Individual Chapter 11 Confirmation Mock Hearing

Hon. Laurel M. Isicoff, Moderator
U.S. Bankruptcy Court (S.D. Fla.); Miami

Hon. A. Jay Cristol
U.S. Bankruptcy Court (S.D. Fla.); Miami

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Hon. Brian K. Tester
U.S. Bankruptcy Court (D. P.R.); San Juan

INDIVIDUAL CHAPTER 11 CONFIRMATION MOCK HEARING

Litigants

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Bench

Honorable A. Jay Cristol, U.S. Bankruptcy Court (S.D. Fla.); Miami, Florida

Honorable Brian Tester, U.S. Bankruptcy Court (D. P.R.); San Juan, Puerto Rico

Moderator

Honorable Laurel M. Isicoff, U.S. Bankruptcy Court (S.D. Fla.); Miami, Florida

A. **Facts**

1. In 2010, John Suds opened Stache Brewery, a microbrewery, in Hoplandia. Fresh out of the University of Hoplandia Professional Brewing Program, Mr. Suds obtained (1) a loan from Wells Fargo secured exclusively by the real property of Stache ($250,000 principal; interest only at 7% APR; maturity in 2020) and (2) a loan from GE Capital secured by Stache's brewing equipment, inventory and accounts ($100,000 principal; interest only at 15% APR; maturity in 2020).

2. Mr. Suds could not afford "fancy New York corporate lawyers" and opened Stache as a sole proprietorship. To save money, Mr. Suds converted the brewery's attic into a living space and made it his sole residence. The attic accounts for 25% of the brewery's square footage.

3. Stache Brewery became immensely popular in Hoplandia for its West Coast style IPAs renowned for their copious use of fresh Centennial and Cascade hops. Stache also perfected a technically difficult triple IPA beer, called *Plato the Blind*, that was released only once a year and had developed a huge cult following. To accomplish this feat, Mr. Suds meticulously customized his brewery equipment and brew kettles to such an extent even his fellow brewmasters have no idea how it operates.

4. Because of its cult status and limited availability, the most recent batch of *Plato the Blind* sold out in record time and at premium prices, as local beer snob bars engaged in a bidding war over the rare kegs.

5. To help manage this sudden influx of cash, Mr. Suds engaged a local branch of a well-known national investment planning firm, Bimini Bob's Barely Legal Brokerage. After looking at the revenues from the last batch of *Plato the Blind*, Bimini Bob invested a portion of Mr. Suds's *Plato* revenues in an off-shore foreign currency structure as a way to defray Mr. Suds's tax bill.

6. In explaining the investment, Bimini Bob noted that, if an IRS audit were to challenge the off-shore investment, Mr. Suds could be hit with a higher tax assessment down the road. But, for the 2013 year, it would mean that Mr. Suds would pay $200,000 less in taxes. Mr. Suds told Bimini Bob that he did not understand all that accountants' lingo, but if it meant he could keep more of his money, he was all for it.

7. When Mr. Suds signed his tax return for 2013, prepared by Bimini Bob, he reported a small net loss for the Stache Brewery operations, despite the hugely successful release that year of *Plato the Blind*, which was largely offset by "losses" sustained as a result of the Bimini Bob investment.

8. Mr. Suds was able to pay off his student debt. However, rather than pay down his business loans with his new found wealth, Mr. Suds invested in an amateur vintage racecar team to compete for the Brewer's Cup—proudly advertising that his team was sponsored by Stache Brewery. During the racing season, Mr. Suds' race crew would trailer his 1957 Ferrari 250 Testarossa to race tracks throughout the country. Mr. Suds was the driver and would fly to meet his team on race day. Mr. Suds spent approximately $25,000 per month on racing expenses. Mr.

Suds believes that his racing sponsorship has led to numerous new distributorship agreements in each of the cities that hosted the Brewer's Cup.

9. Mr. Suds won his first Brewer's Cup. After celebrating with this team, he decided to drive back to Hoplandia rather than fly. Unfortunately, Mr. Suds was pulled over by the HPD and arrested for DUI.

10. Mr. Suds hired Hoplandia's best criminal defense attorney, a partner at Dewey LLP that charges $1,250 per hour. Mr. Suds' criminal defense legal fees are approximately $50,000 per month. Mr. Suds pled not guilty and is scheduled to be tried at some point in the future. If Mr. Suds is convicted of the DUI offense, the Stache Brewery liquor license may be revoked by Hoplandia. But Mr. Suds is mainly concerned that a conviction may lead to a severe sentence which he is determined to avoid. If convicted, he faces a sentence of up to 5 years in jail because this would be his second DUI conviction. Mr. Suds is also worried about the possible imposition of significant fines or penalties.

11. Shortly the DUI arrest, Mr. Suds was in fact audited by the IRS and was assessed a $250,000 deficiency for over-reporting losses on his 2013 return. Faced with his legal bills from the DUI, Mr. Suds did not have the cash to pay the tax deficiency. Instead, he hoped to pay it off after he sold the next year's batch of *Plato the Blind*.

12. Mr. Suds continued to make poor decisions. He limited the production of his wildly popular IPAs and branched out to oatmeal stouts, other sweeter and maltier ales, and some experimental black lagers. Misinterpreting the market, Stache's financials went into a tailspin. Despite becoming insolvent on a cash flow basis and having to tap into his savings to pay his bills, Mr. Suds continued to fund his racing team's monthly expenses, flying first class to the races.

13. Eventually, Mr. Suds saw the caution flag and made a pit stop in bankruptcy. Mr. Suds filed an individual chapter 11 case in Hoplandia.

14. In Hoplandia, a chapter 11 individual debtor has the right to claim certain exemptions, including an exemption for "commercial" motor vehicles valued up to $250,000. Prior to the bankruptcy, Mr. Suds's attorney counseled him to install a towing hitch to his Ferrari so that he could assert the vehicle was used for Stache beer deliveries.

15. Mr. Suds disclosed in his disclosure statement and monthly operating reports that he continued to pay his racing team's monthly expenses postpetition, which to date amount to $200,000. Mr. Suds also disclosed that during a postpetition race, Mr. Suds totaled his race car (valued at $250,000) and purchased a replacement vehicle (also valued at $250,000) in cash from Stache Brewery's operating account. Mr. Suds did not seek bankruptcy court approval for these expenses. Unfortunately, Mr. Suds' insurance policy doesn't cover race cars. Mr. Suds timely filed his monthly operating reports, but nobody objected to, or raised a concern with, his monthly expenditures.

16. Mr. Suds filed a chapter 11 plan, the terms of which are set forth below. Each class accepted the plan except class 2 (Wells Fargo) and class 4 (unsecured claims).

17. Class 4 consists of Stache Brewery's trade creditors, most of whom are supportive of Mr. Suds' efforts to keep his business. Seedy, a hop supply company, is owed $78,000 and is adamantly opposed to the plan. Seedy **objects** to the treatment of its claim, arguing, among other things, that it is unfair that Mr. Suds gets to retain his personal property, including his brewery equipment and race cars, while Seedy only receives 40% of its claim over a number of years. Seedy also **rejects** the plan and his claim is large enough to control the vote of Class 4 creditors.[1] Mr. Suds believes that Seedy has secret plans to enter the brewing business and introduce its own triple hopped IPA.

18. Further, Mr. Suds filed an adversary proceeding seeking to discharge the $250,000 tax assessment under the 2013 IRS audit. In response, the U.S. Attorney, on behalf of the IRS, has alleged that a discharge is not available because Mr. Suds willfully attempted to evade or defeat the tax liability by knowingly investing in Bimini Bob's bogus tax shelter scheme and through lavish personal spending of his assets.

19. Mr. Suds plans to revive Stache Brewery with some ideas he has been tinkering with since he filed his chapter 11 case, especially a new creative process for making *Plato the Blind* that will make it available year round and could prove enormously lucrative. Without Stache Brewery's customized kettles and other unique equipment and processes, as well as Mr. Suds' new ideas and experience, however, Mr. Suds' dream to improve and expand the *Plato* brand will wither and die. Mr. Suds estimates the cost to develop and produce the next generation *Plato the Blind* at $100,000 per year. However, the upside potential is unknown.

B. Plan Terms

1. Classification of Claims and Interests:

Class	Name	Result
Class 1	Administrative Expenses	Unimpaired
Class 2	Wells Fargo	Impaired/Rejecting
Class 3	G E Capital	Impaired/Accepting
Class 4	Unsecured Claims	Impaired/Rejecting

Class 1 -Administrative Expenses

Class 1 consists of compensation of professional persons upon approval by the Court pursuant to sections 330 and 331. These allowed claims will be paid in full upon entry of an order allowing such claim. However, upon confirmation of the Plan, the debtor is authorized to pay his criminal defense attorney's fees in full in the amount of $250,000 without further application to the Court.

[1] *See, e.g., In re Brown,* 505 B.R. 638, 641 (E.D. Pa. 2014) ("Because [creditor's] claim exceeds the one-third threshold, he holds a 'blocking position' pursuant to § 1126(c), that is, without his consent, the plan cannot be approved.") (citation omitted).

Class 2 -Wells Fargo

Wells Fargo has a secured claim against the debtor's residence in the amount of $250,000. Wells Fargo's claim is allowed in the amount of $200,000. This amount, together with interest thereon at the rate of 5% per annum, shall be paid in 180 equal monthly payments of approximately $1,500.00 each. The first payment shall be made on or before July 1, 2015, with subsequent payments to be made on or before the 1st day of each and every month thereafter until the allowed claim is paid in full.

Class 3 - GE Capital

GE Capital has a secured claim against the debtor's personal property in the amount of $50,000. This amount, together with interest thereon at the rate of 5% per annum, shall be paid in 60 equal monthly payments of approximately $900 each. The first payment shall be made on or before July 1, 2015, with subsequent payments to be made on or before the 1st day of each and every month thereafter, until the allowed claim is paid in full.

Class 4- Unsecured Claims

This class includes all unsecured claims, including the Wells Fargo deficiency claim, except those specifically treated elsewhere in this Plan. To be included within this class, unsecured creditors must timely file a proof of claim or be listed in the schedules as undisputed. Any claims that are disputed which are not filed by the claims date shall be barred. All claims uncontested by the Debtor as well as contested claims approved by the Court in this class shall be paid from Stache Brewery's post-confirmation net profits. Stache estimates that creditors will receive an approximate 40% recovery over 5 years payable in annual installments.[2] The Plan also provides for a 15% bonus distribution from the proceeds of an exclusive distributorship agreement if Stache Brewery is successful in making a year round *Plato the Blind.* Payments shall be made every year beginning July 1, 2016.

2. Retention of Property

Mr. Suds will retain all property of the estate. Property that is not needed will be abandoned or sold and the proceeds applied to the appropriate secured creditor's claim, whichever is deemed appropriate by Mr. Suds.

[2] The Plan meets the requirements of section 1129(a)(15) because it devotes the projected disposable income of Stache Brewery over the 5-year period beginning July 1, 2015, even though Stache Brewery assumes significant start-up costs to perfect its new *Plato the Blind* release (costs estimated at $100,000 per year). The Plan also satisfies the requirements of section 1129(a)(7) because a liquidation of the Stache Brewery kettles and equipment would be less than the estimated 40% dividend from future income.

C. Confirmation Issues

1. § 1123(b)(5) - Anti-Modification Provision

Wells Fargo objects to the treatment of Class 2. Wells Fargo's claim is secured by the debtor's residence, which is also the brewery, but the debtor proposes to modify Wells Fargo's claim by reducing the principal and interest rate.

Compare In re Wages, 508 B.R. 161 (9th Cir. B.A.P. 2014) (adopts bright-line approach that anti-modification exception applies to any loan secured only by real property that the debtor uses as a principal residence property, even if that real property also serves additional purposes) *with Scarborough v. Chase Manhattan Mortg. Corp. (In re Scarborough),* 461 F.3d 406 (3d Cir. 2006) (focusing on Congress' use of the word "is" in the phrase "real property that is the debtor's principal residence," and finding 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).

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

The Plan permits Mr. Suds to retain all property of the estate. This includes his *pre-petition* interest in the brewery equipment, recipes and other trade secrets. In addition, the Plan allows Mr. Suds to retain his replacement race car and racing gear and equipment, among other exempt property.

Trade creditor Seedy objected to the Plan on the basis that, among other things, the Court in Hoplandia should adopt the majority view that the absolute priority rule applies to chapter 11 individual debtors and that the Plan violates the absolute priority rule because Mr. Suds intends to retain ownership of his personal property while Seedy is paid only 40 cents on the dollar. Seedy asserts that Mr. Suds' improved technique for making *Plato the Blind* could itself fetch over $100,000 if it were sold to a competing brewery. Without his know-how, however, Stache Brewery would likely not be able to compete against Hoplandia's many local craft brewers and would definitely not generate the profits needed to make a 40% dividend (nor, naturally, the 15% bonus payment from the distributorship agreement).

Does the absolute priority rule apply to individual chapter 11 plans in Hoplandia? If so, does application of the absolute priority rule prohibit Mr. Suds from also retaining his exempt property?

Compare In re Ice House America, LLC v. Cardin, 751 F.3d 734 (6th Cir. 2014) (adopting majority narrow view that absolute priority rule applies to chapter 11 individual debtor); *In re Lively,* 717 F.3d 406 (5th Cir. 2013) (same); *In re Stephens,* 704 F.3d 1279 (l0th Cir. 2013) (same); *In re Maharaj,* 681 F.3d 558 (4th Cir. 2012) (same) *with In re Friedman,* 466 B.R. 471 (9th Cir. B.A.P. 2012) (adopting minority broad view that BAPCPA amendments abrogated absolute priority rule as applied to chapter 11 individual debtors).

