Practicing in the Limelight: Celebrity Bankruptcies

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Whose Life is it Anyway? Treatment of Unique Assets in Bankruptcy

By David L. Neale and Lindsey L. Smith[1]

"A sign of celebrity is often that their name is worth more than their services."

~ Daniel J. Borstin

In today's celebrity-obsessed culture, it's hard to avoid the *schadenfreude* associated with a star's fall from grace. Celebrity bankruptcies attract the attention of the press and the public, even though the issues raised in such cases may be mundane and quite routine. Nonetheless, there are some issues that may be unique to bankruptcy cases involving the famous, and the relatively undeveloped state of the law as it relates to new media and technology creates some questions which are sure to be front and center in celebrity bankruptcy cases in the coming years.

1. Publicity Rights – What are they?

One such example of a unique aspect of celebrity bankruptcy cases involves the right to commercially exploit the characteristics of a celebrity. Publicity rights have been the subject of disputes for more than half a century, and promise to be a continuing source of controversy over the coming years. "Publicity rights" themselves are defined as the right to use a celebrity's name, voice, signature, photograph, or likeness for commercial purposes. *Comedy III Prods., Inc. v. Gary Saderup, Inc.*, 25 Cal. 4th 387, 391, 21 P.3d 797 (2001).

An early case that recognized the existence of publicity rights was the case of *Haelan Labs., Inc. v. Topps Chewing Gum, Inc.*, 202 F.2d 866 (2d Cir. 1953). In that case, the plaintiff, engaged in selling chewing-gum, entered into a contract with a baseball player that gave the chewing gum company the exclusive right to use the baseball player's photograph in connection with the sale of gum. The contract also provided plaintiff an option to extend the term for a designated period. In the contract, the baseball player agreed not to grant any other gum

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manufacturer a similar right during the term of his agreement.

Defendant, a rival chewing-gum manufacturer, knew of plaintiff's contract, and deliberately induced the baseball player to authorize it to use the player's photograph in connection with the sale of the competing brand of gum. Plaintiff sued defendant and asserted that defendant invaded plaintiff's exclusive right to use the photographs. The defendant argued that there was no actionable wrong because the contract with the plaintiff was no more than a release by the baseball player of any potential claim for an invasion of his right to privacy. Defendant further argued that the statutory right to privacy is personal and not assignable and therefore, plaintiff's contract vested in plaintiff no property right or other legal interest which defendant's conduct invaded.

The Court disagreed with defendant and distinguished a right to privacy from the right to publicity. The Court in *Haelan Labs., Inc.* stated that "We think that, in addition to and independent of that right of privacy (which in New York derives from statute), a man has a right in the publicity value of his photograph, *i.e.*, the right to grant the exclusive privilege of publishing his picture, and that such a grant may validly be made 'in gross,' *i.e.*, without an accompanying transfer of a business or of anything else. Whether it be labelled a 'property' right is immaterial; for here, as often elsewhere, the tag 'property' simply symbolizes the fact that courts enforce a claim which has pecuniary worth." The Court further stated that "This right might be called a 'right of publicity.' For it is common knowledge that many prominent persons (especially actors and ball-players), far from having their feelings bruised through public exposure of their likenesses, would feel sorely deprived if they no longer received money for authorizing advertisements, popularizing their countenances, displayed in newspapers, magazines, busses, trains and subways. This right of publicity would usually yield them no

money unless it could be made the subject of an exclusive grant which barred any other advertiser from using their pictures."

The Supreme Court weighed in on publicity rights in *Zacchini v. Scripps-Howard Broad. Co.*, 433 U.S. 562, 573, 97 S. Ct. 2849, 2856, 53 L. Ed. 2d 965 (1977). There, the Supreme Court stated that "The State's interest in permitting a 'right of publicity' is in protecting the proprietary interest of the individual in his act in part to encourage such entertainment. The State's interest is closely analogous to the goals of patent and copyright law, focusing on the right of the individual to reap the reward of his endeavors and having little to do with protecting feelings or reputation." The Supreme Court further noted that "In 'right of publicity' cases the only question is who gets to do the publishing."

Currently, the answer to the question of whether a right to publicity is a statutory right and/or a common law right varies from state to state. For example, in California, the right to publicity is both a statutory and common law right. The statutory right originated in Civil Code section 3344 enacted in 1971, authorizing recovery of damages by any living person whose name, photograph, or likeness has been used for commercial purposes without his or her consent. Later, in *Lugosi v. Universal Pictures* (1979) 25 Cal.3d 813 [160 Cal.Rptr. 323, 603 P.2d 425, 10 A.L.R.4th 1150], California also recognized a common law right of publicity. *See also, Comedy III Prods., Inc. v. Gary Saderup, Inc.*, 25 Cal. 4th 387, 391, 21 P.3d 797 (2001)

2. Are publicity rights property of a bankruptcy estate?

11 U.S.C. §541 determines what is property of the bankruptcy estate and provides in relevant part:

> (a) The commencement of a case under section 301, 302, or 303 of this title creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held:
>
> (1) Except as provided in subsections (b) and (c)(2) of this section, all legal or equitable interests of the debtor in property as of the commencement of the case.

The broad definition of "property of the estate" provided for under 11 U.S.C. §541 would seem to indicate that a debtor's right to publicity would become property of the bankruptcy estate. However, the ability to liquidate such right and the value of such right in the bankruptcy context is not so clear.

3. <u>Can you liquidate the right to publicity in bankruptcy?</u>

In determining whether you can liquidate the right to publicity in bankruptcy, it helps to analyze what Courts have determined is possible with respect to the right to publicity outside of the bankruptcy context. For example, Courts have held that a right of publicity is assignable. In *Haelan Labs.*, *supra*, the Court stated that the right of publicity is assignable during the life of the celebrity, for without this characteristic, full commercial exploitation of one's name and likeness is practically impossible. *Haelan Laboratories v. Topps Chewing Gum, supra*, 202 F.2d at 868. The *Haelan Labs.* Court stated that the right to publicity is assignable *during the life of the celebrity*, which begs the question, does a celebrity's right to publicity survive the celebrity's death?

