S.C. § 341, after the filing of the bankruptcy petition, a debtor is required to attend a meeting of creditors convened by the U.S. Trustee (usually held between 20 and 50 days after filing). Though not held before a court, statements at this meeting are still made under penalty of perjury. At this meeting, creditors (who may be represented by an attorney) are permitted to question the debtor about the content of the Schedules and SOFA, alongside the Trustee.

b. Operating Reports

In addition to the schedules filed with the Court and the initial UST compliance packages, the debtor must keep the UST appraised of any renewals or changes to insurance, and must file regular Monthly Operating Reports (MORs).

MORs are due on the 15th day of each month (accounting for the previous month), and in addition to being served on the UST, are filed with the Court as well (except for a "disbursement summary" cover page). The UST makes a form template available for debtors, and the MORs must reconcile and disclose the monthly (and cumulative) receipts, disbursements and transfers to/from each of the DIP accounts (and cash disbursements as well). The MORs also require a debtor to list income from every source, confirm the regular payment of quarterly UST fees (based on a schedule of fees derived from the total disbursements that quarter), and provide a brief update of what happened in the case the prior month. MORs are signed by the debtor.

Post-confirmation, the reorganized debtor files quarterly reports. Failure to timely file accurate reports and pay quarterly fees may be grounds to convert or dismiss a case (or appoint a trustee), even post-confirmation.

c. Insurance

As mentioned above, a debtor-in-possession needs to update or obtain appropriate insurance coverage. Such coverage may include:

- General comprehensive liability insurance
- Fire and theft coverage
- Worker's compensation
- Motor vehicle insurance
- Product liability insurance

- Other customary insurance

The UST must be an additional interested party on each policy (generally, the declaration page from each policy is sufficient to indicate this is the case). Additionally, the MORs must provide a "snapshot" of the coverage and expiration dates of every policy.

d. Initial Debtor Interview (IDI)

In addition to the Section 31(a) Meeting of Creditors, a chapter 11 debtor-in-possession must attend an "Initial Debtor Interview" (IDI). The IDI is an opportunity for the debtor to tell the Trustee what the bankruptcy case is all about, the expected timetable, and what the debtor hopes to achieve. At that meeting the UST will go over the reporting requirements and will review the MOR form with the Debtor.

C. Insider Compensation

The Bankruptcy Code, at section 101(31), defines "insiders." Insiders of an individual debtor includes relatives of the debtor or a general partner of the debtor, partnership or general partner of the debtor, and a corporation of which the debtor is an officer, director, or person in control.

The UST requires that, before any insider of the debtor receive any compensation from the bankruptcy estate, the debtor must submit an appropriate notice. The initial notice should be filed as soon as possible after case commencement to avoid unnecessary delays in payment. The notice must provide proof of compensation for the prior 12 months before the petition date, and disclose the grounds for why the compensation must be paid. The notice must be served on appropriate parties (including certain creditors or creditors' committee) and the debtor must wait 15 days from service before paying such compensation. If a party opposes within 15 days, the

matter will be settled by the court. A separate notice will need to be filed and served to increase compensation later in the case.

a. Budgets

A court typically does not require that a debtor prepare a regular budget for the pendency of the case (if a debtor abides by statutory and UST procedures and court orders, there is usually sufficient disclosure of how funds are being spent leading up to a plan).

Section 363(c) allows a debtor in possession to enter into transactions and to use property of the estate in the ordinary course of business, without notice or a hearing. "Ordinary course of business" for an individual debtor is not defined in the Code; at least one court has read it very narrowly: "[section 362(c) of the Bankruptcy Code authorizes the individual chapter 11 debtor] "to buy bread and probably to purchase a ticket to travel to a court hearing." *In re Goldstein*, 383 B.R. 496, 499 (Bankr. C.D. Cal. 2007)." In addition, section 503(b) of the Bankruptcy Code accords administrative priority only to expenses necessary to preserve the "estate" as distinct from the "debtor." And when Congress amended the Bankruptcy Code to add section 1115, bringing almost all of the debtor's property into the estate, they did not make a corresponding amendment to Bankruptcy Code section 503(b), which provides administrative priority only to expenses necessary to preserve the estate. However, there are probably no statutory grounds for a court to impose a post-petition budget on an individual chapter 11 debtor. That being said, a court could look at expenditures and determine that a debtor is utilizing estate funds outside the ordinary course of business without court approval and that the debtor is making unauthorized transfers from the estate to third party entities and individuals. In such a situation, the court could exercise its discretion to convert or dismiss a case or, alternatively, in an effort to protect the estate's creditors (but not to recover transferred assets) appoint a chapter 11 trustee (in which

case the trustee takes over management of the estate, and the debtor-in-possession is divested of such status into simply a "debtor"). Hence, voluntarily submitting to a budget could be a sound practice for a debtor-in-possession.

So, while the debtor must prepare a projected cash flow for the early days of a chapter 11 case, and the schedules must disclose the regular monthly income and expenditures of a debtor leading up to the petition date, a debtor may not need to prepare a budget. *But* a budget may be needed for cash collateral purposes (discussed below).

D. Cash Collateral Restrictions

If a debtor is using security collateral to continue its operations, one of the first motions (aside from applications to employ professionals) a debtor will have to consider is a "Motion for Use of Cash Collateral." Secured creditors are entitled to have their collateral adequately protected, and the debtor needs to obtain lender permission or court permission before it can use such collateral. For instance, a debtor collecting rents on secured properties may be required to obtain court permission before using those rents to make payments. Or, if a creditor is secured by accounts receivable financing, the debtor will need court permission before it can use the proceeds from that as well. Oftentimes, negotiated agreements are worked out between debtors and creditors for use of cash collateral after the petition date. *See generally* 11 U.S.C. § 363; *United Savings Ass'n of Texas v. Timbers of Inwood Forest Associates, Ltd.*, 484 U.S. 365 (1988).

Whether through a contested proceeding or negotiated resolution, the debtor in such circumstances should be prepared to satisfy the creditor that its collateral is preserved or being replaced. This will entail a regular budget (with a small variance provision built in to the agreement) prepared by the debtor and signed off by the creditor.