See also In re Gosman, 282 B.R. 45 (Bankr. S.D. Fla. 2002) (exempt property must be devoted to debtor's chapter 11 plans); *but see In re Henderson,* 321 B.R. 550, 561 (Bankr. M.D. Fla. 2005); *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).

3. §§ 363(c)(l) and 1129(a)(2)-(4) - Living Expenses & Defense Counsel

Mr. Suds continued to fund his race team postpetition. Trade creditor Seedy objected to the Plan on the basis that the Plan was not proposed in good faith because such expenses were outside the ordinary course of business and Mr. Suds did not seek bankruptcy court approval.

Consider § 363(c)(1) and the ability to use estate assets to pay ordinary course living expenses. *See In re Seely,* 492 B.R. 284 (Bankr. C.D. Cal. 2013) (payment of ordinary course living expenses should be treated as being within the debtor's ordinary course of business for the purpose of interpreting section 363(c)(1)); *In re Hawkins,* 769 F.3d 662 (9th Cir. 2014) (debtor's prepetition lavish lifestyle and expenditures beyond his earned income did not qualify as a willful attempt to evade or defeat taxes under section 523(a)(l)(c)).

What factors do courts use to evaluate whether an expense is "ordinary" rather than unusual or extraordinary? Is it proper to adopt the horizontal dimension test (industry standard) and vertical dimension test (creditor expectations) articulated by *In re Dant & Russell, Inc.,* 853 F.2d 700 (9th Cir. 1988) (execution of leases was in the ordinary course of business)?

The Plan also seeks to pay Mr. Suds' criminal defense attorney for services rendered postpetition to Mr. Suds in connection with defending his DUI charges. Mr. Suds's criminal defense attorney was not retained under the Bankruptcy Code. Mr. Suds also periodically paid his criminal defense attorney's fees during the pendency of the chapter 11 case.

Trade creditor Seedy also objected to the Plan because it does not satisfy section 1129(a)(4), insofar as it contemplates the payment of legal fees from property of the estate to an attorney that was not retained with the approval of the Court.

Does engaging a criminal defense attorney provide the requisite benefit to the estate to be proper under sections 327 and 330? *In re Miell,* 2009 U.S. Dist. LEXIS 73757 (N.D. Iowa, Aug. 19, 2009) (section 330(a)(4)(B) does not permit payment of a debtor's attorney in a chapter 11 case); *In re Weaver,* 336 B.R. 115 (Bankr. W.D. Tex. 2005) (general counsel was not entitled to be compensated by estate for time spent in dealing with exempt property); *In re Polishuk,* 258 B.R. 238 (Bankr. N.D. Okla. 2001) (attorney representing debtor in state court divorce action was entitled to be compensated from estate for time spent in trial of divorce action and in obtaining equitable distribution of marital property, but not for litigating child support and custody issues, given lack of any

real "benefit" from such services to estate); *In re Dixon,* 2010 WL 3767604 (Bankr. N.D. Ca. 2010) (chapter 11 counsel may not defend exemptions because they are against the interests ofthe estate); *but see In re Warner,* 141 B.R. 762 (M.D. Fla. 1992) (district court found no abuse of discretion in the bankruptcy court's authorization of payment of criminal defense attorneys out of the bankruptcy estate, pursuant to section 327(e)).

4. §§ 1129(a)(2) and (3) - Defense of Exemption

Sections 1129(a)(2) and (3) provide that:

The court shall confirm a plan only if "(2) [t]he proponent of the Plan complies with the applicable provisions of this title" and "(3) [t]he plan has been proposed in good faith and not by any means forbidden by law."

Is counsel's failure to be disinterested and his representation of an interest materially adverse to the estate an appropriate objection to the confirmation of an individual Chapter 11 plan under subsections (a)(2) or (a)(3)? *See Weaver,* 336 B.R. 115 (dealing with attorney compensation); *Dixon,* 2010 WL 3767604 (same).

It is a fundamental principle of bankruptcy law that a trustee (or a debtor in possession exercising the powers of a trustee) is a fiduciary on behalf of the bankruptcy estate for the benefit of creditors, equity security holders and other interested parties. Counsel hired by the trustee represents the estate and not the principals or management of the debtor or the debtor individually. "While he must always take his directions from his client, where counsel for the estate develops material doubts about whether a proposed course of action in fact serves the estate's interests, he must seek to persuade his client to take a different course or, failing that, resign." *In re Perez,* 30 F.3d 1209, 1219 (9th Cir. 1994). The employment of counsel by a trustee (or a committee) is subject to stringent requirements under the Bankruptcy Code. 11 U.S.C. §§ 327, 1103. Only professionals retained under the applicable provisions of the Bankruptcy Code are entitled to compensation from property of the estate, subject to the court's review for reasonableness. 11 U.S.C. §§ 330, 503.

D. Tax Liability, Adversary Proceeding

11 U.S.C. § 523(a)(1)(C) states that a debtor may not discharge any tax debts with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax.

Courts are split as to what constitutes "willful" evasion of a tax liability for purposes of discharge. The 9th Circuit has recently adopted a narrow view similar to a fraud standard for "willfulness" requiring a specific bad act intent.[3] The 10th Circuit, on the other hand, has adopted a broader view, requiring only a finding that a debtor knew of the potential tax liability and acted intentionally in improperly evading that liability. Finally, the 5th

[3] "[M]ere knowledge of the tax consequences of an act, and no bad purpose" was not sufficient for a finding of "willfulness" under the § 523 standard to prevent a discharge. *Hawkins*, 769 F.3d 662 at 667.

Circuit takes perhaps the broadest view, applying a "totality of the circumstances" test to determine a debtor's mental state. *Compare Hawkins v. Franchise Tax Bd. of California*, 769 F.3d 662, 666 (9th Cir. 2014) (adopting a narrow interpretation of "willful" as requiring a specific mental intent to wrongfully evade taxes), *with In re Vaughn*, 765 F.3d 1174, 1180 (10th Cir. 2014) (adopting a broad interpretation of "willful" as requiring only a showing that debtor (1) had a duty to pay taxes, (2) knew he had such a duty, and (3) intentionally acted to violate that duty) *and United States v. Stanley*, 2014 WL 6997518, at *4 (5th Cir. Dec. 12, 2014) (adopting a "totality of the circumstances" test for the mental state element, which includes consideration of facts regarding lavish personal spending).

In keeping with its narrow interpretation of the "willfulness" standard, the 9th Circuit appears to constrict the range of evidence that may be considered as part of the mental state element to include only acts that are specifically linked, and only linked, to improper evasive purposes. Specifically, the 9th Circuit disagrees with the 10th Circuit, as well as the 5th, 6th, and 11th Circuits, as to whether facts regarding a debtor's lavish spending despite knowledge of an impending tax debt may be properly considered as part of a "willfulness" determination. *Compare Hawkins.* 769 F.3d at 669 (9th Cir. 2014) (a debtor spending beyond his means was mere negligence and did not rise to the level of willfulness), *with In re Vaughn*, 765 F.3d 1174, 1180 (10th Cir. 2014) (where debtor knew of a likely impending tax liability, continuing to spend unreasonably constituted a willful act to evade paying taxes).

Should Hoplandia adopt the narrow *Hawkins* interpretation of willfulness requiring a finding of bad act intent or the broader *Vaughn* interpretation that requires knowledge of an impending tax liability and a corresponding willful act, even without specific "bad act" intent? Further, should Hoplandia apply *Hawkins*'s limitation on the types of facts that may be considered as part of a mental state analysis, or instead use the 5th Circuit's *Stanley* "totality of the circumstances" standard?

Under either set of standards, does Mr. Suds' spending constitute a willful act to avoid taxes? Does Mr. Suds' participation in Bimini Bob's tax shelter constitute a willful act to evade taxes given his knowledge of the investment and the artificially low income reported on his 2013 return?

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UNITED STATES BANKRUPTCY COURT

DISTRICT OF HOPLANDIA

In re: JOHN SUDS, Debtor.	Case No.: 14-97513 Chapter 11

MEMORANDUM OF LAW IN SUPPORT OF CONFIRMATION OF PLAN OF REORGANIZATION PROPOSED BY DEBTOR

This memorandum of law (the "Memorandum of Law") is submitted pursuant to section 1129 of Title 11 of the United States Code (the "Bankruptcy Code") on behalf of John Suds ("Suds" or "Debtor"), as debtor and debtor in possession in the above-captioned chapter 11 case, in support of confirmation of the Plan of Reorganization Proposed by the Debtor, dated May 1, 2015 (as it may be amended from time to time, the "Plan").[1]

The Plan has the support of the Debtor and GE Capital. Only two objections to confirmation of the Plan were received. Both objections deal with discrete legal issues and for the reasons set forth below, neither forms a legitimate basis for the Court to deny confirmation. Specifically, Wells Fargo (Class 2) rejected the Plan and objects to confirmation of the Plan on the basis that it violates the anti-modification provisions of section 1123(b)(5). Trade creditor

[1] Capitalized terms used but not defined herein shall have the meanings ascribed to them in the Plan.

Seedy (Class 4) also voted against the Plan and objects to confirmation of the Plan on the basis that it violates the absolute priority rule.[2] Moreover, Seedy objects to the Plan on the basis it was proposed in bad faith, as evidenced by Mr. Suds' use of estate resources to maintain his customary lifestyle, including compensation to his criminal defense attorney in an effort to maintain Stache Brewery as a going concern (among other goals). For the reasons discussed below, these objections should be overruled and the Plan confirmed.[3]

FACTS

1. The pertinent facts are set forth in the Disclosure Statement approved on June 1, 2015, the Plan, the Declaration of John Suds in Support of Confirmation, the Declaration of Amber Keg Regarding Voting With Respect to the Plan of Reorganization Proposed by the Debtor, and any testimony that may be adduced at the Confirmation Hearing.

ARGUMENT

I. THE PLAN PROPONENTS WILL SATISFY THE BURDEN OF PROOF UNDER SECTION 1129 OF THE BANKRUPTCY CODE

2. To obtain confirmation of the Plan, the Debtor must demonstrate that the Plan satisfies the provisions of section 1129(a) of the Bankruptcy Code. The Debtor submits that the objections to the Plan raise issues of law that may be determined without further evidence or the resolution of factual disputes, to the extent there are any.

[2] After tallying the votes in Class 4, Class 4 has also rejected the Plan.

[3] For purposes of this chapter 11 case, the Debtor is not a "small business debtor" as defined by section 101(51D) because the United States trustee has appointed a committee of unsecured creditors pursuant to section 1102(a)(l). The Debtor did not seek an order that a committee not be appointed pursuant to section 1102(a)(3).

II. SECTION 1123(b)(5) PERMITS MODIFICATION OF WELLS FARGO'S CLAIM THAT IS SECURED BY A LIEN IN REAL PROPERTY THAT IS THE DEBTOR'S PRINCIPAL RESIDENCE AND BUSINESS

3. The issue presented is whether a claim secured by real property that includes the debtor's principal residence *as well as* other income-producing property is "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). Although this is a matter of first impression in Hoplandia, the Debtor urges this Court to adopt a standard that will allow an individual chapter 11 plan to modify claims secured by a mortgage on real property that is the debtor's principal residence when such property is also used for income-producing purposes.

4. The mortgage at issue may be modified because Wells Fargo holds a lien not only on property which serves as the Debtor's principal residence, but also on property which serves as the Debtor's business, Stache Brewery. Permissible modification includes the strip down of the lien to the value of the collateral.

5. Section 506(a) defines whether an allowed claim is secured or unsecured. It provides:

> An allowed claim of a creditor secured by a lien on property in which the estate has an interest ... is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, ... and is an unsecured claim to the extent that the value of such creditor's interest . . . is less than the amount of such allowed claim.

11 U.S.C. § 506(a)(l).

6. The normal rule in bankruptcy is that a claim 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). To the extent the collateral does not

support the claim, the claimant is unsecured. 11 U.S.C. § 506(a)(1); *In re Johns,* 37 F.3d 1021, 1023-24 (3rd Cir. 1994). In the instant case, Wells Fargo's $250,00 claim is being treated as a secured claim in the amount of $200,000, which is the current fair market value of the real property securing the claim.

7. Pursuant to section 506(d), the creditor's lien is void to the extent it is unsecured. The debtor is required by section 1129(b)(2)(A) to pay 100% of only the allowed secured portion of the claim. Use of section 506 in conjunction with sections 1123(b) and 1129(b)(2)(A) to reduce the secured claim to the value of the collateral has generally been called "strip down" and the process of modifying the rights of the secured creditor over its objection is referred to as "cram down." *See In re Ferandos,* 402 F.3d 147, 151 (3rd Cir. 2005).

8. Section 1123(b)(5) governs the contents of a chapter 11 plan and 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).

9. Under section 1123(b), debtors generally have the ability to modify secured claims in a chapter 11 plan. However, one exception is specified under section 1123(b)(5), which limits a debtor's ability to modify, through the provisions of a chapter 11 plan, the rights of the holder of a claim secured only by a security interest in real property that is a debtor's principal residence. This exception is known as the "anti-modification provision." *See In re Wages,* 508 B.R. 161 (9th Cir. B.A.P. 2014); *Scarborough v. Chase Manhattan Mortg. Corp. (In re Scarborough),* 461 F.3d 406 (3d Cir. 2006).