States have contrasting positions on whether the right to publicity survives death. In California, the right to publicity survives death and is inheritable. California Civil Code section 3344.1 provides that a right to publicity is inheritable after the celebrity's death and states that

"The rights recognized under this section are property rights, freely transferable or descendible, in whole or in part, by contract or by means of any trust or any other testamentary instrument, executed before or after January 1, 1985." Cal. Civ. Code § 3344.1 (West) In contrast, in New York, one's right of publicity is extinguished at death. *See, Shaw Family Archives, Ltd. v. CMG Worldwide, Inc.*, 434 F. Supp. 2d 203, 207 (S.D.N.Y. 2006).

4. If you can you liquidate the right to publicity in bankruptcy, what do you get?

Going back to the definition of the right to publicity, if someone purchases a celebrity's right to publicity, does that purchaser obtain the right to exploit the celebrity's name or likeness? If the answer to the foregoing question is yes, without any limitations, this would seem to go against the Bankruptcy Code's fresh start policy, since after the outright sale of such right, the celebrity would not be able to use his or her own name or likeness to generate income in the future. In order to get around this issue, it might be possible to sell the exclusive right to use the celebrity's right to publicity for a limited time or limit the sale so that the purchaser can only use the right to publicity in a limited manner (for example only to advertise certain products), and allow the debtor to retain the right to use his or her name and likeness in other non-conflicting ways.

It should also be noted that the right to publicity, if sold, should not include a requirement that the celebrity perform any specific action in connection with the sale of his or her right to publicity. If such a requirement were included, it could amount to involuntary servitude. In the article *Foreclosing on Fame: Exploring the Uncharted Boundaries of the Right of Publicity*, 11 J. Bankr. L. & Prac. 441 (2002), Melissa B. Jacoby and Diane Leenheer Zimmerman make an important point: "[S]tate-law-created publicity rights are properly understood as purely passive in nature; any associated right to command active participation by a celebrity should be

understood as arising separately as a result of a specifically negotiated contract term. This interpretation makes sense in light of current practices and best comports with existing legal principles. Simply put, publicity rights, standing alone, do not include the right to direct a person's future labor."

5. Are a celebrity's social media accounts property of the bankruptcy estate?

In today's culture, not only are celebrity's social media accounts highly valuable but there are actual, social media celebrities – those celebrities that are famous solely as a result of their social media accounts and whose income is solely generated therefrom. Given the foregoing, what happens when a celebrity with a large social media following and with valuable social media accounts files for bankruptcy? Are those accounts considered property of the bankruptcy estate? The Court in *In re CTLI, LLC*, 528 B.R. 359 (Bankr. S.D. Texas 2015) held that the debtor limited liability company's social media accounts were part of the bankruptcy estate. However, the Court in *CTLI* did analyze the difference between the social media account of an LLC as opposed to an individual:

> "The Facebook Page or Profile of a celebrity or other public figure is a different type of property, related to the interest known as a *persona.* A *persona* is "the interest of the individual in the exclusive use of his own identity, in so far as it is represented by his name or likeness, and in so far as the use may be of benefit to him or to others." *Brown v. Ames,* 201 F.3d 654, 658 (5th Cir.2000) (quoting Restatement (Second) of Torts § 652C (1977)). Although heretofore unrecognized by bankruptcy courts, in most states, including Texas, the *persona* is recognized as a property interest, and therefore that falls within the broad reach of "property of the estate."" *See Matthews v. Wozencraft,* 15 F.3d 432, 437 (5th Cir.1994) (recognizing the *persona* as property under Texas law). The primary limitation on recognition of a *persona* as estate property is the 13th Amendment's prohibition on involuntary servitude. Just as a debtor may not assume contracts that would require any individual to perform personal services, 11 U.S.C. § 365(c); *Matter of Tonry,* 724 F.2d 467, 469 (5th Cir.1984), a

> debtor may not use estate property in a manner that would require any individual to perform personal services. Because the value in a Facebook Page or Profile lies in the ability to reach Friends or Fans through future communications, the property interest in an individual Profile would likely not become property of the estate. *See generally Smita Gautam, Bankruptcy: Reconsidering "Property" to Determine the Role of Social Media in the Bankruptcy Estate,* 31 Emory Bankr.Dev. J. 127, 127 (2014) (arguing that an individual debtor's interest in his social media accounts should be treated as a "liberty" interest instead of a "property" interest). However, the official Page of a celebrity or public figure that is managed by employees might be treated differently. *See generally* Melissa B. Jacoby & Diane Leenheer Zimmerman, *Foreclosing on Fame: Exploring the Uncharted Boundaries of the Right of Publicity,* 77 N.Y.U. L.Rev. 1322, 1347–57 (2002) (discussing how *persona* might be disentangled from personal services in general)."

In re CTLI, LLC, at 367.

A contrary conclusion to that reached by the Court in *CTLI* might not result in a meaningful distinction. In *CTLI*, the Court concluded that a celebrity's personal social media account, if managed by the celebrity, is not property of the bankruptcy estate. If the contrary were true – that a social media account becomes property of the bankruptcy estate – since one cannot compel a celebrity to render services in furtherance of the exploitation of that asset absent involuntary servitude (*e.g.*, by forcing the celebrity to post new content), the social media account would likely have no value upon sale.

6. Can you sell normal everyday assets owned by a celebrity for more money because they are celebrity owned?

In this day of crazed fans, Beliebers, groupies and collectors of all sorts, celebrity-owned everyday items may garner more value than those same items owned by non-celebrities. It is common place for celebrities to sell their everyday items at high prices and donate the proceeds to charity – just ask the Kardashian sisters. Often times, when the celebrity items are sold in the normal non-bankruptcy context, they are sold by the celebrity and/or have some sort of

ownership verification so that the buyer or collector has assurance that the item being purchased actually belonged to the beloved celebrity. This certification of ownership surely increases the value of the item even more.