E. Forbidden Payments & Actions

a. Prepetition Unsecured Debt

Chapter 11 debtors-in-possession are not permitted to make payments to unsecured creditors for debts that arose pre-petition. Rather, creditors must wait until a chapter 11 plan has been confirmed, and the reorganized debtor begins making payments per the plan. Depending on the case, unsecured creditors may not be able to expect much in way of payment.

In the chapter 11 context, a plan must demonstrate feasibility, that is, that payments can be made as indicated, and that creditors do not receive less under a chapter 11 plan than they would in a chapter 7 liquidation (unless the part to received less is agreeable).

Under certain circumstances, the bankruptcy court may "cram down" a plan over the objection of creditors (as long as it is not secured by a personal residence). The Code allows dissenting classes to be crammed down if the Plan does not "discriminate unfairly" and is "fair and equitable." The Code does not define discrimination, but it does provide a minimum definition of "fair and equitable." The term can mean that secured claimants retain their liens and receive cash payments whose present value equals the value of their security interest (i.e. a secured claim must receive the entire value of the property securing the claim or the entire value of the claim, whichever is smaller.). The term means that unsecured claimants whose claims are not fully satisfied at least know that no claim or interest that is junior to theirs will receive anything under the plan, except where the Debtor is an individual, has elected to retain property included in the Estate

Therefore, if a class of general unsecured claims votes against the Plan, the Plan ordinarily cannot be confirmed where a non-individual Debtor or a class of interest holders (e.g. shareholders or partners) will receive or retain any property under the Plan, unless the Plan

provides that the class of general unsecured claims shall be paid in full with interest. That is, under this "Absolute Priority Rule", a creditor's plan objection will be upheld if the plan is not "fair and equitable with respect to non-accepting classes of claims which are impaired. Under § 1129(b)(2)(B)(ii), with regards to objecting unsecured creditors, the value of the claims must be paid in full, or any "junior" creditors (including interest holders) must not retain or receive any property under the plan.

b. Paying Professionals

One of the first motions following the petition must be an application of the debtor to employ bankruptcy counsel.

Even though a debtor may have approached an attorney to conduct its initial filings, because of the bankruptcy estate, the debtor will need to seek court permission to employ professionals at the expense of the estate immediately after filing its chapter 11 petition. Such motions are brought pursuant to 11 U.S.C. §§ 327-331, and will also be necessary to employ special or joint counsel, accountants, appraisers, and other individuals or entities that will assist the debtor later in its case. Payment arrangements with primary bankruptcy counsel should be worked out with the client in advance of the filing of the petition. Professionals for other entities – such as those employed by a trustee or Official Committee of Unsecured Creditors – may also seek payment from the estate.

Bankruptcy counsel for a debtor should ensure he or she is properly employed before seeking payment from the estate. Following approval of employment (which an attorney should obtain even if they are being paid by third parties), the statutory requirements indicate that payment is usually done with interim applications seeking compensation of fee and reimbursement of expenses (filed not less than 120 days' apart), which from a practical

standpoint usually requires professionals working on a case to coordinate (a party usually gives 45 days' notice of intent to schedule a fee application hearing). Such applications need to provide detailed listings of services provided and the fees and costs actually charged. Fees need to be approved on a final basis following plan confirmation.

DEALING WITH A MOTION TO APPOINT A TRUSTEE, DISMISS THE CASE, OR CONVERT IT TO CHAPTER 7

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Dealing With a Motion to Appoint a Trustee, Dismiss the Case, Or Convert It to Chapter 7

1. **Introduction.**

Under Bankruptcy Code section 1107, a debtor-in-possession is entitled to exercise all of the powers of a bankruptcy trustee, thus remaining in control of his or her business and assets. However, this state of affairs may be challenged during a chapter 11 case by a motion to appoint a trustee, dismiss the case, or convert the case to chapter 7.

The filing of a motion to dismiss or convert also requires the bankruptcy judge to consider whether appointment of a trustee is appropriate, so it is useful to think of these motions as a group. Each motion entails a fact-based, case-by-case analysis – both for the bankruptcy judge in ruling upon the motion and for the debtor in formulating a strategy to respond to it.

2. **Standard for Appointment of a Trustee**.

A motion to appoint a trustee is governed by Bankruptcy Code section 1104(a), which provides in pertinent part that the court "shall order the appointment of a trustee" either: (1) "for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case, or similar cause," or (2) if such appointment is in the interests of creditors, any equity security holders, and other interests of the estate." 11 U.S.C. § 1104(a).

Courts agree that appointment of a trustee is an "extraordinary remedy," *In re Adelphia Commc'n Corp.*, 336 B.R. 610, 658 (Bankr. S.D.N.Y. 2006), and "should be the exception, rather than the rule." *In re Sharon Steel Corp.*, 871 F.2d 1217, 1225 (3d Cir. 1989). A movant "has the burden of proving grounds that justify the appointment of a Chapter 11 trustee, and in doing so, must overcome a strong presumption that the debtor is to remain in possession." *In re LHC, LLC*, 497 B.R. 281, 291 (Bankr. N.D. Ill. 2013). However, courts are split on whether the

movant's burden is a clear and convincing standard or a preponderance standard. *See, e.g., In re Marvel Entm't Group, Inc.*, 140 F.3d 463, 471 (3d Cir. 1998) (clear and convincing); *In re Keeley & Grabanski Land P'ship*, 455 B.R. 153, 163 (8th Cir. BAP 2011) (preponderance). The Ninth Circuit has not definitively answered the question.

Importantly, the statutory list of factors that may constitute "cause" is non-exclusive. In addition to the statutory list of fraud, dishonesty, incompetence, or gross mismanagement, cause has been found in many other circumstances. *See, e.g., In re Intercat, Inc.*, 247 B.R. 911 (Bankr. S.D. Ga. 2000) (debtor's self-dealing and conflicts of interest constituted cause); *Marvel Entertainment*, 140 F.3d at 472-74 (intense acrimony between debtor and creditors may constitute cause); *In re Sydnor*, 431 B.R. 584 (Bankr. D. Md. 2010) (failure to provide U.S. Trustee with required information and failure to pay U.S. Trustee fees constituted cause).