10. Based on the plain language of section 1123(b)(5), a creditor does not receive anti-modification protection for a claim secured by real property that includes both the debtor's principal residence and other income-producing property. By using the word "is" in the phrase "real property that *is* the debtor's principal residence," Congress equated the terms "real property" and "principal residence." Put differently, this use of "is" means that the real property that secures the mortgage must be only the debtor's principal residence in order for the anti-modification provision to apply. This interpretation is in line with the reasoning of the Bankruptcy Court for the District of Connecticut when it noted that section 1322(b)(2)—the chapter 13 parallel to section 1123(b)(5)[4]—"protects claims secured only by a security interest in real property that is the debtor's principal residence, not real property that includes or contains the debtor's principal residence, and not real property on which the debtor resides." *In re Adebanjo,* 165 B.R. 98, 104 (Bankr. D. Conn. 1994). A claim secured by real property that is, even in part, not the debtor's principal residence does not fall under the terms of section 1123(b)(5). Consequently, "real property which is designed to serve as the principal residence not only for the debtor's family but for other [income-producing purposes] is not encompassed by the clause." *Id.; see also In re Maddaloni,* 225 B.R. 277, 280 (D. Conn. 1998) ("[T]he use of 'is' without any modifier *(e.g.,* 'in whole' or 'in part') does not evince an intent by Congress to apply the anti-modification provision to real property that includes, but is more than, a debtor's residence."); *In re McGregor,* 172 B.R. 718, 720 (Bankr. D. Mass. 1994) (relying on plain language of section 1322(b)(2) to permit modification of claim secured by "the debtor's residence and property which has 'inherent income producing' power"); *In re Legowski,* 167 B.R. 711, 714 (Bankr. D. Mass. 1994) (same).

[4] The wording of each provision is identical.

11. The Debtor concedes that other courts interpreting the "plain language" of section 1123(b)(5) have held that the anti-modification exception applies to any loan secured by real property that the debtor *uses* as a principal residence. *Wages,* 508 B.R. 161 (B.A.P. 9th Cir. 2014). The *Wages* court 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. *Wages,* 508 B.R. at 166.

12. 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). The *Macaluso* court 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. *Wages,* 508 B.R. at 167.

13. Although *Wages*'s "objective" interpretation of section 1123(b)(5) is tempting for its simplicity, it incorrectly interprets the plain meaning of section 1123(b)(5). As the dissent in *Wages* observed, the *Wages* majority takes the statutory phrase "claim secured only by a security interest in real property that is the debtor's principal residence" and recasts it as if the phrase actually read "claim secured only by a security interest in real property that includes the debtor's principal residence." *Id.* at 168.

14. The Third Circuit's approach in *Scarborough* is the better reasoned holding. In *Scarborough,* the Third Circuit held that the anti-modification provisions in section 1322(b)(2) and 1123(b)(5) do not apply to mortgaged real property on which the debtor principally resides if the debtor uses another part of the mortgaged real property to generate income. Accordingly, *Scarborough* effectively construed the anti-modification provisions to apply only to mortgaged real property the debtor uses exclusively as his or her principal residence. *Scarborough*, 461 F.3d at 413-14.

15. The fact that two appellate courts could, after careful analysis, come to such divergent conclusions on the plain meaning of the statute indicates the statute actually is ambiguous. In such a case, it is appropriate to look at the legislative history. In its analysis, the *Scarborough* court points out that the House Judiciary Committee's Report on the Bankruptcy Reform Act of 1994 stated that section 1123(b)(5) "does not apply to a commercial property, or to any transaction in which the creditor acquired a lien on property other than real property used as the debtor's residence." *Scarborough,* 461 F.3d at 413 (citing H.R. Rep. No. 835, at 46 (1994)). The majority in *Wages* made no claim that the legislative history supports its broad interpretation.

16. Accordingly, the legislative history supports *Scarborough's* conclusion that where a creditor's lien extends to income-producing property, the creditor's claim is not secured only by property that is the debtor's principal residence. The plain meaning and the legislative history of section 1123(b)(5) both support the conclusion that the anti-modification provision is inapplicable where, as here, a creditor's claim is secured by a brewery, which also happens to be the debtor's principal place of business.

III. SECTION 1115(a) PERMITS THE DEBTOR TO RETAIN HIS PREPETITION *AND* POSTPETITION PROPERTY DESPITE THE TREATMENT OF CLASS 4 CREDITORS

17. Pursuant to the Plan, Mr. Suds will retain all property of the estate, including his prepetition interest in brewery equipment, recipes and other trade secrets. In addition, the Plan allows Mr. Suds to retain his exempt property. Seedy objects to these Plan provisions on the basis that they violate the absolute priority rule because the Debtor is retaining a junior "interest" in property over the rejection of the Plan by Class 4 creditors holding senior unsecured claims.

18. Section 1129(b)(l) of the Bankruptcy Code states what has come to be known as the "absolute priority rule." The absolute priority rule requires that creditors be paid in full before holders of subordinate claims or equity receive or retain any property under a plan. In individual chapter 11 cases, courts have struggled to determine whether the absolute priority rule should apply to individual debtors though individuals are permitted to be debtors in chapter 11. *See, e.g., Norwest Bank Worthington v. Ahlers,* 485 U.S. 197 (1988) (holding that the absolute priority rule barred chapter 11 debtor's retention of ownership interest in a farm over the objections of creditors holding senior unsecured claims); *see also In re Friedman,* 466 B.R. 471, 479 n.16 (9th Cir. B.A.P. 2012) ("Courts almost universally found that individuals could reorganize and that the absolute priority rule applied to their plan prior to the enactment of BAPCPA.")

19. In 2005, Congress enacted the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"). BAPCPA amended chapter 11 by expanding the bankruptcy estate in individual chapter 11 cases to include postpetition property and earnings. Previously, earnings from services performed by an individual debtor after the commencement of the case were

excluded from the property of the estate. *See* 11 U.S.C. § 541(a)(6). However, as written, the language in section 1129(b)(2)(B)(ii), as it relates to the absolute priority rule applied to individuals, can and has been be interpreted two ways.[5] The first way, often referred to as the "broad view," reads the language of the statute to abrogate the absolute priority rule in individual chapter 11 cases.[6] The second way, the "narrow view," applies the absolute priority rule only to an individual debtor's prepetition property (in other words, the debtor may only retain the "additional" portion added to the estate by section 1115).[7] The Debtor submits that, for the reasons discussed below, this Court should adopt the "broad view" and find that the absolute priority rule does not apply in individual chapter 11 cases.[8] However, in the alternative, the

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[5] *See In re Brown,* 505 B.R. 638, 643-645, n. 12, 13 (E.D. Pa. 2014), for an extensive listing of the jurisdictions and courts adhering to each interpretation under this nationwide split of authority.

[6] For a survey of "broad view" cases, *see In re Friedman,* 466 B.R. 471 (B.A.P. 9th Cir. 2012); *In re Shat,* 424 B.R. 854 (Bankr. D. Nev. 2010); *In re Johnson,* 402 B.R. 851 (Bankr. N.D. Ind. 2009); *In re Tegeder,* 369 B.R. 477 (Bankr. D. Neb. 2007); *ln re Rodemeier,* 374 B.R. 264 (Bankr. D. Kan. 2007).

[7] For a survey of "narrow view" cases, *see Ice House Am., LLC v. Cardin,* 751 F.3d 734 (6th Cir. 2014); *In re Stephens*, 704 F.3d 1279, 1286 (10th Cir. 2013); *In re Maharaj,* 681 F.3d 558 (4th Cir. 2012); *In re Lucarelli,* 517 B.R. 42 (Bankr. D. Conn. 2014)*; In re Arnold,* 471 B.R. 578 (Bankr. C.D. Cal. 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).

[8] *See Friedman,* 466 B.R. at 481-82 ("[W]e observe that there are no conflicting provisions within Chapter 11 relative to our view that the absolute priority rule does not apply in individual chapter 11 cases. We find no anomalies, inconsistencies or conflicts created by this interpretation. More importantly, we find significant contextual concordance with the other requirements for plan confirmation, including those previously described, including but not limited to (1) the new requirement for dedication of all of debtor's disposable income for five years, (2) the straight-forward best interest of creditors test, and (3) the delay of issuance of discharge until the plan has been fully consummated. Including the property within the universe of property contained in § 1115, as we believe a plain-meaning interpretation requires, does no violence to the logical impact of the reorganization process or scheme established in chapter 11. Indeed, especially combined with the new additional requirement of five years of debtor's disposable income, it is illogical to thereafter remove the debtor's means of production of debtor's disposable income by maintaining the absolute priority rule in an individual's case.")

Debtor asks that the Court find that the Plan requires the Debtor to provide "new value" for his retention of his interests in the prepetition property in the form of "sweat equity" and trade secrets.[9]

20. Chapter 11 of the Bankruptcy Code enables an insolvent debtor to reorganize its financial affairs in order to pay back its creditors over a period of time. Most chapter 11 cases are filed by business entities; however, a smaller percentage of cases are filed by individuals who have assets that they wish to save, but debts exceeding the limits imposed on chapter 13 debtors in section 109(e)—as is the case here.[10]

21. For individual debtors in chapter 11 cases, sections 541 and 1115 establish the parameters for what property is to be included in the bankruptcy estate. Property in section 541 includes "all legal or equitable interests of the debtor in property as of the commencement of the case." In individual chapter 11 cases**,** section 1115 redefines the property of the estate to also include in the bankruptcy estate a debtor's post-petition earnings and property.

22. What property creditors receive in an individual chapter 11 case is determined by the confirmed plan. A plan must meet the requirements specified in section 1129 before it can be confirmed by the court. One such requirement is that each creditor in an impaired class of claims either accept the plan or receive under the plan as much as it would under a chapter 7 liquidation.

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[9] The Debtor reserves the right to supplement this Memorandum of Law by further argument at the Confirmation Hearing that the absolute priority rule has no application to an individual debtor in a case under chapter 11 because (a) an individual's ownership of property does not constitute a "claim or interest" against or in a debtor, and (b) 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). In addition, the Debtor reserves the right to argue that the BAPCPA amendments applicable to individual debtors violate the Thirteenth Amendment's prohibition against involuntary servitude. U.S. Const. amend. XIII.

[10] Section 109(e) limits the eligibility of an individual to file chapter 13 to an individual with unsecured debts of less than $383,175 and secured debts of less than $1,149,525.

11 U.S.C. § 1129(a)(7). Another requirement is that, with respect to each class of claims, such class has either accepted the plan (by two-thirds in amount and one-half in number) or such class is not impaired under the plan. 11 U.S.C. § 1129(a)(8). If all requirements of section 1129(a) are met except section 1129(a)(8), a court may still confirm a plan over the rejection of a dissenting class of creditors. 11 U.S.C. § 1129(b)(l).

23. Confirming a plan over the rejection of a dissenting class of claimholders is referred to as a "cram down." Before a cram down is permitted, the plan (1) must not discriminate unfairly against the objecting classes and (2) must be fair and equitable. A plan may cram down a class of unsecured claims provided that the plan meets the criteria set out in section 1129(b)(2)(B), which states:

> For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements:
>
> (B) With respect to a class of unsecured claims-
>
> (i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or
>
> (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 (a)(14) of this section.

24. A class of unsecured claims can be crammed down in two different ways. In the first method, claimholders are paid an amount equal to the present value of the full amount of their claim, either on the effective date or over time. The second method allows unsecured creditors to be paid in part or not at all, so long as the plan does not violate the absolute priority rule.

25. Courts have wrestled with how to apply the absolute priority rule to individual debtors in chapter 11 cases. *Compare Matter of Yasparro,* 100 B.R. 91 (Bankr. M.D. Fla. 1989) (debtor's plan, which did not propose to pay unsecured creditors the full amount of their allowed claims and which proposed that the debtor retain both exempt and non-exempt assets, did not satisfy the absolute priority rule), *with In re Henderson,* 321 B.R. 550, 561 (Bankr. M.D. Fla. 2005) (debtor's plan did not violate the absolute priority rule because a total liquidation of all of the debtor's assets was not required in order for a plan to be fair and equitable to dissenting creditors who were subject to cram down), *aff'd* 341 B.R. 783 (M.D. Fla. 2006).

26. The absolute priority rule was not originally conceived to apply to individuals[11] and it appears that chapter 11 was not either. *See Toibb* v. *Radloff,* 501 U.S. 157, 167 (1991) (Stevens, J. dissenting) ("The repeated references to the debtor's 'business,' the operation of the debtor's business, and the 'current or former management of the debtor' make it abundantly clear that the principal focus of the chapter is upon business reorganizations."). Nevertheless, the Bankruptcy Code permits an individual debtor in a chapter 11 case to use the cram down provisions in section 1129(b). *In re Shat,* 424 B.R. 854, 862 (Bankr. D. Nev. 2010) ("[B]efore 2005, the authorities were pretty much in agreement that the absolute priority rule applied to individuals in chapter 11.").

27. In 2005, Congress adopted BAPCPA. BAPCPA made numerous changes to the Bankruptcy Code, some of which impacted individual chapter 11 debtors. For example, Section 1129(b)(2) was amended by adding the following language to the end of section 1129(b)(2)(B)(ii): "except that in a case in which the debtor is an individual, the debtor may

[11] *Friedman,* 466 B.R. at 478-80 (discussing application of absolute priority rule to individuals).

retain property included in the estate under section 1115, subject to the requirements of subsection (a)(l4) of this section."

28. BAPCPA also added section 1115 which reads:

> (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. The new exception in section 1129(b)(2)(B)(ii) allows an individual debtor to retain property included in the estate under section 1115. Section 1115(a) enlarges the bankruptcy estate by including into the estate two kinds of postpetition property. These two types of property are described as being "in addition to" the kinds of property specified in section 541.