As a result of celebrity worship present in the current culture, if a celebrity were to file for bankruptcy, the celebrity's average personal items could be considerably more valuable than might otherwise be the case, and could be sold to generate substantial funds for the benefit of creditors. If a celebrity were to claim exemptions for ordinary household items, how would one go about valuing such items on the debtor's bankruptcy schedules?

The celebrity debtor (as with all debtors) has a duty to provide accurate schedules of assets and liabilities, including accurate values for such assets. *In re Searles,* 317 B.R. 368, 378 (9th Cir. BAP 2004) (The continuing nature of the duty to assure accurate schedules of assets is fundamental because the viability of the system of voluntary bankruptcy depends upon full, candid, and complete disclosure by debtors of their financial affairs). The Official Form Schedules required to be used by debtors are executed under penalty of perjury for verification in compliance with Fed. R. Bankr.P. 1008. In *In re Leija,* 270 B.R. 497, 502-03 (Bankr.E.D.Cal. 2001), the court found that the term "oath" in Bankruptcy Code section 727(a)(4)(A) necessarily includes the unsworn declarations prescribed in the Official Forms. To hold otherwise would virtually nullify section 727(a)(4)(A) and would render Fed. R. Bankr.P. 1008 meaningless. *Id.* Further, the verification itself is a material representation of fact—that the debtor had read the pleading and that the information was true and correct to the best of the debtor's information and belief. *Id.* Based on the foregoing, the celebrity debtor has a duty to properly value his or her assets taking into account the added value that the celebrity ownership affords to an everyday item.

After determining the proper, and likely, higher value for the celebrity debtor's assets, the celebrity debtor next turns to properly scheduling his or her exemptions in such assets. Under the California exemption scheme, a debtor has two sets of exemptions from which to choose. Under the first set – the set provided pursuant to CCP Section 703 – for the debtor's personal items, the debtor has an unlimited exemption pursuant to CCP Section 703.140(b)(3) so long as no single item is worth more than $675. Additionally, for personal items, a debtor may supplement his or her other exemptions using the wild card exemption provided for under CCP Section 703.140(b)(5).

Under the second set of exemptions offered to a debtor pursuant to CCP Section 704, for a debtor's household and personal items, the debtor can exempt those assets which are *reasonable and necessary* pursuant to CCP Section 704.020. However, Courts have ruled that what is "reasonably necessary for the support of the debtor should be sufficient to sustain basic needs, and not related to the debtor's former status in society or lifestyle to which he or she is accustomed." *In re Gillead,* 171 B.R. 886, 890 (Bankr. E.D. Cal. 1994) *citing In re Taff,* 10 B.R. 101 (Bankr.D.Conn.1981).

Under the first exemption scheme, it appears that the celebrity debtor would be limited to asserting an exemption in the amount of $675 for each personal item; however, it is likely that due to the debtor's celebrity status, his or her personal items would each easily be valued at more than $675. Thus, in under this scenario, a trustee or celebrity debtor, as the case may be, there would need to be an allocation between the exemption amount and the amount available to satisfy creditor claims. Essentially, this could result in the forced liquidation of all of a celebrity's assets because, unlike the "average Joe" creditor, there could be a market for a used article of clothing or furniture.

Under the second exemption scheme, a celebrity debtor could argue that although his or her particular personal item is more valuable than normal due to the debtor's celebrity status, that personal item is reasonable and necessary. Thus, using the second exemption scheme a celebrity debtor might have a better chance of retaining his or her ordinary personal assets. This result is more questionable when dealing with exotic cars, jewelry and other goods perceived to be luxuries.

Another issue unique to a celebrity debtor is that often after a celebrity's death, his or her assets may increase in value even more. Given the foregoing, what happens when a celebrity debtor dies during his or her bankruptcy case and the value of his or her assets suddenly skyrocket? How are his or her claimed exemptions affected? To answer this question, it helps to look to bankruptcy cases of non-celebrities in which the debtors have passed away during the bankruptcy.

When a debtor passes away during the pendency of his or her bankruptcy case, the only assets that go into the probate estate are the property claimed as exempt in the debtor's bankruptcy case. *In re Bauer*, 343 B.R. 234, 236–37 (Bankr. W.D. Mo. 2006). Because the Debtor's right to claim a (homestead) exemption is generally fixed upon the date the chapter 7 petition is filed, the Debtor's post-petition death does not affect his right to claim a (declared homestead) exemption under California law. *In re Combs*, 166 B.R. 417, 421 (Bankr. N.D. Cal. 1994); *See also In re Peterson*, 897 F.2d 935, 935 (8th Cir. 1990).

However, any appreciation in value of assets that occurs after the filing of the bankruptcy that are above the amount of the claimed exemptions belongs to the estate. *In re Gebhart*, 621 F.3d 1206, 1211 (9th Cir. 2010). The Court in *In re Gebhart,* citing several cases, stated "what is frozen as of the date of filing the petition is the value of the debtor's exemption, not the fair

market value of the property claimed as exempt. *See Hyman v. Plotkin (In re Hyman),* 967 F.2d 1316, 1320 n. 9 (9th Cir.1992). A number of our cases have held that, under the California exemption scheme, the estate is entitled to postpetition appreciation in the value of property a portion of which is otherwise exempt. *See Alsberg v. Robertson (In re Alsberg),* 68 F.3d 312, 314-15 (9th Cir.1995); *Hyman,* 967 F.2d at 1321; *Schwaber v. Reed (In re Reed),* 940 F.2d 1317, 1323 (9th Cir.1991); *see also Viet Vu v. Kendall (In re Viet Vu),* 245 B.R. 644, 647-48 (9th Cir.BAP2000)." *Id.*

Taking into account the above, it seems that any increase in the value of the celebrity's assets due to the celebrity's post-petition death would be property of the bankruptcy estate and the celebrity's probate estate would be limited to the exemption amounts asserted by the celebrity at the beginning of the bankruptcy case.