There is less case law on when a trustee should be appointed under the "interests of the estate" prong of 1104(a), though it is notable that this prong focuses on not just the interests of creditors, but the interests of all constituencies of the estate, including equity. Under either prong, bankruptcy courts have broad discretion in determining whether a debtor-in-possession's conduct justifies appointment of a trustee. *Comm. of Dalkon Shield Claimants v. A.H. Robins Co.*, 828 F.2d 239, 242 (4th Cir. 1987).

3. **Standard for Motion to Dismiss or Convert Case.**

Motions to dismiss or convert a case are governed by Bankruptcy Code section 1112. Section 1112(b) provides in relevant part that "the court shall convert a case under this chapter to a case under chapter 7 or dismiss a case under this chapter, whichever is in the best interests of creditors and the estate, for cause unless the court determines that the appointment under section 1104(a) of a trustee or an examiner is in the best interests of creditors and the estate." Section 1112(b) thus gives a similar "cause" standard as we see in a trustee motion, and also

explicitly requires the court to consider whether appointment of a trustee or examiner would better serve the interests of creditors and the estate than would dismissal or conversion.

Similar to Section 1104(a), Section 1112(b)(4) provides a non-exclusive list of what constitutes "cause" for dismissal or conversion, with sixteen different items listed.[1]

4. **Debtor Strategies to Respond to Motion to Appoint Trustee, Dismiss Case, or Convert Case.**

A debtor's strategy in responding to any of the above motions is highly dependent on the asserted factual circumstances. Some of the strategies come directly from Sections 1104 and 1112 themselves.

4.1 *Show Progress in the Case By Getting a Plan on File.*

One of the primary strategies for a debtor is to get a plan on file, if one is not already. When bankruptcy courts consider the merits of any of these motions, they do so while contemplating how to best move the case forward. To the extent to which the requested relief is unnecessary or appropriate to do so, the relief may be denied. By filing a plan, a debtor can demonstrate progress towards plan confirmation that will potentially help defeat said motions.

[1] The sixteen examples of cause in 1112(b)(4) are: "(A) substantial or continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation; (B) gross mismanagement of the estate; (C) failure to maintain appropriate insurance that poses a risk to the estate or to the public; (D) unauthorized use of cash collateral substantially harmful to 1 or more creditors; (E) failure to comply with an order of the court; (F) unexcused failure to satisfy timely any filing or reporting requirement established by this title or by any rule applicable to a case under this chapter; (G) failure to attend the meeting of creditors convened under section 341(a) or an examination ordered under rule 2004 of the Federal Rules of Bankruptcy Procedure without good cause shown by the debtor; (H) failure timely to provide information or attend meetings reasonably requested by the United States trustee (or the bankruptcy administrator, if any); (I) failure timely to pay taxes owed after the date of the order for relief or to file tax returns due after the date of the order for relief; (J) failure to file a disclosure statement, or to file or confirm a plan, within the time fixed by this title or by order of the court; (K) failure to pay any fees or charges required under chapter 123 of title 28; (L) revocation of an order of confirmation under section 1144; (M) inability to effectuate substantial consummation of a confirmed plan; (N) material default by the debtor with respect to a confirmed plan; (O) termination of a confirmed plan by reason of the occurrence of a condition specified in the plan; and (P) failure of the debtor to pay any domestic support obligation that first becomes payable after the date of the filing of the petition."

This strategy is based in part on Bankruptcy Code section 1112(b)(2)(A), which provides that a court may not convert or dismiss a case if the court finds that "there is a reasonable likelihood that a plan will be confirmed . . . within a reasonable time."

4.2 *Attack or cure the alleged basis for the motion.*

Another option is to fight the factual basis of the motion. The debtor is typically in a position of greater knowledge regarding the facts and circumstances of the case than is the U.S. Trustee or other moving party, and so may simply be able to refute the factual basis for the motion. For example, if a party seeks appointment of a trustee because of alleged incompetence or mismanagement, the debtor can introduce evidence of the facts and circumstances supporting the various business decisions made by the debtor before or during the case.

Alternatively, if conversion or dismissal is sought for failure to do an act, such as the failure to pay U.S. Trustee fees, the debtor may cure the problem by performing the act (e.g., paying the fees).

The above strategy is based in part on the fact that with respect to motions to dismiss or convert, Section 1112(b)(2)(B) specifically provides that a court shall not convert or dismiss a case if the alleged grounds are ones "for which there exists a reasonable justification" or "that will be cured within a reasonable period of time."

4.3 *Seek the Imposition of a Less Extreme Remedy.*

If the debtor cannot successfully rebut the factual allegations supporting one of the above motions, the debtor may suggest that the court impose a less extreme remedy. For example, appointment of an examiner is listed as an alternative to appointment of a trustee in Section 1104. An examiner would not displace the debtor as debtor-in-possession, but would give some comfort to the court and creditors that the debtor is being adequately monitored. The

powers of an examiner are set forth in Bankruptcy Code section 1106(b), and they include investigating the debtor's actions and filing a report with the findings of the investigation.

Similarly, if the facts are very unfavorable to the debtor, appointment of a trustee or examiner may be a less extreme alternative to dismissal of the case.

Finally, the debtor may also propose a termination of exclusivity as a less extreme alternative to any of the above motions.

Certain Ramifications for Errors in Schedules:

1. **Failure to Disclose May Result in Lost Exemptions.**

With certain exceptions, a debtor's interest in any property becomes property of the bankruptcy estate when the bankruptcy case is commenced. 11 U.S.C. § 541(a). However, such debtor is entitled to claim certain property as exempt from the property of the estate. 11 U.S.C. § 522(b)(1). In order to claim such property as exempt, the debtor is required to list the property claimed as exempted as part of its Schedules of Assets (collectively, the "Schedules"). 11 U.S.C. § 522(l); Fed. R. Bankr. P. 4003(a) ("A debtor shall list the property claimed as exempt under § 522 of the Code on the schedule of assets required to be filed by Rule 1007.").

Any creditor (and the bankruptcy trustee or creditors committee if one is appointed) may file objections to the debtor's claimed exemptions. Fed. R. Bankr. P. 4003(b). However, absent special circumstances, such objections must be filed "within 30 days after the meeting of creditors held under § 341(a) is concluded or within 30 days after any amendment to the list or supplemental schedules is filed, whichever is later." *Id.* If no such objections are filed, then "the property claimed as exempt . . . is exempt." 11 U.S.C. § 522(l).