30. Admittedly, courts are split as to whether the absolute priority rule applies to individual debtors due to the awkward language used in sections 1115 and 1129(b)(2)(B)(ii). *In re Maharaj,* 2012 WL 2153066 (4th Cir. June 14, 2012) ("A significant split of authorities has developed nationally among the bankruptcy courts regarding the effect of the BAPCPA amendments on the absolute priority rule when the Chapter 11 debtor is an individual."). Two interpretations exist. The broad, and better reasoned, view adopts an expansive reading of section 1115 in which section 1115 subsumes and supersedes section 541 in defining property of the estate. *See In re*

Friedman, 466 B.R. 471, 482 (B.A.P. 9th Cir. 2012); *SPCP Group, LLC v. Biggins,* 465 B.R. 316 (M.D. Fla. 2011); *In re Shat,* 424 B.R. 854 (Bankr. D. Nev. 2010); *In re Johnson,* 402 B.R. 851 (Bankr. N.D. Ind. 2009); *In re Tegeder,* 369 B.R. 477 (Bankr. D. Neb. 2007); *In re Roedemeier,* 374 B.R. 264 (Bankr. D. Kan. 2007);[12] *In re Bullard,* 358 B.R. 541 (Bankr. D. Conn. 2007).

31. Under the broad view, property included in the estate under section 1115 includes: (1) prepetition property; (2) property acquired by the debtor postpetition; and (3) postpetition earnings of the debtor. The broad view abrogates the absolute priority rule for individual debtors because the exception in section 1129(b)(2)(B)(ii) applies to all property in the bankruptcy estate.[13]

32. The second interpretation, the narrow view, favors a limited interpretation of section 1115's effect on section 541 in which the phrase "in addition to the property specified in section 541" is a cross-reference and "property included in the estate under section 1115" only includes: (1) property acquired by the debtor postpetition and (2) postpetition earnings of the debtor. *See In re Maharaj,* 681 F.3d 558 (4th Cir. 2012); *In re Arnold,* 471 B.R. 578 (Bankr. C.D. Cal. May 17, 2012); *In re Kamel,* 451 B.R. 505 (Bankr. C.D. Cal. 2011); *In re Gbadebo,* 431 B.R. 222

[12] *But see In re Stephens*, 704 F.3d 1279, 1286 (10th Cir. 2013) (adopting a narrow interpretation for the Tenth Circuit, which includes Kansas).

[13] The Debtor also notes that "[a]s pointed out by the bankruptcy court in *In re Lively,* 467 B.R. 884, 890, n. 3 (Bankr. S.D. Tex. 2012) (citing by way of example to *In re Shat,* 424 B.R. 854 (Bankr. D.Nev. 2010)), some courts have suggested that 11 U.S.C. § 1129(b)(2)(B)(ii)'s express reference to 11 U.S.C. § 1129(a)(14) is a scrivener's error and that Congress actually intended the reference to instead be to (a)(15), thus making (b)(2)(B)(ii)'s exemption for individual debtors from the absolute priority rule (whatever its extent) subject to (a)(15)'s requirements and not those of (a)(14): *Lucarelli,* 2014 WL 4388250, *3 n. 2. This interpretation is in contrast to Collier's understanding that section 1129(b)(2)(B)(ii) "may not be used to undermine the confirmation requirement that the debtor be current on all postpetition domestic support obligations as required for confirmation by section 1129(a)(14)." 7 COLLIER ON BANKRUPTCY ¶ 1129.04[d] (16th ed. 2014).

(Bankr. N.D. Cal. 2010). Therefore, the narrow view only applies the absolute priority rule to prepetition property because section 1115 includes only two kinds of post-petition property.

IV. SECTION 1115 ABROGATES THE ABSOLUTE PRIORITY RULE IN INDIVIDUAL CHAPTER 11 CASES

33. Numerous courts to address the issue have adopted the broad view and abrogated the absolute priority rule as it applies to individual chapter 11 cases. *See In re Friedman,* 466 B.R. 471 (9th Cir. B.A.P. 2012); *SPCP Group, LLC v. Biggins,* 465 B.R. 316 (M.D. Fla. 2011); *In re Shat,* 424 B.R. 854 (Bankr. D. Nev. 2010); *In re Johnson,* 402 B.R. 851 (Bankr. N.D. Ind. 2009); *In re Tegeder,* 369 B.R. 477 (Bankr. D. Neb. 2007*); In re Roedemeier,* 374 B.R. 264 (Bankr. D. Kan. 2007); *In re Bullard,* 358 B.R. 541 (Bankr. D. Conn. 2007).

34. First, the unambiguous language of section 1115 requires abrogation. The courts in *Tegeder, Biggins,* and *Friedman* found the language of section 1115 to be clear and unambiguous. *Biggins,* 465 B.R. at 322 ("The Court reaches this conclusion not by analyzing the legislative history of the relevant statutes, as the *Shat* and *Gelin* courts did, but by focusing on the statute's plain language."); *Tegeder,* 369 B.R. at 480 ("Thus, § 1115 is clear that property of the estate in a case in which the debtor is an individual includes the property described in § 541 ... as well as postpetition property and earnings."). The Ninth Circuit BAP in *In re Freidman* gave a thoughtful analysis as to why the language at issue is unambiguous. The *Friedman* majority found that the plain language, when read in context with the rest of the Bankruptcy Code, does not require the application of an absolute priority rule to an individual. *In re Friedman,* 466 B.R. 471, 483 (9th Cir. B.A.P. 2012) ("Finally, a plain reading of §§ 1129 and 1115 demonstrates that, just as in chapter 13, to confirm a plan does not require the application of an absolute priority rule.")

35. Second, Congress, in adopting BAPCPA's individual debtor chapter 11 provisions, borrowed language from chapter 13. Chapter 13 has no absolute priority rule equivalent. Therefore, Congress likely intended to abrogate the absolute priority rule. *Id.* Moreover, since the new disposable income requirement of section 1129(a)(l5)—which closely resembles the disposable income requirement of section 1325(b)(1)—requires the contribution of post-confirmation disposable income (presumably generated from the property retained by the debtor), this negates the need for the absolute priority rule. *Id.* ("As in Chapter 13, the disposable income requirement insures that the individual debtor is required to dedicate all of his or her disposable income over a designated time period (three or five years in Chapter 13, at least five years in chapter 11) to plan payments directed to unsecured creditors."). Why would Congress require an individual debtor to actively dedicate future post-petition earnings or income to the repayment of creditors, yet place at risk the debtor's very earning ability from his continued use and exploitation of prepetition property?

36. The similarities between the BAPCPA amendments and certain other chapter 13 provisions demonstrate that Congress intended to bring individual chapter 11 cases more in line with chapter 13. *Friedman,* 466 B.R. at 484 ("However, clearly, the drafters of § 1129(a)(15) tried to create symmetry between chapters 11 and 13 for individual debtors."); *Shat,* 424 B.R. at 868 ("Here, given the host of change [sic] to chapter 11 with respect to individuals, all made with the goal of shaping an individual's chapter 11 case to look like a chapter 13 case . . . this court concludes that the broader interpretation is the proper one."); *Roedemeier,* 374 B.R. at 275-76 (Bankr. D. Kan. 2007) ("Many of the BAPCPA's changes to Chapter 11 apply only to individual debtors and are clearly drawn from the Chapter 13 model . . . . Taken together, these changes indicate Congress intended to extend the exemption from the absolute priority rule to

individual Chapter 11 debtors as well."). *Compare* § ll23(a)(8) *with* § 1322(a)(1); § 1129(a)(15) *with* § 1325(b)(1); § 1141 (d)(5)(A) *with* § 1328(a); § 1141(d)(5)(B) *with* § 1328(b); § 1127(e) *with* § 1329(a).

37. In many cases, the BAPCPA amendments match the chapter 13 provision word for word. BAPCPA imported chapter 13 concepts into individual chapter 11 cases; by extension, individuals should be exempt from the absolute priority rule because chapter 13 has no such requirement.

VI. EQUITY REQUIRES THE ABROGATION OF THE ABSOLUTE PRIORITY RULE IN INDIVIDUAL CHAPTER 11 CASES

38. If the absolute priority rule was not abrogated in Hoplandia by section 1115, equity and common sense require the abrogation of the absolute priority rule in individual chapter 11 cases. Absent such abrogation, vindictive unsecured creditors could, regardless of the intrinsic fairness of the proposed dividend, maintain a stranglehold on a plan and require a debtor to either pay them in full or relinquish virtually all of his assets—as Seedy is doing in the instant case.[14] Mr. Suds's equipment is highly customized and would not fetch as much following a liquidation of the assets as they would in Mr. Suds's unique control.

[14] *In re Lucarelli,* 517 B.R. 42, 52 (Bankr. D. Conn. 2014) ("The court notes that when the real-world implications of each view are compared, the broad view leads to a more practical and functional result in individual Chapter 11 cases. The narrow view will have the practical effect of making confirmation of a nonconsensual plan in an individual Chapter 11 case highly unlikely, if not virtually impossible . . . . Indeed, the narrow view effectively requires an individual debtor whose liabilities exceed the Chapter 13 debt limits, and whose creditors will not consent to less than full payment of their claims, to undergo the functional equivalent of a liquidation. Additionally, as is true in this case, debtors in many individual Chapter 11 cases have a pre-petition ownership interest in a business that is their primary source of income. How can liquidating a debtor's primary source of post-petition disposable income—his business—be reconciled with maximizing the amount returned to creditors under Section 1129(a)(15)? It appears that the two cannot be reconciled in a way that maximizes the return to creditors and allows an individual debtor to successfully reorganize under Chapter 11 in the absence of a consensual plan.")

39. First, section 1129(a)(7)(A)(ii) requires that the holder of an impaired claim that rejects a plan receive an amount under the plan that is not less than the creditor would have received if the debtor were liquidated under chapter 7. Seedy rejected the Plan and is thus entitled to receive an amount not less than Seedy would receive if the Debtor were liquidated under chapter 7. In the instant case, Seedy's projected recovery on its Class 4 claim far exceeds what it would receive in a chapter 7 case, so this requirement is satisfied.

40. Second, if the holder of an unsecured claim objects to confirmation, section 1129(a)(15) requires that an individual chapter 11 plan either pay such claim in full or provide that "the value of the property to be distributed under the plan is not less than the projected disposable income of the debtor (as defined in section 1325(b)(2)) to be received during the 5-year period beginning on the date that the first payment is due under the plan, or during the period for which the plan provides payments, whichever is longer." 11 U.S.C. § 1129(a)(15)(B). Accordingly, section 1129(a)(15) effectively requires that the holder of a claim receive at least what the creditor would have received in a chapter 13 case. Seedy objects to confirmation of the Plan. As such, Seedy is entitled to receive an amount not less than Seedy would receive if the Debtor were in chapter 13. In the instant case, Seedy's projected recovery on its Class 4 claim exceeds what it would receive in a chapter 13 case. Moreover, Seedy stands to recover substantially more—a 15% bonus distribution—if the Debtor is able to use his market know-how in creating a year round *Plato the Blind.* Accordingly, this requirement is satisfied.

41. Not content with receiving a higher recovery than it would in a chapter 7 or chapter 13 case, Seedy voted to reject the Plan. Because of the size of Seedy's claim (more than two-thirds of the dollar amount of Class 4), Seedy has a blocking position in Class 4. As such, Seedy's

rejection of the Plan caused Class 4 to reject the Plan. When an impaired class rejects a plan, section 1129(b)(2)(B) requires that the plan conform to the absolute priority rule.

42. If this Court were to adopt the "narrow view" discussed above, the Debtor would be required to amend the Plan so that the only interest retained by the Debtor would be his post-petition property; despite that, he would also, pursuant to section 1129(a)(15), be required to commit his disposable income to plan distributions for at least the next 5 years. However, the Debtor would be without the means to implement the Plan. For example, the Debtor's projected disposable income is premised on his income as a brewmaster and, specifically, his ability to bring *Plato the Blind* to market year round utilizing his customized equipment and trade secrets. However, without his equipment and access to Stache Brewery, the Debtor will not be able to implement his Plan. Mr. Suds' livelihood is in Stache Brewery and the customized equipment. Depriving Mr. Suds of these prepetition assets is to deprive him of his livelihood.

43. This form of indentured servitude could not possibly be what Congress had in mind when it adopted the BAPCPA provisions. Accordingly, Seedy's objections must be overruled and this Court must adopt the "broad view" such that, where a creditor receives more than it would in a chapter 7 or chapter 13 case, the absolute priority rule is abrogated. To hold otherwise would functionally eliminate nonconsensual individual chapter 11 cases. *Friedman,* 466 B.R. at 478 ("The absolute priority rule was not intended for individual chapter 11 cases, but 'was a judicially created concept, arising from a series of early twentieth-century railroad cases . . . The U.S. Supreme Court adopted the absolute priority rule to prevent deals between senior creditors and equity holders that would impose unfair terms on secured creditors.'"). As the *Friedman* court recognized, "Congress affirmatively amended the law so that § 1129(a)(15)(B) would trump § 1129(b)(2)(B)(ii) in individual debtor cases." *Id.* at 484.

VII. NEW VALUE EXCEPTION ALSO PERMITS DEBTOR TO RETAIN INTERESTS

44. If the Court were to adopt the "narrow view" and conclude that the absolute priority rule applies in individual chapter 11 cases, the Debtor submits that his post-confirmation efforts in connection with bringing *Plato the Blind* to market year round constitute "new value" and any interest retained in prepetition property is on account of this "new value."

45. The absolute priority rule is not absolute. "[C]ourts have always reviewed § 1129(b)(2)(B)(ii) through the lens of common sense and have approached legislative interpretation in a way to facilitate the goals of the statute." *Friedman,* 466 B.R. at 478 ("An interesting feature of the absolute priority rule, even before enactment of the BAPCPA amendment to § 1129(b)(2)(B)(ii), is that the rule has never been absolute."); *Kansas City Terminal Ry. Co. v. Cent. Union Trust Co.,* 271 U.S. 445, 455 (1926) (recognizing, in dicta, that a new, substantial, and necessary contribution could allow an old equity holder to retain an interest in the reorganized debtor).