In addition, could a trustee compel a celebrity debtor to certify ownership of a particular item to be sold, thereby increasing its value? Although it might be in the celebrity's financial best interest to cooperate and certify ownership of the item so to ensure that the highest possible price is received, there is no provision of the Bankruptcy Code under which one could compel the celebrity to do so. More likely, if the celebrity is unwilling to certify ownership and a trustee is appointed in the particular case, the trustee would sell the item and could make the statement that based upon the celebrity debtor's schedules filed under penalty of perjury, the trustee represents that the item to be sold was owned by the celebrity debtor; however, this type of representation would be inconsistent with the typical sale of assets under 11 U.S.C. § 363 that is accomplished on an "as is, where is" basis to avoid later litigation over such representation.

In summary, a number of unique issues may arise when a bankruptcy is filed by a celebrity. Due to the current culture, expanding number and types of celebrities and dramatic

developments in media and technology, one should expect that these issues will become more and more common. It also appears likely that each of the states will be called upon to address issues concerning publicity and related matters.

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ABI - 28th Winter Leadership Conference
Panelist: Leslie A. Cohen, Leslie Cohen Law PC

A. Will John Heartthrob be able to modify the loans on his Beverly Hills estate?

11 U.S.C. § 1123(b)(5) permits a chapter 11 plan to "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, or of holders of unsecured claims, or leave unaffected the rights of holders of any class of claims."

John might argue that should be able modify the loans on his home because he also conducts business there, and therefore it is not solely his principal residence. For example, he may work out of his home, completing film projects etc. or he may receive rental income from renting out his guest house.

Some courts have followed Scarborough v. Chase Manhattan Mortgage Corporation, 461 F.3d 406 (3d Cir. 2006), where the Third Circuit concluded "the real property that secures the mortgage must be only the debtor's principal residence (and not serve another function, such as income property etc) in order for the anti-modification provision to apply."

However, the 9th Circuit BAP has rejected Scarborough, and held 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." Wages v. J.P. Morgan Chase Bank, N.A. (*In re* Wages), 508 B.R. 161, 168 (B.A.P. 9th Cir. 2014). In Wages, the debtors ran their trucking business out of their home and parked the trucks there, but that didn't matter because it was their residence.

B. How Will John Heartthrob's Net Disposable Income Be Determined for his Chapter 11 Plan

Prior to his death, John is advised by his bankruptcy attorney that his creditors will either have to be paid in full, or he will have to devote at least 5 years' worth of his projected disposable income to fund his plan of reorganization under 11 U.S.C. § 1129(a)(15).

> 11 U.S.C. § 1129(a)(15) states:
> In a case in which the debtor is an individual and in which the holder of an allowed unsecured claim objects to the confirmation of the plan-- (A) the value, as of the effective date of the plan, of the property to be distributed under the plan on account of such claim is not less than the amount of such claim; or (B) the value of the property to be distributed under the plan is not less than the projected disposable income of the debtor (as defined in section 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.

Depending on whether Alan Accountant takes advantage of the various film and marketing opportunities outlined in the hypothetical, there may be enough money available to pay John's creditors in full. In which case, John won't have to worry about contributing 5 years of his net disposable income. If, however, there aren't enough funds to pay creditors, John must contribute the 5 years of net disposable income, which is daunting if not outright

prohibitive to a high-earning individual. Although this requirement is a confirmation issue that arises in connection with a plan,[1] it is certainly important to consider even prior to filing for bankruptcy.[2]

Per 11 U.S.C. § 1129(a)(15), the Code directs us to the chapter 13 net disposable income definition, which includes all income, other than child support, less amounts reasonably necessary for maintenance or support of debtor/dependents, and less charitable contributions up to 15% of debtor's gross income. All of the calculations use the applicable median family income and expense standards, which varies by state and household size. However, John's average income and expenses will be substantially higher than the standard median calculations, due the nature of his work and lifestyle. If the median calculations were used, John would be required to devote so much of his income to his plan that it would be excessively burdensome and not conducive to his continued work in his industry. Consequently, his counsel will need to work with him to determine how manage the proper calculation of his net disposable income given the facts of this case.

a. Business Expenses:

One avenue would be to run John's income and expenses though a personal corporation. Under 11 U.S.C. § 1325(b)(2)(A-B), if the debtor owns a business, then his net disposable income excludes amounts necessary for ordinary operations.[3] There are essentially three ways to determine what qualifies as an ordinary and necessary business expense. One way is to employ a subjective test, basing the determination that particular business' prior actions. Another is by using an objective test, looking to the normal conduct in the trade overall. The majority of circuit courts have utilized a combination of both the subjective and objective tests to decide what is eligible as an ordinary and necessary business expense.[4] Beyond the three tests, the courts have also considered several particular business costs to determine what qualifies as an ordinary and necessary expense. Some specific examples which have qualified include computer costs, promotional activities and promotional giveaways. Even purchasing stock has been considered an ordinary and necessary business expense for those engaged in this type of business. On the other hand, some more extraneous costs, such as start-up costs, have been precluded from deduction as an ordinary and necessary expense.[5]

As part of the expenses incurred in the course of running a business, entertainment expenses also play a role. Entertainment expenses generally are deductible when they are an ordinary and necessary expense of a business.[6] However, the entertainment expense must meet one of two tests used to determine deductibility. Under either test, the purpose of the entertainment should to be to benefit the business either by creating or maintaining business or relations.[7]

One test is the "directly related" test. Under this approach, there are three prongs: 1 - the main purpose of the activity must be to conduct business, 2 - business must actually be conducted, and 3 - the taxpayer must have had more than a general expectation of getting income or some other specific business benefit at some future time.[8]

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[1] *In re* Hyatt, 479 B.R. 880, 890 (Bankr. D.N.M. 2012) (declining to convert or dismiss case, noting "the level of expenses should be determined as part of the confirmation process").