Failure to claim property as exempt may result (in addition to the debtor's facing potential denial of discharge and/or criminal liability, as noted in the sections below) in the

debtor's losing ability to retain such property following bankruptcy. *See, e.g., In re Wisdom*, 478 B.R. 394, 399 (Bankr. D. ID 2012) (refusing to accept debtor's claim of exemption in schedules "by implication"). The omission, however, may be corrected by an amendment to the list of the exempt property. Pursuant to Fed. R. Bankr. P. 1009(a), a debtor can amend his or her Schedules any time before the case is closed, which could include amending exemptions for a previously undisclosed asset. Fed. R. Bankr. P. 1009(a) ("A voluntary petition, list, schedule, or statement may be amended by the debtor as a matter of course at any time before the case is closed."). However, the ability to correct such omission is not without limits. The bankruptcy court may disallow such amendment if it was made in bad faith or would result in prejudice to creditors. *In re Myatt*, 101 B.R. 197, 199 (Bankr. E.D. 1989) ("The ninth circuit . . . has adopted a limiting caveat . . . that a court might deny leave to amend on a showing of a debtor's bad faith or of prejudice to creditors.") (Internal quotes and citation omitted).

2. **Failure to Disclose May Result in Criminal Liability.**

Transparency regarding the debtor's financial condition is one of the main aspects of the bankruptcy process. *In re Michael*, 433 B.R. 214, 220 (Bankr. N.D. Ohio 2010) ("[A] debtor must accept not only the benefits afforded by the Bankruptcy Code, but also its burdens. Among those burdens, a debtor is required to be absolutely transparent in all matters regarding their financial affairs."). At times, debtors fail to comply with this requirement, either intentionally or negligently, and end up not disclosing certain assets in their bankruptcy Schedules. Insufficient disclosure about the debtor's financial assets and liabilities may lead to serious, unpleasant consequences for the debtor. One of such consequences is criminal liability.

18 U.S.C. section 152 lists several bankruptcy crimes. The first bankruptcy crime listed relates to the concealment of assets. Section 152(1) states that a crime is committed by a person who:

> knowingly and fraudulently conceals from a custodian, trustee, marshal, or other officer of the court charged with the control or custody of property, or, in connection with a case under title 11, from creditors or the United States Trustee, any property belonging to the estate of a debtor . . . .

18 U.S.C. § 152(1). A debtor's has criminal liability if the following elements are proven: "(i) concealment; (ii) from a court officer or from creditors; (iii) of property of some bankruptcy debtor's estate (which in turn requires the commencement of a case under title 11); (iv) that is done knowingly and fraudulently." 1-7 COLLIER ON BANKRUPTCY P 7.02 (16th ed. rev. 2014).

Separately, inaccurate statements on the Schedules may subject the debtor to criminal prosecution for perjury. The Schedules are verified as they are the debtor signs them under penalty of perjury. Pursuant to 18 U.S.C. section 152(2), a crime is committed by a person who:

> knowingly and fraudulently makes a false oath or account in or in relation to any case under title 11 ... ." The crime is a Class D felony, 93 punishable by five years in prison, a fine of up to $250,000, or both. 94 This section existed in substantially the form it appears in today as part of section 29b of the 1898 Act. .

18 U.S.C. § 152(2). Accordingly, as a result of failing to make accurate and complete statements on the Schedules, the debtor may face criminal prosecution for perjury.

3. **Failure to Disclose May Result in Denial or Revocation of Discharge**.

Omissions or inaccuracies on the debtor's Schedules may lead to the debtor being denied a discharge under the Bankruptcy Code. If the fact of such commissions or inaccuracies comes to light after the discharge is entered, the discharge may be revoked.

As stated above, the Schedules should accurately disclose the financial condition of the debtor – in fact, the debtor signs them under the penalty of perjury. "Scheduling of debts and property must be done with candor and accuracy, and most likely requires a search and examination of the debtor's books, records, bills, accounts, mind and memory. It is not to be lightly treated, for concealment of assets may be a crime as well as grounds for denial of

discharge." *In re Shapkin*, 16 B.R. 26, 28 (Bankr. D. Cal. 1981). Debtors may find themselves facing a denial of discharge for false oaths under 11 U.S.C. section 727(a)(4)(A) to the extent there are false statements made in the Schedules. Under section 727(a)(4)(A), a debtor is denied a discharge if "the debtor knowingly and fraudulently, in or in connection with the case . . . made a false oath or account." 11 U.S.C. § 727(a)(4)(A).

Even if the Debtor successfully concealed the false statements in the Schedules and thereafter received a discharge, the debtor may still face the risk of having the discharge revoked upon the discovery of the false statements. Under 11 U.S.C. section 727(d), discharge can be revoked if:

> (1) such discharge was obtained through the fraud of the debtor, and the requesting party did not know of such fraud until after the granting of such discharge;
>
> (2) the debtor acquired property that is property of the estate, or became entitled to acquire property that would be property of the estate, and knowingly and fraudulently failed to report the acquisition of or entitlement to such property, or to deliver or surrender such property to the trustee;
>
> (3) the debtor committed an act specified in subsection (a)(6) of this section; or
>
> (4) the debtor has failed to explain satisfactorily—
>
> (A) a material misstatement in an audit referred to in section 586 (f) of title 28; or
>
> (B) a failure to make available for inspection all necessary accounts, papers, documents, financial records, files, and all other papers, things, or property belonging to the debtor that are requested for an audit referred to in section 586 (f) of title 28.

11 U.S.C. § 727(d). Therefore, it is prudent for the debtor to carefully complete the Schedules after due inquiry and provide complete and accurate disclosures.

CONFIRMATION ISSUES

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CONFIRMATION ISSUES

1. Section 1123(b)(5) -- Anti-Modification

Generally, a claim that is secured by a lien on property is treated as a secured claim "only to the extent of the value of the property on which the lien is fixed." *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235 (1989). If the value of the collateral is less than the claim, the claimant is unsecured as to the difference and the debtor can bifurcate the claim. 11 U.S.C. § 506(a)(1); *In re Johns*, 37 F.3d 1021, 1023-24 (3rd Cir. 1994).