46. Historically, the Supreme Court has recognized that a debtor's promise of future services, in the context of "new value" is intangible, inalienable, and unenforceable. *Norwest Bank Worthington v. Ahlers,* 485 U.S. 197, 204 (1988) (quoting *Case v. Los Angeles Lumber Products Co.,* 308 U.S. 106, 122-23 (1939)). However, *Ahlers* was decided pre-BAPCPA. Specifically, it was decided prior to the adoption of sections 1123(a)(8) and 1129(a)(15) that *require* a debtor to distribute its disposable income for at least 5 years. Accordingly, future labor and management skills are no longer "merely vague hopes or possibilities"—they are mandatory. Accordingly, the Debtor submits that Congress implicitly overruled the holding in *Ahlers* when it enacted sections 1123(a)(8) and 1129(a)(15).

VIII. RACING EXPENSES ARE ORDINARY COURSE EXPENSES

47. Seedy objects to the Plan on the basis that it was not proposed in good faith as required by section 1129(a)(3). Specifically, Seedy contends that the Debtor's payment of monthly racing expenses during the pendency of this chapter 11 case were unauthorized payments outside the ordinary course of business in contravention of section 363(c)(1). However, the Debtor submits that such expenses were incurred on a regular basis prepetition and constitute the Debtor's ordinary course living expenses. Moreover, such expenses were disclosed in monthly operating reports and incurred in furtherance of the business as a marketing tool. Accordingly, pursuant to section 363(c)(1), court authority was not required.

48. Section 363(c)(l) 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.

11 U.S.C. § 363(c)(l).

49. Prior to the enactment of section 1115, few cases addressed the issue of whether a debtor was required to obtain court approval for the payment of living expenses from estate property. Of those courts that considered the issue, some held that normal living expenses of an individual chapter 11 debtor did not need court approval, while others indicated that some form of court approval would be necessary, at least in cases of significant expenses. *Compare In re Murray,* 216 B.R. 712, 713 (Bankr. W.D.N.Y. 1998); *In re Keenan,* 195 B.R. 236, 243 (Bankr. W.D.N.Y. 1996); *In re Bradley,* 185 B.R. 7, 8 (Bankr. W.D.N.Y. 1995) ("[W]hen a Chapter 11 Debtor-in-

Possession is a natural person, his personal expenses and his obligations for incidents of his personal life are every bit as much a part of the ordinary course of his business and financial affairs as are expenses incident to the operation of the various shopping malls, nursing homes, and office buildings that he owned."), *with In re Harp,* 166 B.R. 740, 741-46, 755-56 (Bankr. N.D. Ala. 1993) (discussing that the chapter 11 debtor violated his fiduciary duties by paying for rental of vacation homes, sponsoring a football game brunch and taking a vacation to an exclusive resort in the Netherland Antilles). However, other pre-BAPCPA courts held that no authority permitted the payment of an individual chapter 11 debtor's living expenses from estate property. *In re Vincent,* 4 B.R. 21, 23 (Bankr. M.D. Tenn. 1979); *see also In re Walter,* 83 B.R. 14, 19-20 (B.A.P. 9th Cir. 1988) ("The bankruptcy court properly relied on case law whereby courts had held that personal living expenses for debtors and their families, as well as attorney's fees which benefitted the debtor as an individual, but not the bankruptcy estate, could not be paid out of monies or assets of the estate. The bankruptcy court has authority to deny the debtor use of estate property for living expenses for himself or his family.").

50. However, it is worthwhile to emphasize that the above decisions interpreting section 363(c)(1) in the context of ordinary living expenses arose prior to the adoption of section 1115, which brings into the estate postpetition earnings. Accordingly, prior to the enactment of section 1115, debtors could indisputably spend their postpetition earnings freely. They could not, however, spend their prepetition assets (which became part of the estate) on lavish ordinary course living expenses.

51. Post-BAPCPA courts have been more lenient and have held that section 363(c)(l) authorizes individual chapter 11 debtors to use estate property to pay ordinary living expenses, without obtaining court approval. *In re Villalobos,* 2011 WL 4485793, at *8-9 (B.A.P. 9th Cir.

Aug. 19, 2011); *In re Seely,* 492 B.R. 284, 289-91 (Bankr. C.D. Cal. 2013); *see also In re Goldstein,* 383 B.R. 496, 499 (Bankr. C.D. Cal. 2007).

52. The *Seely* court reasoned:

> Notwithstanding section 363(c)(l)'s reference to the ordinary course of a debtor's *business,* because the debtor cannot continue to generate post-petition wages without being able to pay for the personal expenses necessary to permit him to live his life and remain gainfully employed, section 363(c)(1) has generally been understood to authorize chapter 13 debtors to pay post-petition living expenses without notice and an opportunity for hearing or a prior court order so long as such expenses are "ordinary course' rather than unusual or extraordinary. If a chapter 13 debtor's post-petition living expenses prove unreasonable or excessive, his chapter 13 case will be converted or dismissed, either because his plan was not proposed in good faith or because he is unwilling to devote all of his disposable income to the payment of creditors under his plan, and not because the debtor failed to obtain prior court approval for the payment of his ordinary course living expenses during the pendency of the case.
>
> Rather than struggle to invent out of whole cloth a procedure and standard for approving requests by chapter 11 debtors for authority to spend property of the estate for the payment of post-petition living expenses, the court should give section 363(c)(l) the same interpretation in chapter 11 cases as it has always been understood to have in chapter 13 cases. That is, the court should recognize that section 363(c)(1) authorizes a debtor in possession to use property of the estate to pay post-petition living expenses without prior court approval, so long as the amounts to be disbursed qualify as "ordinary course" expenses. An individual chapter 11 debtor needs to pay his living expenses in order to continue generating revenues for the estate. Thus, the payment of ordinary course having expenses should be treated as being within the debtor's ordinary course of business for the purpose of interpreting section 363(c)(1).

In re Seely, 492 B.R. at 290.

53. Seedy is likely to urge this Court to ignore the Debtor's standard of living and the undisputed fact that the Debtor historically paid his monthly racing expenses. *Villalobos,* 2011

WL 4485793, at *8-9 (bankruptcy court's finding that individual chapter 11 debtor had historically paid certain expenses was insufficient grounds for approving debtor's post-petition payment of luxury vehicles, expensive homes, and college tuition of grandchildren from estate property). However, the Debtor submits that the racing expenses were regular, generally fixed, ordinary monthly expenses. Moreover, the racing expenses were ordinary marketing expenses for Stache Brewery, which indirectly benefited Seedy. Stache Brewery was prominently displayed on the race cars, trailers, and uniforms, increasing brand awareness throughout the country. In addition, the Debtor is convinced that the perception that Stache Brewery was operational during its bankruptcy was essential to keeping the status quo among its customers, distributors, and suppliers. As such, the Debtor submits that such expenses should be allowed as ordinary course expenses under section 363(c)(l).

54. Regardless, such expenses were not incurred in bad faith. Although perhaps lavish, and incurred at a time when the Debtor was living beyond his earned income, such expenditures were not a willful attempt to direct funds away from the Debtor's creditors. *Cf.*, *In re Hawkins,* 769 F.3d 662 (9th Cir. 2014) (debtor's prepetition lavish lifestyle and expenditures beyond his earned income did not qualify as a willful attempt to evade or defeat taxes under section 523(a)(l)(c)).

IX. CRIMINAL LEGAL FEES BENEFIT THE ESTATE AND MAY BE PAID

55. Seedy also objects to the Plan because it contemplates the payment of legal fees from property of the estate to an attorney that was not retained with the approval of the Court. Specifically, Seedy contends that the Plan does not comply with section 1129(a)(4) because Seedy's criminal defense attorney was not retained under sections 327 and 330 of the Bankruptcy Code. Moreover, Seedy contends that the criminal defense attorney could not have

been retained under sections 327 and 330 because he does not provide the requisite benefit to the estate. *In re Dixon,* 2010 WL 3767604 (Bankr. N.D. Ca. 2010) (chapter 11 counsel may not defend exemptions because they are against the interests of the estate); *In re Miell,* 419 B.R. 357 (N.D. Iowa 2009) (section 330(a)(4)(B) does not permit payment of a debtor's attorney in a chapter 11 case); *In re Weaver,* 336 B.R. 115 (Bankr. W.D. Tex. 2005) (general counsel was not entitled to be compensated by estate for time spent in dealing with exempt property); *In re Polishuk,* 258 B.R. 238 (Bankr. N.D. Okla. 2001) (attorney representing debtor in state court divorce action was entitled to be compensated from estate for time spent in trial of divorce action and in obtaining equitable distribution of marital property, but not for litigating child support and custody issues, given lack of any real "benefit " from such services to estate); *but see In re Warner,* 141 B.R. 762 (M.D. Fla. 1992) (district court found no abuse of discretion in the bankruptcy court's authorization of payment of criminal defense attorneys out of the bankruptcy estate, pursuant to section 327(e)).

56. First, the Debtor submits that Dewey LLP's services were rendered in the ordinary course because such fees were incurred prepetition and postpetition. As such, they may be paid pursuant to section 363(c)(1).

57. Second, the Debtor respectfully submits that Court approval of an individual's criminal defense attorney in a chapter 11 case is not required and any such requirement would infringe on an individual's fundamental freedom to be represented by counsel of his choosing.

58. Third, Congress overlooked the potential need for criminal defense attorneys in individual chapter 11 cases when it adopted section 1115. Section 330(a) generally prescribes the standard for compensation of officers: reasonable compensation for actual, necessary services

rendered by the trustee, examiner, ombudsman, professional person, or attorney. However, section 330(a) was amended by section 224(b) of the Bankruptcy Reform Act of 1994. This amendment deleted the reference to the debtor's attorney, thus eliminating statutory authority for a debtor's attorney to recover fees from a chapter 7 estate. However, such amendment was enacted 11 years before Congress added section 1115 bringing post-petition income into the chapter 11 estate. Accordingly, between 1994 and 2005, an individual chapter 11 debtor could use his postpetition earnings to pay his criminal defense fees.

59. Today, Seedy submits that an individual chapter 11 debtor must first seek to retain his or her criminal defense attorney under sections 327 and 330 of the Bankruptcy Code. By implication, Seedy's proposal leaves the selection of an individual's criminal defense attorney to the Bankruptcy Court's discretion. More troubling, however, is the power of a trustee. Sections 327 and 330 permit a trustee or debtor in possession to retain counsel. If a trustee is appointed in a chapter 11 case and denies a debtor's request to hire a criminal defense attorney, the individual debtor is without recourse. Section 1115 brings post-petition funds into the purview of the chapter 11 trustee. In this scenario, the debtor is effectively denied access to counsel. Congress could not have intended this outcome.

60. Instead, the Debtor submits that Congress mistakenly failed to amend section 330 to permit the payment of a debtor's personal attorney in an individual chapter 11 case when it added section 1115. At times, it is proper for a court to look at the statutes holistically and through the lens of common sense. This is one of those times. A man's liberty hangs in the balance. Without authority to pay his criminal defense attorneys, Mr. Suds will be required to proceed to sentencing without the benefit of counsel. The Debtor respectfully requests that the

Court recognize the drafting flaw in the Bankruptcy Code and permit confirmation of the Plan allowing the payment of the Debtor's criminal defense attorney's fees.

X. DEBTOR'S TAX DEBT IS DISCHARGEABLE

61. Debtor seeks to discharge the $250,000 in tax debt that resulted from an IRS audit of the Debtor's 2013 tax return.

62. Generally, a debtor is permitted to discharge all debts that arose before the filing of his bankruptcy petition. 11 U.S.C. § 727(b). However, the Bankruptcy Code provides for certain exceptions to that general rule, including that a debtor may not discharge any tax debts "with respect to which the debtor made a fraudulent return or *willfully* attempted in any manner to evade or defeat such tax." 11 U.S.C. § 523(a)(1)(C) (emphasis added).

63. In response to Debtor's motion, the U.S. Attorney, on behalf of the IRS, filed an opposition arguing that Mr. Suds's tax debt is non-dischargeable because it is the result of his willful attempt to evade his tax liability through (a) his participation in the Bimini Bob offshore investment; and (b) his lavish personal spending, particularly the Brewer's Cup racing expenses, during the time when he knew or should have known the tax was owed.

64. For a debt to be non-dischargeable under § 523, the party opposing discharge has the burden of proving a "willful attempt" to evade taxes, which includes both a conduct requirement (that the Debtor took some action) and a mental state requirement. *In re Vaughn*, 765 F.3d 1174, 1180 (10th Cir. 2014). Non-payment of taxes, without more, is not sufficient conduct to support the application of the § 523 discharge exception. Rather, there must be some additional, willful

act taken by the debtor in an attempt to evade the assessment or collection of the tax. *United States v. Stanley*, 2014 WL 6997518, at *4 (5th Cir. Dec. 12, 2014).

65. There is a split of authority regarding the interpretation of the mental state requirement—specifically whether "willfully" in the context of § 523 should be narrowly construed to require a specific "bad intent" to evade taxes or broadly construed to require only that the evasive conduct be taken consciously and voluntarily, without the need for showing a specific intent to defraud or evade the IRS. *Compare Hawkins v. Franchise Tax Bd. of California*, 769 F.3d 662, 666 (9th Cir. 2014), *with United States v. Stanley*, 2014 WL 6997518, at *4 (5th Cir. Dec. 12, 2014); *and In re Vaughn*, 765 F.3d 1174, 1180 (10th Cir. 2014).