[2] This "best efforts" requirement exists alongside the "absolute priority rule" which may "work[] a 'double whammy' on a debtor." Zachary v. Cal. Bank &Trust, 811 F.3d 1191, 1199 (9th Cir. 2016) (overruling *In re* Friedman, 466 B.R. 471 (B.A.P. 9th Cir. 2012)).

[3] The Ninth Circuit Bankruptcy Appellate Panel (BAP) has affirmed that even if these do not qualify for calculating "current monthly income," such ordinary and necessary business expenses are appropriately subtracted 'when calculating disposable income pursuant to § 1325(b)(2)." Drummond v. Wiegand (*In re* Wiegand), 386 B.R. 238, 239 (B.A.P. 9th Cir. 2008).

[4] *See In re* Fred Hawes Organization, Inc., 957 F2d. 239 (6th Cir. 1992).

[5] *See* Lewis v. C.I.R., 861 F.2d 1232 (10th Cir. 1988); Central Texas Sav. & Loan Ass'n v. U.S., 731 F.2d 1181 (5th Cir. 1984).

[6] 26 U.S.C.A. s 274; *see also* Lewis v. C. I. R., 560 F.2d 973 (9th Cir. 1977).

[7] *See* Pelowski v. U.S., 605 F. Supp. 65 (N.D. Ohio 1985); *see* also Danville Plywood Corp. v. U.S., 899 F.2d 3 (Fed. Cir. 1990).

[8] Treas. Reg. § 1.274-2(c)(3).

This test does not require that the business actually received a benefit; only that there was a reasonable expectation of the business being benefitted at some point.

The second test is the "associated" test.[9] This approach requires that the entertainment was associated with the active conduct of the trade or business, and that the entertainment occurred directly before or after a substantial business discussion. Here, benefit to the business is not even mentioned, but the association of the entertainment to the business must be manifested in substantial business discussion.

b. Encourage a case-by-case approach

While there is little case law under Chapter 11 explaining how to navigate the net disposable income issue for high-earning individuals, it makes sense to encourage the court to assess the legitimate needs of each particular chapter 11 debtor.[10] John can emphasize that the Chapter 13 rules simply do not work for the individual Chapter 11 debtor because Chapter 13 is written primarily for consumers. With the debt limitations for Chapter 13, Chapter 13 debtors will most likely be consumers with primarily consumer debt and in a very different situation than John and other Chapter 11 debtors. An individual Chapter 11 debtor is more likely to have a business related to them personally – their personal lifestyle is run like, and is part of, the business that enables them to earn money. Examples – hair and makeup for a model; entertainment for a movie producer; training and bodywork for an athlete; private security. Moreover, there is a wider range in debt, income, expenses and lifestyle for individual Chapter 11 debtors than for Chapter 13 debtors, all of whom must fall below the Chapter 13 debt limitations.

The court should have an understanding that an individual in the debtor's position needs to maintain a certain lifestyle in order to prosper. For example, travel expenses, country club memberships for entertaining, expenses incurred by supporting others not in the house and other entertainment expenses play a more pivotal role for high-earning debtors than they do for the average debtor. Furthermore, these expenses may be necessary for the debtor to continue to market themselves in a way that permits their careers to continue. Giving credence to lifestyle expenses allows the individual debtor to operate as if they were a debtor in possession under 11 U.S.C. § 1103. The expenses necessary to maintain this lifestyle would be treated in the same was as business expenses and entertainment expenses under the tax code. So long as the expenses are ordinary and necessary and bear a reasonable connection to the business of that debtor, such expenses would be deducted from the debtor's projected disposable income.

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[9] Rev. Rul. 63-144 (1963).

[10] *E.g.* *In re* Roedemeier, 374 B.R. 264, 272-273 (Bankr. D. Kan. 2007) ("the Court concludes that in calculating an individual Chapter 11 debtor's projected disposable income, § 1129(a)(15)(B) must be read to allow a judicial determination of the expenses that are reasonably necessary for the support of the debtor and his or her dependents.") A leading treatise agrees that incorporating § 1325(b)(3)'s means-test deductions in § 707 would be a "flawed" analysis given the language of the statute. See also 7 COLLIER ON BANKRUPTCY, ¶ 1129.03[15][a] (citing *Roedemeier* and Hamilton v. Lanning (*In re* Lanning), 545 F.3d 1269, 1280 n.7 (10th Cir. 2008)).

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PRACTICING IN THE LIMELIGHT: CELEBRITY BANKRUPTCIES

By: Kristin B. Mayhew

I. Curtis James Jackson, III a/k/a 50 Cent

(A) Overview

1. According to his bankruptcy pleadings, "[t]he Debtor, Curtis James "50 Cent" Jackson, III, is an internationally recognized recording artist, an actor, an entrepreneur, and a philanthropist. Since his entrance onto the music scene in 2003 with his multi-platinum debut album, the Debtor has sold more than 22 million albums worldwide, and has received numerous awards and Grammy nominations throughout his career."

2. "Jackson is a preeminent hip-hop artist known for his hard-knocks success story and vast musical talent. Jackson has sold more than 30 million albums worldwide. Jackson has leveraged his musical achievements into a popular record label, 'G-Unit Records', a clothing line, 'G-Unit Clothing Company', and several other lucrative ventures and has created and steered the '50 Cent' brand to among the most recognized and respected in the entertainment world."

3. Jackson holds a Substantial or Controlling Interest in 32 entities further compounding the difficulties in determining Jackson's net worth.

(B) Events Leading To Filing

1. $20 million in litigation costs and adverse judgments against Mr. Jackson within the one year before the filing.