Section 1123(b)(5), pertaining to the contents of a chapter 11 plan, provides:

> (b) Subject to subsection (a) of this section, the plan may -
> (5) modify the rights of holders of secured claims, other than a claim secured only by a security interest in real property that is the debtor's principal residence. . . .

11 U.S.C. § 1123(b)(5).

This section – known as the "anti-modification provision" – limits the debtor's ability in a plan to modify the rights of the holder of a claim secured only by a security interest in real property that is the debtor's principal residence. *See In re Wages*, 508 B.R. 161 (B.A.P. 9th Cir. 2014); *Scarborough v. Chase Manhattan Mortg. Corp. (In re Scarborough)*, 461 F.3d 406 (3d Cir. 2006).

The purpose of section 1123(b)(5) was to equalize the treatment of residential mortgages in chapters 11 and 13. Legislative history reflects Congressional intent to extend the anti-

modification provision applicable to chapter 13 plans (under section 1322(b)(2)) to proceedings under chapter 11 in accordance with the Supreme Court's decision in *Nobelman v. Am. Sav. Bank*, 508 U.S. 324 (1993).

Application of the anti-modification provision raises a few issues. First, what date should be used to determine the debtor's primary residence? Second, what if the debtor's residence is part of a mixed use property? Third, what if the loan is secured by two pieces of real property, one of which is the debtor's primary residence and one is not?

To resolve these issues, many courts look to cases analyzing section 1322(b)(2) – the chapter 13 parallel to section 1123(b)(5)—since the wording of each provision is identical.

For example, *In re Christopherson*, 446 B.R. 831 (Bankr. E.D. Ohio 2011), addresses two of these issues. In its analysis of the determination date, the *Christopherson* court states:

> Determining whether a property is a debtor's residence requires the consideration of two methods of reasoning. The majority of courts has determined that the critical date is the petition filing date. *In re Baker*, 398 B.R. 198 (Bankr.N.D. Ohio 2008); See, e.g., *In re Howard*, 220 B.R. 716, 718 (Bankr.S.D.Ga. 1998); *In re Lebrun*, 185 B.R. 665, 666 (Bankr.D.Mass. 1995); *In re Wetherbee*, 164 B.R. 212, 215 (Bankr.D.N.H. 1994). This rationale is supported by the policy against postpetition modification. Courts following this view reason that the failure to consider the petition date could lead to creditor manipulation. *In re Dinsmore*, 141 B.R. 499, 505-06 (Bankr.W.D.Mich.1992). Utilizing the petition date prevents creditors from disavowing, on a post-petition basis, a security interest in property not constituting a debtor's principal residence so as to gain the protections of § 1322(b)(2)'s anti-modification clause. *Id.*

466 B.R. at 835.

As to the issue of whether the anti-modification clause applies in multi-unit properties in which the debtor lives in one unit, the *Christopherson* court observes:

> Several courts have addressed this issue in the context of multi-unit properties and have held that the anti-modification clause does not apply utilizing a bright line rule that anti-modification clause does not apply to multi-unit properties in which the Debtor lives in only one unit. See, *Lomas Mortgage Inc., v. Louis*, 82 F.3d 1 (1st Cir. 1996); *In re Scarborough*, 461 F.3d 406 (3rd Cir. 2006); *In re Kimbell*, 247 B.R. 35 (Bankr.W.D.N.Y. 2000). Other courts have adopted a case-by-case analysis, opining that the applicability of the anti-modification provision should depend on the intended primary use of the property, not its physical dimensions. See *In re Brunson*, 201 B.R. 351, 352-54 (Bankr.W.D.N.Y. 1996); *In re Guilbert*, 176 B.R. 302 (Bankr.D.R.I 1995) (A debtor's residential property is not rendered "something other than a [primary] residence" regardless of its income-earning functions or its residents). Some courts have declined to follow this approach as it requires a subjective analysis of the parties' intentions.

446 B.R. at 436.

In *Scarborough v. Chase Manhattan Mortg. Corp. (In re Scarborough)*, 461 F.3d 406 (3d Cir. 2006), the Third Circuit focused on Congress' use of the word "is" in the phrase "real property that is the debtor's principal residence," and found that, by using "is," Congress equated "real property" and "principal residence," meaning that, for the anti-modification provision to apply, the property "must *be only* the debtor's principal residence" and have no other use.

However, in *In re Wages*, 508 B.R. 161 (B.A.P. 9th Cir. 2014), the *Wages* panel disagreed with the Third Circuit's parsing of the words of the statute in *Scarborough* because it disregarded the Bankruptcy Code's definition of "debtor's principal residence" in section 101(13A). That term "means a residential structure, including incidental property, without regard to whether that structure if used as the principal residence by the debtor, is attached to real property." 11 U.S.C. § 101(13A). Accordingly, the *Wages* court concluded that the definition does not equate the term "real property" with "debtor's principal residence" and, therefore, an analysis which equates the two is misplaced. 508 B.R. at 166. The *Wages* panel adopted the

bright line approach taken by the bankruptcy court in *In re Macaluso*, 254 B.R. 799, 800 (Bankr. W.D.N.Y. 2000), which held that the anti-modification exception in section 1322(b)(2) applies to any property that is used as the debtor's principal residence (notwithstanding the fact that the debtor's property in that case included a second residential unit and a store). In doing so, the *Wages* court adopted an objective rule – either a property is a debtor's principal residence or it is not. 508 B.R. at 167.

2. Sections 1115(a) and 1129(b) -- Absolute Priority Rule

The United States Supreme Court's decision in *Norwest Bank Worthington v. Ahlers,* 45 U.S. 197 (1988), held that the absolute priority rule applied in that individual chapter 11 case. However, post BAPCPA, in order for a plan to be fair and equitable, it must provide that "[t]he holder of any claim or interest that is junior to the claims of such [dissenting] 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 (a)(15) of this section.*" 11 U.S.C. § 1129(b)(2)(B)(ii) [BAPCPA amended language highlighted].

BAPCPA also amended prior law by including, as property of the estate, the debtor's post-petition personal service income and other property acquired during the case up to closing, dismissal or conversion. *See* 11 U.S.C. § 1115. After BAPCPA became effective, courts have differed as to whether BAPCPA eliminated the absolute priority rule in individual chapter 11 cases.