66. Under the Ninth Circuit's narrow interpretation, the "willfulness" mental state element requires a showing that the debtor committed the acts intentionally *and* with a specific intent to evade taxation. The mere fact that the debtor was conscious of his actions and those actions resulted in evasion of taxes is not sufficient. *Hawkins*, 769 F.3d at 670. To prove specific intent, courts may look to certain badges of "evasive motivation," such as "declining to file tax returns, shifting assets to another person or a false bank account, shielding assets, and switching all financial dealings to cash." *Id.* (citing *United States v. Coney,* 689 F.3d 365, 377 (5th Cir. 2012)); *In re Gardner,* 360 F.3d 551, 558 (6th Cir. 2004); *United States v. Fretz* (*In re Fretz*), 244 F.3d 1323, 1329 (11th Cir. 2001); *Tudisco v. United States* (*In re Tudisco*), 183 F.3d 133, 137 (2d Cir. 1999); *United States v. Fegeley* (*In re Fegeley*), 118 F.3d 979, 984 (3d Cir. 1997); *In re Birkenstock,* 87 F.3d 947, 951–52 (7th Cir. 1996); *Dalton v. IRS,* 77 F.3d 1297, 1302 (10th Cir. 1996).

67. Such a narrow standard is in line with a key policy purpose of the Bankruptcy Code, which strives to provide debtors with a "fresh start" through discharge. Exceptions to that fresh start should only be available upon a showing of some sort of fraud or deceit on the part of the debtor. Merely making poor financial choices, such as unwise spending habits or questionable investments, are not enough to defeat the "fresh start" presumption. Otherwise, few debtors would ever be able to take advantage of a discharge through bankruptcy. *See Hawkins*, 769 F.3d at 669.

68. In contrast, other circuits have broadly applied the "willfulness" standard as only requiring a showing that (1) the debtor had a duty under the law; (2) the debtor knew he had the duty; and (3) the debtor voluntarily and intentionally violated that duty. The third prong of this broad standard is satisfied by either "an affirmative act or culpable omission, that, under the *totality of the circumstances*, constituted an attempt to evade or defeat the assessment, collection, or payment of a tax." *United States v. Stanley*, 2014 WL 6997518, at *3 (5th Cir. Dec. 12, 2014).

69. By injecting the "totality of the circumstances" into the "willfulness" analysis, the broad view courts have blown open the "badges of evasiveness" test to include a debtor's generally poor spending habits and financial decisions, even if such behavior is just an extension of the bad habits that led to debtor's need for bankruptcy discharge. *Id.* at *4 ("As a result, evidence of lavish living while simultaneously failing to meet tax obligations may suggest voluntary and intentional violation of one's duty to pay taxes."); *In re Vaughn*, 765 F.3d 1174, 1181 (10th Cir. 2014) (finding that lavish spending and poor investment choices "inconsistent with [debtor's] business acumen" was evidence of willfulness).

70. A broad interpretation of "willfulness" that includes generally poor financial management as a badge of evasive intent is counter to the intent of the Bankruptcy Code and would create an exception that would swallow the general rule of discharge, which is a pillar of a debtor's ability to achieve a fresh start.

71. The threat of the broad view cases to the goals of bankruptcy is evident in Debtor's case. In the time leading up the bankruptcy, Mr. Suds made poor decisions—including unwise spending, unwise investments, unwise business practices and even unwise personal decisions, including driving under the influence. All of these decisions led to his eventual insolvency and the need for bankruptcy protection, including protection from the IRS. Nothing about Mr. Suds's decisions during this time speaks to a specific intent to evade the IRS or any other creditor. But, under the "totality of the circumstances" test proposed by *Stanley* and *Vaughn* and promoted by the IRS in the instant case, each of those actions, including Mr. Suds's DUI arrest, could be seen as a willful act to evade taxes, simply because they were conscious choices that contributed to Mr. Suds's eventual inability to pay his tax assessment.

72. As to Mr. Suds's race team expenses, such spending went on before Mr. Suds had any reason to suspect there was any possible issue with the IRS. While such spending may or may not have been the best management of his resources, it is an incredible stretch to say Mr. Suds's continuing participation in racing somehow morphed from expensive hobby into an indicia of tax evasion.

73. Similarly farfetched is the notion that engaging a financial advisor to help manage a sudden influx of revenue is a sign of ill-purposes—akin to saying only guilty people hire lawyers. Mr. Suds, who until recently had only a modest income from Stache Brewery, engaged

Bimini Bob's Barely Legal Brokerage for the perfectly reasonable purpose of helping to manage the revenue from a wildly successful sell-through of *Plato the Blind*. As part of those services, Mr. Suds rightfully expected Bimini Bob to provide some assistance in navigating the complicated tax issues that can come along with a successful sole proprietorship.

74. But legitimate attempts to limit liability are not the same as improper evasion of tax liability. And while the offshore investment structure set-up by Bimini Bob, in the end, led to an improper underreporting of income, there is nothing to indicate that a financially unsophisticated individual like Mr. Suds had any improper purpose in relying on the financial advice provided by a nationally known financial institution. Like millions of Americans each year, in 2013, Mr. Suds filed a return that was prepared by his financial advisor and paid whatever was assessed. Mr. Suds had no reason to know the return was not accurate or that more was owed until after the result of the IRS audit—which hit Mr. Suds at the same time as he was having to pay substantial legal bills resulting from his DUI arrest. The fact that he could not pay the 2013 assessment was not the result of some elaborate tax evasion scheme, but rather a series of unfortunate financial calamities that all contributed to the need for bankruptcy protection from all creditors—of which the IRS happened to be just one of many.

75. Because none of Mr. Suds actions constitute an willful attempt to evade taxes, the 2013 IRS assessment should be treated like every other unsecured claim under the Bankruptcy Code and should be subject to discharge as part of the Debtor's chance at a fresh start.

XI. OBJECTIONS TO BANKRUPTCY COUNSEL'S FEES ARE RESERVED FOR THE HEARING ON FINAL FEE APPLICATIONS

76. Seedy has also raised an objection to the Debtor's bankruptcy counsel's fees on the basis that fees incurred protecting the Debtor's exempt property was materially adverse to the estate.

The Debtor submits, however, that the Plan requires professionals retained in the bankruptcy case to submit final fee applications and professionals will only be paid upon entry of an order allowing such fees. Accordingly, this objection should be reserved for the hearing on the final fee application and is not an appropriate objection to confirmation.

77. For the foregoing reasons, the Debtor respectfully requests that the Court enter an order confirming the Plan.

Dated: November 25, 2015
Costa Mesa, California

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Caselaw Supplement

Section 1123(b)(5) – Anti-Modification Provision

William Lobel, Esq.

Courts have struggled with the application of Section 1123(b)(5) in cases where chapter 11 debtors assert that their property is used for both residential and business purposes.

Majority View

Scarborough v. Chase Manhattan Mortg. Corp. (In re Scarborough), 461 F.3d 406 (3d Cir. 2006) – The Third Circuit held that anti-modification protection does not apply to a multi-unit property where the debtor lived in one unit and rented the others. 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.

In re Bullard, 494 B.R. 92 (1st Cir. B.A.P. 2013) (assuming without discussion that if residential real estate includes a unit separate from the one in which the debtor resides, the lender's claim is not secured solely by the debtor's primary residence).

Pawtucket Credit Union v. Picchi (In re Picchi), 448 B.R. 870 (1st Cir. B.A.P. 2011) (permitting cramdown of a multi-unit dwelling where the debtor resided).

Lomas Mtg., Inc. v. Louis, 82 F.3d 1 (1st Cir. 1996) (the anti-modification provision does not bar modification of a secured claim on a multi-unit property in which one of the units is the debtor's principal residence and the security interest extends to the other income-producing units).

See In re Mobley, 2011 WL 5833976 (Bankr. N.D. Ill. 2011) and *In re Colcord*, 2015 WL 5461543 (Bankr. E.D. Mich. 2015) (slip decisions listing cases that have hold that the anti-modification provision does not prohibit modification of a mortgage on a multi-unit property).

Accord In re Abrego, 506 B.R. 509 (Bankr. N.D. Ill. 2014) (adopting the "majority" view and holding that the debtors' use of a portion of their property other than for residential purposes meant that creditor was not protected by the anti-modification provision).

Bright-Line Approach

In re Wages, 508 B.R. 161 (9th Cir. B.A.P. 2014) – The Ninth Circuit Bankruptcy Appellate Panel rejected the majority view (and the totality of the circumstances approach discussed below) and adopted a bright-line approach that the anti-modification exception applies to any loan secured only by real property that the debtor uses as a principal residence property, even if that real property also serves

additional purposes. In *Wages*, the Ninth Circuit BAP held that debtors could not use their plan to modify the rights of a mortgage lender whose claim was secured only by real property that was the site of debtors' principal residence, although the debtors also used the property to park truck tractors and trailers used in debtors' trucking business, and the residence also contained an office out of which the debtor-wife performed administrative tasks associated with trucking business. The Ninth Circuit BAP rejected its prior "totality of the circumstances" decision in *Lievsay v. W. Fin. Sav. Bank, F.S.B. (In re Lievsay)*, 199 B.R. 705 (9th Cir. B.A.P. 1996) (holding that modification under section 1123(a)(5) was not appropriate when debtor failed to show that a home office added significant value to his property, or that the bank relied on the additional security offered by his home office in making the loan secured by the property).

Accord In re Macaluso, 254 B.R. 799 (Bankr. W.D.N.Y. 2000) (the anti-modification provision applies to any property that is used as the debtor's principal residence, notwithstanding the fact that the debtor's property included a second residential unit and a store).

Totality of the Circumstances / Case-By-Case Approach

Other cases apply a more fact-intensive approach to determine whether a debtor's commercial use of the property has become so significant that the property should no longer be considered the debtor's principal residence. These cases focus on the predominant character of the transaction, and what the lender bargained to be within the scope of its lien. If the transaction was predominantly viewed by the parties as a loan transaction to provide the borrower with a residence, then the anti-modification provision will apply. If, on the other hand, the transaction was viewed by the parties as predominantly a commercial loan transaction, then modification will be available. *See Brunson v, Wendover Funding, Inc. (In re Brunson),* 201 B.R. 351 (Bankr. W.D.N.Y. 1996) (listing factors to use in a case-by-case determination of whether property is commercial or the debtor's principal residence).

In re Zaldivar, 441 B.R. 389 (Bankr. S.D. Fla. 2011) – The bankruptcy court adopted the *Brunson* totality of the circumstances test, holding that it is the predominant character of the transaction which will control whether the anti-modification provision applies. Where there was no owner-occupancy requirement in the mortgage, the court found that the predominant character of the transaction could not be viewed by the parties as a loan transaction to provide the borrower with a residence. Therefore, the court allowed modification of the lien.

In re Cady, 2015 WL 631359 (Bankr. M.D. Fla. Jan. 27, 2015) – The bankruptcy court held that, under any approach, the anti-modification provisions of § 1123(b)(5) prevented the debtors from modifying the lender's secured claim against property that served both as the debtors' principal residence and as a home office for the husband's work as a real estate agent. The court based its decision on the facts that (1) the property was a single family residential property, (2) the debtors agreed (in their mortgage documents) to occupy the property as their principal residence, and (3) the debtors actually resided on the property with their children.

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UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF HOPLANDIA

IN RE: Case No.: 14-12345-BKC

JOHN SUDS, Chapter 11

Debtor.
_____/

SEEDY CO.'S OBJECTION TO DEBTOR'S PLAN OF REORGANIZATION

Seedy Co. ("Seedy"), through undersigned counsel, objects (the "Objection") to the John Suds' (the "Debtor") proposed Plan of Reorganization. In support of the Objection, Seedy states:

BRIEF ARGUMENT

The Plan of Reorganization promises to support the Debtor a lavish lifestyle while simultaneously providing the Estate's unsecured creditors a distribution of mere cents on the dollar. Seedy, one of the Debtor's largest unsecured trade creditors, objects to the Plan for two primary reasons: first, the Plan does not comport with the absolute priority rule and second, the Plan is not proposed in good faith. Seedy asserts that a plan could be proposed which would result in a substantially higher return to unsecured creditors. Because the Plan does not confirm to two major requirements of § 1129, it should not be confirmed.

BACKGROUND

1. The Debtor owns and operates a sole proprietorship, Stache Brewery ("Stache"), in Hoplandia.

2. For some time, Stache was a successful endeavor. However, despite the considerable income the Debtor received from Stache's operations, the Debtor failed to make any attempts to pay his business loans with Wells Fargo Bank, N.A. Instead, the Debtor paid off his student loans and funneled money into his amateur-racing hobby.

3. After receiving a DUI, the Debtor made a series of decisions that ultimately led to the filing of a voluntary petition under Chapter 11.

4. During the course of the bankruptcy, the Debtor has not acted in good faith and has acted contrary to the Bankruptcy Code.

5. For instance, the Debtor made post-petition, unauthorized payments to support his racing team that were outside of the ordinary course of business.

6. The monthly payments to support the racing team, to date, amount to $200,000.00.

7. Additionally, the Debtor failed to abide by the United States Trustee operating guidelines when he did not insure a racecar worth $250,000.00.

8. That racecar was totaled in a post-petition race after which the Debtor, without authorization from this Court, paid $250,000.00 for a replacement racecar.

9. Previously, the Debtor's failure to insure the racecar was the subject of a prior Motion to Appoint a Chapter 11 Trustee [ECF No. 55].

10. On October 1, 2014, the Debtor filed his Plan of Reorganization (the "Plan").

11. Seedy objects to the Plan because, among other things, it was not filed in good faith, nor does it comport with the absolute priority rule, as set forth below.