2. Most notably, in July, 2015, after 5 years of litigation in the New York Supreme Court, Lastonia Leviston obtained a judgment against Mr. Jackson in the amount of $5 million arising from Mr. Jackson's release of a sex tape depicting Ms. Leviston and her then boyfriend.

3. On the day the punitive damages phase of the trial was to commence, Mr. Jackson filed for bankruptcy in the United States Bankruptcy Court for the District of Connecticut.

(C) The Bankruptcy Filing

1. On July 13, 2015, Mr. Jackson filed for Chapter 11.

2. Total Assets = $24,823,899.18

3. Total Liabilities = $32,509,549.91

4. Three Largest Creditors:
   a. Sleek Audio, LLC - $18,131,668.65
   b. Lastonia Leviston - $7,000,000.00
   c. SunTrust Bank - $3,890,000.00 & SunTrust Mortgage - $1,022,587.74

(D) Leviston's Relief From Stay

1. Immediately upon the filing, Ms. Leviston sought relief from the automatic stay to permit the New York Supreme Court to complete the punitive damages phase of the trial

2. On July 15, 2015, the Bankruptcy Court granted Ms. Leviston's Motion for Relief from Stay

3. The Jury subsequently awarded Ms. Leviston an additional $2 million in punitive damages

(E) Payment of Personal Living Expenses & Use of Budgets

1. Prior to BAPCPA, the post-petition wages of individual Chapter 11 debtors were not property of their bankruptcy estates. As such, individual Chapter 11 debtors used post-petition wages to pay their post-petition expenses.

2. After BAPCPA, Chapter 11 debtors' post-petition wages became property of their bankruptcy estates.

3. Section 1115(a)(2) which was added by BAPCPA, provides in relevant part, that "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" are not the debtor's property, but instead are property of the bankruptcy estate.

4. Some courts have held that Section 363(c) permits a debtor to use post-petition wages to pay ordinary course living expenses without the necessity of Court approval. *See In re Seely*, 492 B.R. 284 (Bankr. C.D.Cal. 2013); *In re Goldstein*, 383 B.R. 496 (Bankr. C.D.Cal. 2007); and *In re Massenburg*, 554 B.R. 769 (D. Maryland 2016).

5. However, where such expenses are not considered ordinary, the Chapter 11 debtor should seek approval of budgeted expenses. *See In re Villalobos*, 2011 WL 4485793 (9th Cir. B.A.P. Aug. 19, 2011)(IRS objected to debtor's proposed payment of over $115,000 in tuition expenses for his grandchildren for one school year as inappropriate personal living expenses and court remanded for further factual findings); *see also In re John Joseph Louis Johnson III*, 546 B.R. 83 (Bankr. S.D. Ohio 2016)(individual Chapter 11 debtor's (a former professional hockey player) excessive personal living expenses of over $370,000 during 10 months in Chapter 11 was a violation of debtor's fiduciary duties to his creditors even though court held that debtor was permitted to pay for his own reasonable, ordinary course living expenses out of his post-petition income without the need for prior approval).

6. Debtors should provide proposed budgets for personal living expenses with creditors upon commencement of case.

7. According to Schedule I, Mr. Jackson had monthly income of $185,000. Schedule J showed monthly expenses of $108,000 which included $5,000 for gardening, $2,500 for support for Mr. Jackson's grandparents and a $5,800 monthly lease for his Bentley.

(F) <u>Three Largest Creditors' Joint Plan Of Reorganization</u>

1. On January 13, 2016, Sleek Audio, Lastonia Leviston and SunTrust Bank filed their Joint Plan of Reorganization and Disclosure Statement

2. The Creditors challenged the completeness of the financial disclosures made by Mr. Jackson

3. The Creditors challenged Mr. Jackson's use of social media

4. Provided for the turnover of all of the Debtor's Property to a Trustee appointed under Plan.

5. Provided for liquidation of certain of Mr. Jackson's Property

6. Provided for sharing of Debtor's income generated from business with creditors over a five (5) year period

7. Provided for creation of a Post-Confirmation Committee

8. Debtor opposed the Creditor's Plan – Alleged that Plan terms constituted involuntary servitude

(G) Debtor Opposed the Creditor's Plan

1. Objected on basis that Plan required the turnover of 100% of any post-confirmation income

2. Alleged that Plan terms violated the 13th Amendment by forcing the Debtor into involuntary servitude

3. Jackson denied hiding any assets despite his Instagram posts depicting him with piles of cash

(H) Debtor's Use Of Social Media

1. Throughout the case, Mr. Jackson posted several photos on his Instagram account depicting large amounts of cash

2. In one instance, Mr. Jackson posted a picture of an extravagant home and pool and stated, "My crib is almost finished in AFRICA. I'm gonna have the craziest House warming party ever…"

3. The Instagram picture was captioned "The KANA Tape now playing, I'm Too Rich," the "Hate It or Love It."

(I) United States Trustee Moves For Appointment Of Examiner

1. On February 22, 2016, the Office of the United States Trustee moved for the appointment of an Examiner, in part based on the pleadings filed by the Creditors that raised "serious concerns about the accuracy of the information provided by the Debtor to the Court and his Creditors."

2. The Debtor responded that the large amounts of cash were so-called "prop money" used in the film and television industry.