There are two views concerning the effect of sections 1129(b)(2)(B)(ii) and 1115, combined, on the absolute priority rule: the broad view (absolute priority rule is abrogated) and

the narrow view (absolute priority rule is preserved). The broad view is that section 1115 encompasses all estate property, including post-petition section 541 property and post-petition earnings, as well as all other section 541 pre-petition and other property. The narrow view holds that section 1115 property is only post-petition section 541 property and post-petition earnings.

Proponents of the narrow rule (most of the later cases and the Sixth and Tenth Circuits) in general find the statutory language to be ambiguous. They note that abrogation of the absolute priority rule would change the careful balance of the working of the bankruptcy code. The courts agree that "if Congress intended to make a 'momentous change' in the law by eliminating the absolute priority rule, a central principle of chapter 11 reorganization theory and practice, for individual chapter 11 debtors, it would have merited at least a mention in the legislative history, which is silent on the issue." *In re Arnold*, 471 B.R. 578, 612 (Bankr. C.D. Cal. 2012). *See also In re Ice House Am., LLC v. Cardin*, 751 F.3d 734 (6th Cir. 2014); *In re Lively*, 717 F.3d 406 (5th Cir. 2013); *In re Stephens*, 704 F.3d 1279 (10th Cir. 2013); *In re Maharaj*, 681 F.3d 558 (4th Cir. 2012); *In re Lee Min Ho Chen*, 482 B.R. 473 (Bankr. D.P.R. 2012); *In re Martin*, 497 B.R. 349 (Bankr. M.D. Fla. 2013); *In re Kamell*, 451 B.R. 505 (Bankr. C.D. Cal. 2011); *In re Gbadebo*, 431 B.R. 222 (Bankr. N.D. Cal. 2010); *In re Lucarelli*, 2014 WL 4388250 (Bankr. D. Conn. 2014); *In re Tucker*, 2011 WL 5926757 (Bankr. D. Or. 2011); *In re Borton*, 2011 WL 5439285 (Bankr. D. Idaho 2011); *In re Lindsey*, 453 B.R. 886 (Bankr. E.D. Tenn. 2011); *In re Draiman*, 450 B.R. 777, 820-22 (Bankr. N.D. Ill. 2011); *In re Walsh*, 447 B.R. 45, 47-49 (Bankr. D. Mass. 2011); *In re Stephens*, 445 B.R. 816, 820-21 (Bankr. S.D. Tex. 2011); *In re Karlovich*, 456 B.R. 677 (Bankr. S.D. Cal. 2010); *In re Steedley*, 2010 WL 3528599 (Bankr. S.D. Ga.

2010); *In re Gelin*, 437 B.R. 435 (Bankr. M.D. Fla. 2010); and *In re Mullins*, 435 B.R. 352, 359-61 (Bankr. W.D. Va. 2010).

Proponents of the broad view claim that the language of section 1115 is unambiguous, and that the language Congress inserted was lifted from chapter 13 which has no absolute priority rule equivalent. In addition, because the new disposable income requirement of section 1129(a)(15) (resembling the language of section 1325(b)(1)) requires the contribution of post-confirmation disposable income, Congress could not have meant that the debtor would not have access to Section 541 assets, since in most instances the debtors need such assets to comply with the new section 1129(a)(15) requirements. Those cases further note that it is clear that Congress intended to bring individual chapter 11 cases more in line with chapter 13 based on the sheer number of similar chapter 13 provisions that were incorporated into chapter 11 (*e.g.* section 1322(a)(1) (new section 1123(a)(8)); section 1325(b)(1) (new section 1129(a)(15)); section 1328(a) (new section 111(d)(5)(A)), section 1328(b) (new section 1141(d)(5)(b)) and section 1329(a) (new section 1127(e))). S*ee In re Shat*, 424 B.R. 854 (Bankr. D. Nev. 2010); *In re Tegeder*, 369 B.R. 477 (Bankr. D. Neb. 2007); *In re Rodemeier*, 374 B.R. 264 (Bankr. D. Kan. 2007); *In re Johnson*, 402 B.R. 851 (Bankr. N.D. Ind. 2009); *In re Friedman*, 466 B.R. 471 (B.A.P. 9th Cir. 2012). *In re O'Neal*, 2013 Bankr. LEXIS 1531, 3637 (Bankr. W.D. Ark. 2013), *SPCP Group, LLC v. Biggins*, 465 B.R. 316 (M.D. Fla. 2011); *In re Bullard*, 359 B.R. 541 (Bankr. D. Conn. 2007) and *In re Sample*, 2013 WL 3759795 (Bankr. D. Ariz. 2013).

See discussion below regarding issues related to exemptions.

Issues regarding the narrow view.

The narrow view also raises other potential issues.

First, creative debtors can argue that the absolute priority rule has no application to an individual debtor because the debtor's ownership in property is not a "claim or interest" against or in a debtor and an individual debtor does not retain his ownership of property under a plan, "*on account*" of any such junior claim or interest, as such italicized terms are used in section 1129(b)(2)(B)(ii). Section 541(a)(6) exempts "earnings from services performed by an individual debtor after the confirmation of the case" from property of the estate. *See Toibb v. Radloff*, 501 U.S. 157 (1991). Section 1115 did not change section 541(a)(6). In *In re FitzSimmons*, 725 F.2d 1208 (9th Cir. 1984), the Ninth Circuit held that section 541(a)(6) "excepts from the proceeds of the estate only those earnings generated by services personally performed by the individual debtor." *Id.* at 1211. Contrast this with *In re Harp*, 166 B.R. 740 (Bankr. N.A. Ala. 1993), which found that "[a]ll the earnings of an enterprise during bankruptcy, regardless of the source, must of necessity be "an interest in property" acquired by the estate." *Id.* at 752.