OBJECTIONS

I. BECAUSE THE PLAN DOES NOT COMPORT WITH THE ABSOLUTE PRIORITY RULE IT SHOULD NOT BE CONFIRMED OVER SEEDY'S OBJECTION.

12. The Plan does not comport with the absolute priority rule because it permits the Debtor to retain all property of the estate, despite a proposed cramdown on Class 4 of unsecured creditors.

13. The majority of Circuit Courts that have considered the issue and find that the absolute priority rule applies to individual Chapter 11 debtors.[1]

14. The absolute priority rule is triggered when a debtor attempts to confirm a nonconsensual plan over the objection of an impaired creditor. *Ice House America, LLC v. Cardin,* 751 F.3d 734, 737 (6th Cir. 2014). To satisfy the absolute priority rule, every unsecured creditor must be paid in full before the debtor may retain any property under the plan. *Id; see also* 11 U.S.C. § 1129(b)(2)(B)(ii).

15. In the 2005 amendments to the Bankruptcy Code, Congress expanded the definition of "property of the estate" to include property obtained by the Debtor *after* the commencement of the bankruptcy case. Additionally, the Court revised § 1129(b)(2)(B)(ii) to add "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)(14) of this section." 11 U.S.C. § 1129(b)(2)(B)(ii).

16. Some courts believe the revised § 1129(b)(2)(B)(ii) excepts all of a debtor's property—both pre- and post-petition—from the absolute priority rule, rendering the rule

[1] *See In re Ice House America, LLC v. Cardin*, 751 F.3d 734 (6th Cir. 2014) (adopting majority narrow view that absolute priority rule applies to chapter 11 individual debtor); *In re Lively*, 717 F.3d 406 (5th Cir. 2013) (same); *In re Stephens*, 704 F.3d 1279 (10th Cir. 2013) (same); *In re Maharaj*, 681 F.3d 558 (4th Cir. 2012) (same).

inapplicable to individual debtors. *Id.* However, the majority of Circuit Courts that have ruled on the issue hold that § 1129(b)(2)(B)(ii) only removes post-petition property from the absolute priority rule. *Id.*

17. The split in authority rests on a purported ambiguity in the terms "included in" and "under." *In re Lively,* 717 F.3d 406, 410 (5th Cir. 2013). However, as the Fifth Circuit held "[r]eadng the phrase in § 1129(b)(2)(B)(ii) to evince ambiguity seems a grammatical stretch, because § 1115 expressly states that property is being 'added' to that comprised by § 541; the section does not supersede § 541 property, any more than '2' supersedes '3' when added to it." *Id.*

18. Additionally, "repeals by implication are not favored and will not be presumed unless the intention of the legislature to repeal is clear and manifest." *In re Stephens,* 704 F.3d 1279, 1286 (10th Cir. 2013) (citing *Nat'l Ass'n of Home Builders v. Defenders of Wildlife,* 551 U.S. 644, 662 (2007). Without any clear indication from Congress that it intended to make the absolute priority rule inapplicable to individual Chapter 11 debtors, the Court should find that it applies.

19. The Plan proposes to allow the Debtor to retain his *prepetition* interest in brewery equipment, recipes and other trade secrets, inventory, and other non-exempt personal property. Moreover, the Plan allows the Debtor to retain his replacement racecar and racing gear and other equipment. The Debtor's improved technique for making *Plato the Blind* could itself be worth $100,000.00 if it were sold to a competing brewery, which would result in a substantially higher recovery that the current forty cents on the dollar.

20. Even if the Court were to apply the absolute prority rule here, the Debtor argues that the new value exception to the absolute priority rule applies based upon the Debtor's post-

confirmation efforts in connection with brining *Plato the Blind* to market year round. In relation to this argument, the Debtor's Memorandum of Law recognizes that the Supreme Court has historically recognized a Debtor's promise of future services in the context of new value to be "intangible, inalienable, and unenforceable." *See Norwest Bank Worthington v. Ahlers,* 485 U.S. 197, 204 (1988). However, the Debtor submits that Congress implicitly overruled the Supreme Court's holding in *Ahlers* by the adoption of §§ 1123(a)(8) and 1129(a)(15), which requires a debtor to distribute its disposable income for at least five years. Nevertheless, the formula and process for producing *Plato the Blind,* as well as any associated intellectual property, is rightfully pre-petition property that cannot constitute "new value."

21. Accordingly, the Court should adopt the holding of a majority of courts and apply the absolute priority rule in this case. Therefore, Seedy objects to the Plan based on its failure to comply with the absolute priority rule.

II. THE PLAN IS NOT PROPOSED IN GOOD FAITH AND SHOULD NOT BE CONFIRMED.

22. The Debtor's Plan is not proposed in good faith. First, the Debtor continues to fund his race team post-petition and such expenses are outside the ordinary course of business, for which the Debtor did not seek bankruptcy court approval. Second, the Debtor continues to make payments to a professional that has not been approved by this Court. Third, the Debtor's attorney is conflicted in this case. Lastly, the Plan fails to require the Debtor to pay all his disposable income to creditors for five years. Accordingly, confirmation of the Plan should be denied.

A. The Payments Made of Monthly Racing Expenses Were Unauthorized, Outside of the Ordinary Course of Business, and in Contravention to § 363(c)(1).

23. Pursuant to § 363(c)(1), the debtor may enter into transactions, and may use property of the estate in the ordinary course of business without notice or a hearing. The Bankruptcy Code contemplates an ability to use estate assets to pay ordinary course living expenses.

24. In the Chapter 13 context, where a debtor's post-petition living expenses are proven to be unreasonable or excessive, his Chapter 13 case will be dismissed or converted "either because his plan was not proposed in good faith or because he is unwilling to devote all of his disposable income to the payment of creditors under his plan, and not because the debtor failed to obtain prior court approval for the payment of his ordinary course living expenses…." *See In re Seely*, 492 B.R. 284 (Bankr.C.D.Cal. 2013) (payment of ordinary course living expenses should be treated as being within the debtor's ordinary course of business for the purpose of interpreting section 363(c)(1)).

25. In *Seely*, the BAP thought it appropriate to give § 363(c)(1) the same effect in Chapter 11 cases; that is, "the court should recognize that section 363(c)(1) authorizes a debtor in possession to use property of the estate to pay post-petition living expenses without prior approval, so long as the amounts to be disbursed qualify as 'ordinary course' expenses" and are not unusual or extraordinary.

26. To determine whether expenses are ordinary within the meaning of § 363(c), courts look to two tests: (1) the Horizontal Dimension Test (industry standards) and (2) the Vertical Dimension Test (creditor expectations). *In re Dant & Russell, Inc,* 853 F.2d 700, 704 (9th Cir. 1988). The horizontal dimension test looks at whether the post-petition transaction is of a type that other similar businesses would engage in as ordinary business. The vertical dimension test views the disputed transaction "from the vantage point of a hypothetical creditor and inquires whether the transaction subjects a creditor to economic risks of a nature different from those he accepted when he decided to extend credit." *Id.* at 705 (internal citations omitted).

27. The Debtor's authorization under § 363(c) is not unlimited and the Debtor may not use estate property to fund a lavish lifestyle. Here, the Debtor fails both the horizontal and vertical dimension tests.

28. Specifically, the Debtor has spent over $200,000.00 to date to fund racing expenses and purchased a $250,000.00 racecar, outside of the ordinary course of business, and without bankruptcy court approval.

29. Although usual marketing costs may be considered ordinary course business expenses, the Debtor's expenditure of hundreds of thousands of dollars on a racing team, and flying first class to each race, is beyond what is ordinary for similar businesses similarly situated to that of Stache. Additionally, the vertical dimension test is failed because the Debtor's racing

hobby, within the context of Chapter 11, subjects Seedy and the Debtor's other creditors to economic risks that are different from those at the outset of the debtor-creditor relationship. In particular, the post-petition racing exposes the estate to significant liability, which could diminish the already low returns to creditors.[2]

30. Importantly, it is not a creditor's obligation to monitor monthly operating reports for extraordinary expenses; rather, the Debtor has a fiduciary obligation to tailor its budget to ordinary course business expenses.

B. The Plan Impermissibly Proposes to Pay for the Debtor's Criminal Defense Attorney.

31. Seedy objects as the Plan seeks to pay the Debtor's criminal defense attorney for services rendered post-petition in connection with defending the Debtor's DUI charges. The Debtor's criminal defense attorney was not retained under §§ 327 and 330 and the Debtor made unauthorized payments to his criminal defense attorney during the pendency of this case. Moreover, the criminal defense attorney was not intended to provide a benefit to the estate.

32. The "court may authorize the employment of defense counsel if the criteria of either § 327(a) or § 327(e) are met, i.e., if the employment of defense counsel either assists the debtor in possession in carrying out his duties under Chapter 11 or is in the best interest of the estate." *Official Comm. of Disputed Litig. Creditors v. McDonald Investments, Inc*., 42 B.R. 981, 985 (N.D.Tex. 1984).

33. Although it is true that Stache's liquor license could be revoked were the Debtor to be convicted of a DUI offense, discovery in this case revealed that the Debtor was "mainly concerned that a conviction may lead to a severe sentence which he is determined to avoid" and that he "is also worried about the possible imposition of significant fines or penalties."

[2] Indeed, the Debtor's failure to insure a $250,000.00 racecar, which was subsequently totaled, is an example of this risk, manifested.

34. Because the benefit inures to the Debtor personally, and not to the estate, the employment of the criminal defense attorney is not in the best interests of the estate. Regardless, the Debtor's failure to attempt to employ this professional, and his continued payment of the same, is illustrative of his lack of good faith.

C. The Plan Does Not Meet the Good Faith Requirement of Section 1129 Because the Debtor's Attorney is not Disinterested.

35. Section 1129(a)(2) requires the proponent of a plan to comply with all applicable provisions of title 11. By defending the Debtor's exemptions, Debtor's counsel has failed to be disinterested and his representation of an interest materially adverse to the estate. *In re Weaver*, 336 B.R. 115 (Bankr. W.D. Tex. 2005) (general counsel was not entitled to be compensated by estate for time spent in dealing with exempt property). Throughout this Chapter 11, the Debtor's own conflicts are exacerbated by his lawyer's undisclosed conflicts with the estate.

D. The Plan Fails to Pay All Disposable Income to Unsecured Creditors.

36. Section 1123(a)(8) requires future income to be used to fund payments to creditors. Additionally, § 1129(a)(15) requires an individual Chapter 11 debtor to pay all unsecured creditors in full, or that the debtor's plan devote an amount equal to five years' worth of the debtor's projected disposable income to unsecured creditors.

37. Section 1129(a)(15) refers to section 1325(b)(2) for a definition of "disposable income." Section 1325(b)(2)(B) defines expenses for a debtor engaged in business as those "necessary for the continuation, preservation, and operation of such business."

38. Accordingly, all the Debtor's disposable income should be used to pay unsecured creditors in full, or the Plan should devote an amount equal to five years' worth of the Debtor's projected disposable income. The Debtor's plan to invest funds in the "start up" venture related to a new type of beer is not consistent with these provisions of the Bankruptcy Code.

III. THE PLAN'S MODIFICATION OF WELLS FARGO'S CLAIM IS IMPERMISSIBLE.

39. The Debtor's proposed modification of Wells Fargo's claim, which is secured by a lien on real property that is both his place of business and principal residence, is impermissible under the bankruptcy code and confirmation of the Plan should therefore be denied.

40. On one hand, when defending his exemptions of the real property, the Debtor has downplayed the fact that the Stache Brewery is a place of business. Now, when the property being considered a business better suits his purposes, the Debtor makes the argument that he may modify a secured claim of Wells Fargo because the property is his principal residence and his place of business.

41. A plan should only be confirmed if it comports with the applicable provisions of Chapter 11. *See* § 1129(a)(1); *see also In re Wages,* 500 B.R. 161, 164-5 (9th Cir. BAP 2014). Of relevance here is § 1123(b)(5), which does not allow a plan to modify the rights of holders of secured claims when the security interest is in real property that is the debtor's principal residence. *Id.*

42. For the anti-modification provision of section 1123(b)(5) to come into effect, three distinct requirements must be met: "first, the security interest must be in real property; second, the real property must be the only security for the debt; and third, the real property must be the debtor's principal residence." *Id.* at 165.

43. The line of cases argued by the Debtor focus on Congress' use of the word "is" in the phrase "real property that is the debtor's principal residence." These courts find that "by using 'is,' Congress equated 'real property' and 'principal residence,' meaning that, for the antimodification provision to apply, the property 'must *be only* the debtor's principal residence'

and no other use" (emphasis in original). *Id.* (*citing Scarborough v. Chase Manhattan Mortg. Corp. (In re Scarborough),* 461 F.3d 406, 411 (3d Cir. 2006)).

44. Other courts disagree with this interpretation "because it disregards the bankruptcy code's definition of 'debtor's principal residence' in § 101(13A). The term 'means a residential structure if used as the principal residence by the debtor, including incidental property, without regard to whether that structure is attached to real property.'" *Id.* at 166.

45. Here, Seedy urges the Court to adopt the "bright line" approach. This approach finds that the antimodification exception applies to any property that is used as the debtor's principal residence.[3] *Id.*

46. Section 1123(b)(5), by its plain language, does not protect from modification "claims secured only by a security interest in real property that is *exclusively* the debtor's principal residence," or "claims secured only by a security interest in real property that is the debtor's principal residence, *unless the debtor also uses the property for significant commercial purposes.*" *Id.* at 167. Thus, it would be improper to read such an effect through Congress' use of the word "is" into this provision.

47. As discussed in *In re Wages,* the bright line rule is objective and "promotes certainty in the home mortgage lending market." *Id.*

48. Accordingly, where the Plan violates the antimodification provision of § 1123(b)(5) and thus does not comply with the applicable provisions of title 11, confirmation of the Plan should be denied.