3. The Debtor also denied owning or ever owning any real estate in Africa.

4. The Court ordered the Debtor to personally appear at the next hearing

5. Despite the Judge's warnings concerning the seriousness of the bankruptcy process, Mr. Jackson posed a "selfie" with stacks of cash in his pants taken in the Courthouse during a hearing

6. On March 8, 2016, the Debtor filed his Plan of Reorganization and Disclosure Statement, which was subsequently amended

7. The Plan provides for the Debtor's payment of allowed claims over a period of 5 years and a cash contribution of up to $23.4 over the life of the Plan

8. On July 6, 2016, the Debtor's 3rd Amended Plan of Reorganization was confirmed by the Court

CHAPTER 11 CRAMDOWN FOR AN INDIVIDUAL AND THE ABSOLUTE PRIORITY RULE
(October 1, 2016)

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CHAPTER 11 CRAMDOWN FOR AN INDIVIDUAL AND THE ABSOLUTE PRIORITY RULE

The 2005 Bankruptcy Abuse Prevention and Consumer Protection Act ("BAPCPA") provided a number of amendments to the Bankruptcy Code with respect to individuals. Many of the changes have been refined by judicial interpretation over the past ten years. One of the changes that has become more clear as court decisions have developed is whether the absolute priority rule applies to individuals in a chapter 11 case. The early case law analyzing this issue gave rise to a clear split among bankruptcy courts as to whether the absolute priority rule no longer applied with respect to individuals. This analysis was due to the changes made to Bankruptcy Code §§ 1115 and 1129(b)(2)(B)(ii). These sections permit an individual in a cram down situation, with respect to unsecured creditors, to retain property included in the bankruptcy estate under §1115. The question became, how much property could be retained in a cram down? This provision differs from the cram down test under the absolute priority rule with respect to unsecured creditors in a non-individual case where the debtor is not allowed to retain or receive any property on account of the plan. The fair and equitable test with respect to gaining confirmation of a plan over the dissent of a class of unsecured creditors was modified with respect to individuals to account for the fact that the then newly added §1115 included within the estate the debtor's post-petition personal service income. The cram-down provisions had to adjust to allow the debtor to retain the use of personal income in order to survive and allow for a plan confirmation despite the rejecting vote of unsecured creditors. While the model is based on chapter 13, the application of the absolute priority rule causes unique problems for a practitioner who cannot develop a consensual plan.

11 U.S.C. §1115

The 2005 amendments added §1115 to the Bankruptcy Code. Prior to 2005, § 541(a)(7) provided that post-petition income derived from personal services of an individual was not property of the estate. The individual could include all or a portion of their income to fund a plan or pay creditors but they were not required to do so. §1115 was added to the Code to include within the bankruptcy estate all income derived by the

debtor from personal services as well as all of the property described in §541 that the debtor acquires after commencement of the case and before the case is closed, dismissed, or converted to a case under chapter 7, 12, or 13. This amendment had tremendous ramifications for the individual debtor. Once all assets including income were included in the estate, creditors could arguably have a say as to how the income was spent. In order to allow the debtor to confirm a plan over the dissenting vote of unsecured creditors, Congress amended §1129(b) to allow the Debtor to retain certain assets included in the estate under §1115.

11 U.S.C. §1129(b)(2)(B)(ii)

The rules for a cram down of a plan on unsecured creditors are generally contained in §1129(b). A chapter 11 plan could generally be confirmed over the rejection of the plan by unsecured creditors if either the plan paid the unsecured creditors in full or the plan provided that there was no class junior to the unsecured creditor class that would "receive or retain under the plan on account of such junior claim or interest any property". Payment in full was never a very popular option in chapter 11 so the latter portion of this provision received all of the attention. The latter portion became known as the absolute priority rule. It required payment in full to senior classes before a junior class received or retained anything. In short, if the unsecured creditors were not paid in full and they rejected the plan, the plan could not be confirmed over the rejection if the existing shareholders, members or equity received or retained any property. This provision did not work well with an individual who now found their income included in the estate. As a result, §1129(b)(2)(B)(ii) was amended to include the following:

> 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.

The drafting of this provision created the issue of whether the absolute priority rule had been abrogated for individuals. Did the provision mean that the debtor could retain all property included in the estate under §1115 including the property that had traditionally been part of the estate under §541 or did it mean the debtor could only retain the property that was newly added to the estate under §1115, such as personal service income.

The Bankruptcy Court Decisions

Several courts have interpreted §1129(b)(2)(B)(ii) and §1115 together to indicate that Congress intended to exempt individual chapter 11 debtors from the absolute priority rule. *See In re Roedemeier,* 374 B.R. 264 (Bankr. D. Kan. 2007) and *In re Tegeder,* 369 B.R. 477, 480-81 (Bankr. D. Neb. 2007). The *Tegeder* and *Roedemeier* cases were two of the first cases to examine the issue as to the elimination of the absolute priority rule for individuals. In *Tegeder* the court concluded the absolute priority rule was eliminated because §541 was referenced within §1115. In *Roedemeier* the court believed Congress intended to make chapter 11 more like chapter 13 and therefore repealed the absolute priority rule. In the case of *In re Shat*, 424 B.R. 854 (Bankr. D. Nev. 2010) the court analyzed the language of the property of the estate under new §1115 and the apparent ties between chapter 11 and 13 and concluded that the absolute priority rule had been eliminated in order to further the rehabilitative goals of chapter 11. Therefore, according to these courts, a chapter 11 debtor may retain prepetition and post-petition property and still cram-down a plan of reorganization over the objection of unsecured creditors. These courts adopted the so-called "broad view" reading of the statute.

Following these decisions were a series of "narrow view" cases that held that the exception to the absolute priority rule only applied to the property added by §1115 to the definition of property of the estate under §541. The narrow view cases included *In re Gbadebo*, 431 B.R. 222 (Bankr. N.D. Cal. 2010), *In re Mullins*, 435 B.R. 352 (Bankr. W.D. Va. 2010), *In re Karlovich*, 456 B.R. 677 (Bankr. S.D. Cal. 2010), *In re Stephens*, 445 B.R. 816 (Bankr. S.D. Tex. 2011), *In re Walsh*, 447 B.R. 45 (Bankr. D. Mass 2011), *In re Draiman*, 450 B.R. 777 (Bankr. N.D. Ill. 2011), *In re Kamell*, 451 B.R. 505 (Bankr. C.D. Cal. 2011), *In re Maharaj*, 449 B.R. 484 (Bankr. E.D. Va. 2011), *In re Lindsey*, 453 B.R. 886 (Bankr. E.D. Tenn 2011), and *In re Tucker*, 2011 WL 5926757 (Bankr. D.Or. 2011). The cases from 2010 and 2011 were overwhelmingly sided on the narrow view approach. In 2012 through 2014 the cases were similarly overwhelmingly sided with the narrow view reading of the statute.