Second, debtors have argued that the BAPCPA amendments applicable to individual debtors violate the Thirteenth Amendment's prohibition against involuntary servitude. U.S. Const. amend. XIII. Prior to BAPCA, confirmation of plans providing for payment from future services was denied. *See Northwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988). Under the new law, however, not only are post-petition earnings property of the estate, but a debtor is compelled to use those earnings to fund a chapter 11 plan. This can be constitutionally troubling, particularly since an individual can be placed into a chapter 11 involuntarily, has no absolute

right to dismiss or convert his chapter 11 case, and may be forced to comply with the requirements of a plan submitted by creditors. *See* Keach, Robert, *Dead Man Filing Redux: Is the New Individual Chapter Eleven Unconstitutional?*, 13 Am. Bankr. Inst. L. Rev. 483 (Winter 2005).

In re Gordon, 465 B.R. 683 (Bankr. N.D. Ga. 2012), held that it was constitutional to convert an individual's chapter 7 case to a chapter 11 case, although the *Gordon* court found that the issue of constitutionality was not ripe as to any potential consequences of such conversion, such as a creditor filing a plan requiring the debtor to work or to pay projected disposable income into the plan for five years, since those consequences had not yet occurred. Interestingly, the court noted that when the party has a choice, even though it is a painful one, there is no involuntary servitude. *Id.* at 701.

Finally, in the event a plan cannot be confirmed because it violates the absolute priority view, query whether the debtor can provide "new value" in the form of services in order to retain his interest in the pre-petition property in the form of "sweat equity," trade secrets, or distribution of other exempt property in light of *Ahlers*, 485 U.S. at 204 (promise of future services in context of new value is unenforceable)?

A recent case has held that a new value plan, where the debtor retained equity interests in estate property because the debtor's family members were contributing new value, was confirmable. *In re Eagan*, 2013 WL 237812 (Bankr. W.D.N.C. 2013); *see also In re Henderson*, 341 B.R. 783, 790-91 (M.D. Fla. 2006) (confirming a plan where the debtor retained assets having a market value of $410,600 and a liquidation value of $212,500 based on a contribution

of $525,000 by a non-debtor spouse); *In re Draiman*, 450 B.R. 777 (Bankr. N.D. Ill. 2011) (new value exception satisfied by business associate providing $100,000.).

But in *In re Tucker,* Chief Bankruptcy Judge Alley in applied *Ahlers* without reference to Section 1123(a)(8) in rejecting the debtor's tender of future salary as new value. *See also In re Kamell*, 451 B.R. 505, 510 (Bankr.C.D.Cal. 2011) (questioning whether "such a momentous change" as overruling *Ahlers* would "have at least merited a mention in the legislative history.")

3. Section 1129(a)(3) -- Good Faith

Prior to BAPCPA, courts often found that unless a debtor contributed post-petition earnings to fund a plan, the plan might not satisfy the good faith standard, and were particularly troubled by excess or lavish spending. *See, e.g., In re Kemp*, 134 B.R. 413 (Bankr. E.D. Cal. 1991); *In re Brotby*, 303 B.R. 177 (B.A.P. 9th Cir. 2003); *In re Weber*, 209 B.R. 793 (Bankr. D. Mass. 1997). Although now, pursuant to section 1123(a)(15), the amount of contribution of post-petition earnings is specified, there is still no guarantee that such contribution, in and of itself, is enough to carry a finding of good faith.

4. BAP Precedent -- Absolute?

The Ninth Circuit BAP has said that its decisions are binding on all bankruptcy courts in the Ninth Circuit. *In re Windmill Farms*, 70 B.R. 618, 622 (B.A.P. 9th Cir. 1987). The Ninth Circuit itself has ruled only that BAP decisions are controlling authority in the district where the case was originally heard, unless the U.S. District Court in that district has ruled differently. *Bank of Maui v. Estate Analysis, Inc.* 904, F.2d 470, 472 (9th Cir. 1990). Notwithstanding, because bankruptcy judges generally appreciate that the establishment of BAP is to create

consistency, if a BAP decision is on point, the judges generally defer to the decision regardless of the district in which the case was heard.

On the issue of the abrogation of absolute priority in individual chapter 11 cases, however, a bankruptcy court in the central district of California declined to follow the BAP decision as to the "broad view" in *In re Friedman*, 466 B.R. 471 (B.A.P. 9th Cir. 2012). *See In re Arnold*, 471 B.R. 578 (Bankr. C.D. Cal. 2012).

In a 2013 Arizona case, *In re Sample*, 2013 WL 3759795 (Bankr. D. Ariz. 2013), Judge Collins discusses the history of BAP precedent, and notes that since *Friedman* was originally heard in the District of Arizona and there is no published Arizona District Court case to the contrary, the BAP decision is binding on the court, notwithstanding that he personally favors the dissenting opinion of Judge Jury in *Friedman*.

5. Exemption

One of the interesting questions presented by the BAPCPA amendments in individual chapter 11 cases is whether the debtor's attempted retention of property that is exempt is a violation of the absolute priority rule. As was the case with whether the absolute priority rule exists in individual chapter 11 cases, this issue has also caused a conflict among some of the decisions considering it.

For example, in *In re Egan*, 142 B.R. 730 (Bankr. E.D. Pa. 1992), the debtors' plan did not provide for any payments to unsecured creditors, while the debtors claimed exemptions for property they were retaining. Most of the unsecured creditors voted against the plan but none filed separate objections. The bankruptcy court observed: "if debtors intend to retain only exempt property, then they are merely retaining that which is their absolute right to retain in any

event, and they are not, properly speaking, receiving or retaining 'any interest that is junior to the interests' of any class of creditors, 11 U.S.C. § 1129(b)(2)(B)(ii), including the class of unsecured creditors." 142 B.R. at 733. *See also In re Henderson*, 321 B.R. 550, 561 (Bankr. M.D. Fla. 2005) ("Henderson"); aff'd, *VanBuren Indus. Investors v. Henderson* (In re Henderson), 341 B.R. 783 (M.D. Fla. 2006) (individual debtor can retain exempt property without violating absolute priority rule because once a debtor's claim of exemptions is allowed, the property is no longer property of the estate). However, in *Henderson* the court noted that issues as to the unfairness of the debtor's retention of $3.5 million of exempt property (including their unlimited homestead exemption) should be dealt with as a question of good faith under section 1129(a)(3). *Henderson*, 321 B.R. at 560.