[3] The "bright line" approach the antimodification statute we urge the Court to apply through § 1123(b(5) in this case is consistent with a similar antimodification provision found in § 1322(b)(2). *See e.g. In re Macaluso,* 254 B.R. 799, 800 (Bankr.W.D.N.Y. 2000).

V. DEBTOR'S $250,000 TAX DEBT IS THE RESULT OF WILLFUL TAX EVASION AND IS THEREFORE NOT DISCHARGEABLE

49. In 2013, Mr. Suds received windfall profits from a wildly successful sell-through of his annual batch of *Plato the Blind*. Worried about the tax implications of this sudden influx in revenue, Mr. Suds engaged Bimini Bob's Barely Legal Brokerage to help set up a bogus tax shelter investment to generate "losses" that would counteract the effect of the additional revenues on his 2013 tax bill.

50. In April 2014, Mr. Suds signed a tax return for 2013 which, when taking into account the "losses" from the Bimini Bob investment, reported a small net loss from Stache Brewery's operations, despite record breaking sales. In 2014, Mr. Suds was the subject of an IRS audit. As part of the audit, the IRS discovered that Mr. Suds drastically over-reported losses from the bogus Bimini Bob tax shelter investment in order to avoid paying taxes on the profits generated by the sale of the 2013 batch of *Plato the Blind*. The audit resulted in a $250,000 tax assessment against Mr. Suds for amounts owed from 2013.

51. Knowing that he had drastically underreported his income and knowing that taxes were actually owed for 2013, Mr. Suds nevertheless chose to instead spend considerable amounts of money on his personal racing team, first class travel to and from racing events and to pay down his student loan debt. Even after the $250,000 assessment was entered after the audit, Mr. Suds continued to throw money at his expensive racing hobby instead of paying his tax bill—including the purchase of a new race car for an amount that was precisely equal to the amount owed to the IRS.

52. Now, Debtor seeks to have his $250,000 tax debt completely discharged as part of his chapter 11 plan. However, the Bankruptcy Code does not permit the discharge of a tax debt

that is the result of a debtor's willful attempt to evade or defeat either the assessment or collection of taxes. 11 U.S.C. § 523(a)(1)(C).

53. Courts have interpreted the § 523 "willful attempt" standard as having two elements—a conduct element and a mental state element. To satisfy the conduct element, there must be some evasive act by the debtor in addition to the non-payment of the tax bill. To satisfy the mental state element, the party opposing discharge must show the debtor "(1) had a duty to pay taxes under the law, (2) knew he had that duty, and (3) voluntarily and intentionally violated that duty." *United States v. Stanley*, 2014 WL 6997518, at *3 (5th Cir. Dec. 12, 2014) (internal citations omitted).

54. In addressing the second prong for debtor's knowledge of the duty to pay, it is not necessary for there be a formal tax assessment before the debtor can be found to have knowledge of his tax liability. So long as the debtor reasonably knew taxes were owed and that an investigation would likely yield an additional assessment, the debtor can be said to have knowledge of an impending tax liability and a duty to pay. *In re Vaughn*, 765 F.3d 1174, 1182 (10th Cir. 2014).

55. The third prong is satisfied by either an "affirmative act or culpable omission that, under the totality of the circumstances, constituted an attempt to evade or defeat the assessment, collection, or payment of a tax.'" *Stanley*, 2014 WL 6997518, at *3. Specific intent to defraud the IRS is not required to satisfy the mental state element. *Id.* "Willfulness" merely requires a showing that the debtor took an evasive action and did so voluntarily, consciously or knowingly, and intentionally. *Vaughn*, 765 F.3d at 1181 (citing *Dalton v. I.R.S.*, 77 F.3d 1297, 1302 (10th Cir. 1996); *see also In re Toti*, 24 F.3d 806, 809 (6th Cir. 1994).

56. Mr. Suds meets the conduct element through (1) his participation in the bogus Bimini Bob tax shelter and using the "losses" from that shelter to dramatically understate his net income on his 2013 return; and (2) his lavish spending on his personal racing hobby, both before and after the formal assessment from the 2013 audit. The mental state element is satisfied, because Mr. Suds took all these actions voluntarily and consciously, while knowing of his impending tax liability.

57. In seeking his discharge, Mr. Suds mainly relies on a single Ninth Circuit case as support for a stringent "specific intent" interpretation of the § 523 "willfulness" standard. *Hawkins v. Franchise Tax Bd. of California*, 769 F.3d 662, 666 (9th Cir. 2014). In *Hawkins*, the Ninth Circuit interpreted the mental state element of "willfulness" to require a showing of a debtor's specific intent to evade taxes, similar to what is required for criminal evasion and fraud. *Id.* at 668. Further, the *Hawkins* opinion drastically constricted the evidence available for consideration as part of the mental state calculation, and specifically prohibited courts from considering facts regarding a debtor's lavish and irresponsible spending down of assets as evidence of evasive intent. *Id.* at 669.

58. Mr. Suds's reliance on *Hawkins* is misplaced and this Court should not adopt the Ninth Circuit's extreme minority opinion arguing for the narrow "specific intent" standard of "willfulness." In interpreting § 523, the Fifth, Sixth, Tenth and Eleventh Circuits have all adopted a broad reading of the mental state element and in each case, these circuits have expressly considered a debtor's lavish discretionary spending as evidence of willful, evasive intent sufficient to defeat discharge—particularly when debtor had the means to satisfy the tax liability at the time the lavish spending occurred. *Stanley*, 2014 WL 6997518, at *4 ("[A] debtor's failure to pay taxes when he or she had the ability to pay, while not dispositive, can also

suggest willfulness."); *Vaughn*, 765 F.3d at 1181; *In re Mitchell*, 633 F.3d 1319, 1329 (11th Cir. 2011); *In re Gardner*, 360 F.3d 551, 557 (6th Cir. 2004). Further, when irresponsible spending is coupled with a debtor's participation in questionable tax shelter investments, broad view courts have found that such a combination does not suggest the sort of "honest but unfortunate" debtor for whom "fresh start" and discharge benefits should apply. *See Stanley*, 2014 WL 6997518, at *4; *Vaughn*, 765 F.3d at 1181.

59. Additionally, Mr. Suds cannot hide behind his reliance on Bimini Bob's recommendation of the offshore tax shelter as an excuse for his evasive actions to hide his 2013 tax liability. In considering similar cases, courts have held that such reliance only serves as a defense to the extent that it is reasonable. Where the facts and circumstances suggest that the debtor should have known that the tax avoidance scheme was improper, the debtor is not allowed to blindly rely on the fact that the scheme was executed by a financial professional to defeat the knowledge component of § 523. *Vaughn*, 765 F.3d at 1182 (holding that debtor's reliance on advice from KPMG as his longtime tax advisor regarding a tax shelter scheme did not prohibit a finding of "willfulness" for the purposes of § 523).

60. Like the debtor in *Vaughn*, Mr. Suds knew he had an impending tax liability due to his windfall revenue from 2013's batch of Plato the Blind. Even if Mr. Suds did not exactly understand the operation of the Bimini Bob tax shelter, the facts are sufficient to show that Mr. Suds should have known that he would have to pay taxes on that income and that the reported net income on his 2013 return—to the point of showing a loss for Stache Brewery— was drastically understated in a year where he sold more beer for more money than any year previous.

61. The Bankruptcy Code 's "fresh start" discharge provisions were not meant to be a "Plan B" for debtors whose tax shelters crumbled under an IRS audit. Further, the debtors who

consciously abuse and refuse to abide by the restrictions of the bankruptcy process through lavish spending down of their estate assets should not be allowed to use such abuse as a means to protect themselves from their creditors.

62. Mr. Suds—through participating in shady tax avoidance schemes to avoid tax liability and by continuing to fund his extravagant person hobbies in lieu of paying those liabilities—acted to "willfully" evade his tax obligations. Such obligations are therefore not subject to discharge and must be paid in full as part of the chapter 11 reorganization.

VI. IF THE COURT DENIES CONFIRMATION OF THE PLAN, IT SHOULD APPOINT A CHAPTER 11 TRUSTEE IN THIS CASE.

63. Previously, Seedy moved to appoint a Chapter 11 trustee over this case. That request was initially denied to give the Debtor an opportunity to propose a plan, but without prejudice in the event of continued creditor concerns.

64. Section 1104(a)(1) authorizes the appointment of a Chapter 11 trustee "for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement f the case, or similar cause…if such appointment is in the best interests of creditors…" 11 U.S.C. § 1104(a)(1).

65. If the Court denies confirmation of the Plan, and based on the Debtor's unauthorized use of estate funds to purchase a $250,000.00 racecar and his failure to insure his previous racecar, Seedy respectfully requests this Court appoint a Chapter 11 trustee to safeguard the estate and its assets.

CONCLUSION

WHEREFORE, Seedy respectfully requests this Court: (1) sustain the Objection; (2) deny confirmation of the Plan; (3) appoint a Chapter 11 Trustee; and (4) grant any other relief it deems appropriate.

Dated: November 25, 2015
San Juan, Puerto Rico

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CASELAW SUPPLEMENT

ABSOLUTE PRIORITY RULE

Luis Marini, Esq.

Overview:

The absolute priority rule is codified at section 1129(b)(2)(B) of the Bankruptcy Code, which provides, as amended by BAPCPA:

> (B) With respect to a class of unsecured claims--
> (i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or
> (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 (a)(14) of this section.**

11 U.S.C. § 1129(b)(2)(B) (Emphasis supplied as to the amendments made by BAPCPA).

Section 1115 provides in its pertinent parts:

> (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.

11 U.S.C. § 1115.

There is some dispute over the meaning of "property included in the estate under section 1115". 11 U.S.C. § 1129(b)(2)(B). The issue which has divided the courts is the interpretation of section 1129(b)(2)(B)(ii)'s language as to "property included in the estate under § 1115". Essentially, the issue is whether said language should be construed as incorporating all of the property of the estate under section 541 of the Bankruptcy Code (i.e., the debtor's pre-petition

property) within the context of section 1115. Those courts that understand that the answer is "yes" have held that all of the debtor's pre and post-petition property would be excepted from the operation of the absolute-priority rule. If, on the contrary, the answer were to be on the negative, then the absolute-priority rule will apply to individual chapter 11 debtors.

Courts Finding that the Absolute Priority Rule Applies:

- In re Lee Min Ho Chen, 482 B.R. 473 (Bankr. D.P.R. 2012) Adopting the "narrow view" and finding that pre-petition property "is unaffected by section 1115 for purposes of section 1129(b)(2)(B)(ii) and therefore cannot be retained unless senior classes of claims are paid in full or unless all senior classes vote to accept the proposed plan".
- In re Walsh, 2011 WL 867046 (Bankr. D. Mass. Mar. 9, 2011) . In Walsh, the debtor "own[ed] and operate[d] 56 residential apartments in five locations…and own[ed] a home and a vacation property". Id. The debtor's proposed plan provided for the class of general unsecured claims to receive 5% of their claims over five years and for all properties to revest in the reorganized debtor. An undersecured creditor voted its secured and unsecured claims against the plan. The court found that if general unsecured claims voted against the plan, it would not satisfy the absolute priority rule.
- In re Gbadebo, 431 B.R. 222, 229 (Bankr. N.D. Cal. 2010) ("Gbadebo"). In Gbadebo, the court explained as follows:

> Notwithstanding the [analysis by courts holding otherwise], the Court is unable to agree with [their] conclusion. If the Court were writing on a clean slate, it would read the phrase "included in the estate under section 1115" to be reasonably susceptible only to one meaning: i.e., added to the bankruptcy estate by section 1115.
>
> Section 103(c) provides that Section 541 applies in a chapter 11 case, including an individual chapter 11 case. Section 541 provides that, when a petition is filed, a bankruptcy estate is created, consisting of the debtor's pre-petition property. Section 1115 provides that, in an individual chapter 11 case, in addition to the property specified in Section 541, the estate includes the debtor's post-petition property. If the clause referring to

> Section 541 had not been included in Section 1115 and if Section 1115 had merely stated that an individual chapter 11 debtor's estate included post-petition property, the argument could have been made that an individual chapter 11 debtor's estate did not include his pre-petition property.

- In re Arnold, 2012 WL 1820877 (Bankr. C.D. Cal. May 17, 2012):

> Without requiring the Plan to comply with the absolute priority rule, the Debtors would write off about $3.5 million in unsecured debts, forcing General Unsecured Creditors to take a loss of at least 85 cents on the dollar, while the Debtors retain all prepetition and postpetition property, including an investment property valued at $5,434,000 at a time that arguably may be the bottom of the real estate market. Under the proposed Plan, the Debtors have unlimited upside potential for profit on their prepetition and postpetition assets while [the bank] and other General Unsecured Creditors must absorb the loss fixed under the proposed Plan. … This situation in this case appears to be what Congress stated it intended to prevent with the passage of BAPCPA.

Cases Holding That Absolute Priority Rule Does Not Apply:

- In re Tegeder, 369 B.R. 477, 479–481 (Bankr.D.Neb.2007);
- In re Roedemeier, 374 B.R. 264, 273–276 & nn. 15–19 (Bankr. D. Kan. 2007);
- In re Shat, 424 B.R. 854, 862–868 (Bankr. D. Nev. 2010);
- SPCP Group, LLC v. Biggins, 465 B.R. 316, 320–324 (M.D. Fla. 2011);
- Friedman v. P+P, LLC (In re Friedman), 466 B.R. 471 (9th Cir. BAP 2012);
- In re Johnson, 402 B.R. 851, 852–853 (Bankr.N.D.Ind.2009); and
- In re Hockenberry, 457 B.R. 646, 660–661 & n. 14 (Bankr.S.D.Ohio 2011).