The Circuit Courts Weigh In

Beginning in 2013, we had Circuit Court decisions that all adopted the narrow view. The rulings by the Circuit Courts have been consistent and their answer is, there is no change in the law for individual debtors with respect to the absolute priority rule. While the debtor may retain post-petition income notwithstanding the fact that it is now included in the estate, the debtor could always retain such income since it was never included in the estate prior to 2005. *In re Lively, 717 F. 3d 406 (5th Cir. 2013); In re Stephens, 704 F. 3d 1279 (10th Cir. 2013); In re Maharaj, 681 F. 3d 558 (4th Cir. 2012); In re Cardin*, 751 F.3d 734 (6th Cir. 2014); *In re Zachary v. California Bank & Trust*, 811 F.3d 1191 (9th Cir. 2016). The absolute priority rule clearly applies in these Circuits. The remaining Circuits still contain a mix of Bankruptcy and District Court opinions, however it does seem as though courts are siding more with the narrow view rulings.

Many of the narrow view decisions rely on the notion that there was no legislative history to support a change from the past application of the absolute priority rule and even though the statute is ambiguous Congress would have been more explicit if they were changing prior law. The individual debtor in a Chapter 11 is not permitted to retain any non-exempt property in a cram-down on unsecured creditors, with the exception of the new assets added to the estate under §1115, unless the dissenting unsecured creditor class is paid in full.

Do Creditors Really Control the Debtor's Earnings Prior to Confirmation

While §1115 does include the debtor's post-petition earnings in the estate, the question arises as to what degree such assets are subject to the control of creditors. Are the earnings to be treated as if they are cash collateral in which unsecured creditors have an interest or does the debtor have control over their use. Prior to plan confirmation there could be an extended period of estate administration. During this time the debtor should have the right to any applicable state earnings exemption. Under many of these exemptions the debtor may be able to exempt up to 75% or 100% of their earnings from creditor claims, depending upon the state. While 100% of the earnings are property of the estate, there is no limit on the application of exemptions. In fact, §1123(c) provides that in a plan proposed by a creditor in an individual case, the plan may not provide for the use, sale, or lease of exempt property unless the debtor consents. While the debtor

may provide under their plan that exempt assets will be used to pay creditors, that provision will not be effective until the plan is confirmed and a debtor should not give up the right to exempt assets prior to plan confirmation. The right to choose to use exempt assets under a plan may be a key bargaining point in a debtor's attempt to negotiate a consensual plan with creditors. Given the growing general application of the absolute priority rule in a cram down situation with unsecured creditors it is important to try to negotiate a consensual plan in order to avoid application of the rule. The use of exempt assets may also constitute "new value" to allow the debtor to retain assets in a cram-down situation.

Is the "new value exception" working?

Several recent cases focus on individual debtors who have attempted to address the absolute priority rule, generally through the new value exception. In *In re Batista-Sanchez*, 505 B.R. 222 (Bankr. N.D. Ill. 2014), the debtor proposed bidding on equity interests to allow unsecured creditors to credit bid on the debtor's equity interests in a sole-proprietorship as a means of satisfying the absolute priority rule. In *In re Gerard*, 495 B.R. 850 (Bankr. E.D. Wis. 2013), the debtor proposed to contribute $27,000 in new value to the plan to retain non-exempt interests. This was ultimately denied because the debtor had a cash account and other assets that exceeded the new value contribution. In *In re Lee Min Ho Chen*, 482 B.R. 473 (Bankr. D.P.R. 2012) the debtor was similarly denied the use of the new value exception because the funds did not come from an external source. While the reported cases on debtors' attempts to utilize the new value exception have largely been found to be unsuccessful primarily because not enough money was being contributed, at least one court has recognized that an individual debtor may use the new value exception to retain non-exempt property in a cram-down and allowed the debtor to retain exempt property. *See Van Buren Indus. Investors v. Henderson (In re Henderson)*, 341 B.R. 783 (M.D. Fla. 2006). In the *Van Buren* case, the new value exception was met through new cash in the amount of $525,000 contributed by the debtor's former wife.

What Else Might Work

In certain cases, the debtor may be able to propose a full payment plan over an extended period of time. The debtor may allow the estate to continue to exist for the duration of the plan and utilize the estate assets as they are used in turn by the debtor to generate the income necessary to fund the plan. At some point in time the debtor will have: a) accomplished the goal of paying off the creditors; b) worked hard enough to allow for a plan amendment to provide for less than full payment and an accepting vote; or c) converted the case to chapter 7 after selling off assets over time and not realizing enough to pay the creditors in full. In many cases, the debtor just needs time to try to sell an asset and pay creditors. Such a strategy may or may not work but at least the debtor will have had a chance to make it work.

The debtor may be able to create a liquidating trust under the plan and transfer all assets to the trust. The trust may then be able to resell the assets to the debtor over time or to the debtor's family members in order to retain continuity and allow the income or profit from sale to be paid to creditors. In the interim the assets could be leased to the debtor by the trust.

A number of alternatives exist as to how an individual debtor can successfully achieve a cram down with respect to unsecured creditors. The debtor will have to be creative and resourceful if locating "new value" from an outside investor, partner, relative or a wealthy ex-spouse as in the *Van Buren* case. Alternatively, selling assets over time while retaining them in the estate, transferring assets to an entity created under the plan, or placing the assets in a newly created entity to be used to generate value for creditors over time can work under the right circumstances. In each case an earn back or creditor pay off situation may allow the debtor to reacquire the assets over time.