The trial court in the original *Maharaj* case, 449 B.R. 484 (Bankr. E.D. Va. 2011), indicated that allowing an individual chapter 11 debtor to retain exempt property in a plan under section 1129(b) was consistent with the correct reasoning in the *Egan* decision and was also correct in light of section 1123(c). Id. at 493 n.4.

See also In re Shin, 306 B.R. 397, 404 n. 17 (Bankr. D.D.C. 2004) (relying on West's Bankruptcy Law Letter (October 2002)) ("to apply the absolute priority rule to an individual debtor's wholly exempt property stands the absolute priority rule on its head – affording to unsecured creditors an artificial 'priority' in exempt property that unsecured creditors simply do not otherwise possess"); *In re Brotby*, 303 B.R. 177, 195-96 (B.A.P. 9th Cir. 2003) (a contribution from an exempt pension would constitute new value); *Collier on Bankruptcy* ¶ 1129.03[4][c] (16th ed. rev. 2014); *In re Bullard*, 358 B.R. 541, 544-545 (Bankr.D.Conn. 2007); *In re Steedley*, 2010 WL 3528599 (Bankr.S.D.Ga.2010).

In *In re Grosman*, 282 B.R. 45 (Bankr. S.D. Fla. 2002), the court reached a contrary result. There, the debtor's plan proposed limited payments to the unsecured creditors while keeping the exempted assets. The bankruptcy court denied the approval of the disclosure statement because the plan lacked feasibility (thereby denying confirmation) and found: "[t]here can be no question that the Debtor in this case is a 'holder of an interest that is junior' to the claims of unsecured creditors . . . [because] Debtor owns an interest in the Exempt Property." 282 B.R. at 48. The *Grosman* court also ruled that the section 1129(b)(2)(B)(ii) reference to including "any property" prevents a debtor from retaining exempt or non-exempt property without paying the value of all such property to creditors.

6. Discharge Issues

Under section 1141(d)(5), an individual does not receive a discharge upon confirmation, but receives it only until all plan payments are completed. This will generally take five years. Individual debtors should move to close their cases under Section 350 as soon as the elements of the Advisory Committee Note to Fed.R.Bankr.P. 3022, which implements Section 350, have been met. The Note provides:

Entry of a final decree closing a chapter 11 case should not be delayed solely because the payments required by the plan have not been completed. Factors that the court should consider in determining whether the estate has been fully administered include (1) whether the order confirming the plan has become final, (2) whether deposits required by the plan have been distributed, (3) whether the property proposed by the plan to be transferred has been transferred, (4) whether the debtor or the successor of the debtor under the plan has assumed the business or

the management of the property dealt with by the plan, (5) whether payments under the plan have been commenced, and (6) whether all motions, contested matters, and adversary proceedings have been finally resolved.

The United States Trustee Program has indicated it will not object to an individual chapter 11 debtor's request to close before discharge, subject to reopening for discharge upon completion of plan payments if the estate has been fully administered and any trustee has been discharged. See Walter W. Theus, Jr., Individual Chapter 11s: Case Closing Reconsidered, 29 Am. Bankr. Inst. J. 1, 62 (Feb. 2010).

Case law to date goes both ways on whether early closing subject to reopening is appropriate. *See, e.g., In re Mendez*, 464 B.R. 63 (Bankr.D.Mass. 2011) (authorizing closing); *In re Kerley*, 2011 WL 5330667 (Bankr.N.D.Ala. 2011) (denying closing).

In light of the Theus Article, the court in *In re Mendez*, was "persuaded that an individual Chapter 11 case need not remain open during the entire post-confirmation period only because a discharge has not entered and plan payments have not been completed," even though the reason for closing the case was to avoid having to continue paying U.S. Trustee's fees. 464 B.R. 65. However, the court in Mendez recognized some complications. First under section 362(c)(2)(A), the closing of the case would terminate the automatic stay, even though the discharge injunction was not yet in place. Further, if the automatic stay terminated, this would end the tolling of unexpired nonbankruptcy statutes under section 108(c). Therefore, both debtors and creditors could be harmed if the case were closed without dealing with these issues. Second, the court referenced the notice of no discharge required to be issued by the clerk of the court under Fed. R. Bankr. P 4006, and the court thought that would be misleading because the debtor planned on

reopening the case and receiving a discharge upon the closing of a case. Id. at 66-67. Therefore, the court invoked section 105(a) and ordered that the automatic stay pursuant to Bankruptcy Code § 362 remain in place and ordered that the clerk not issue the 4006 notice. Id.

By contrast, the court in *In re Kerley* rejected the approach of the Mendez court in significant measure because it viewed the provisions of sections 362(c)(2)(A) and 108(a) and Fed. R. Bankr. P. 4006 as indications that Congress did not intend chapter 11 cases for individual debtors to be closed prior to discharge. The court also noted that it believed the 1991 Advisory Committee Note to Fed. R. Bankr. P. 3022 was still applicable to chapter 11 cases for individuals after BAPCPA. In addition, the court in *Kerley* was concerned that the cost of reopening a closed case (including attorney's fees) might preclude creditors from moving for modification of a confirmed plan or dismissal on default. 2011 WL 5330667 (Bankr.N.D.Ala. 2011)

In addition to closing and reopening the case, 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 that, after notice and hearing ten days before discharge, section 522(q) provisions relating to securities law crimes are not applicable (note that the debtor does not have to have been convicted).

7. Modification

Pursuant to section 1127(e), if a debtor is an individual, a confirmed chapter 11 plan for may be modified on the request of the debtor, the trustee, the UST or the holder of an unsecured claim, even after substantial consummation, to increase or reduce payments on claims of a

particular class, or extend or reduce the time period for such payments, or alter the amount of distribution to a creditor that has received payments other than under the plan. Section 1127(e) is substantially similar to section 1329(a) (prior to BAPCPA).

Subsection (f)(1) of section 1127 sets forth the tests the court is to apply to a proposed post-confirmation modification of an individual chapter 11 debtor's plan, i.e., it must comply with sections 1121 through 1129, and there must be such disclosure under section 1125 as the court may direct, notice and a hearing, and court approval. Neither section 1127(e) nor (f) imposes any requirement like "good cause." However, through reference to section 1129, they appear to impose a "good faith" requirement on plan modifications.