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Consumer

Small Business Cases and Individual Chapter 11 Cases

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ETHICAL ISSUES IN INDIVIDUAL CHAPTER 11 CASES

During the course of my career, I have discovered that an ethical issue normally arises simply because the practitioner representing an individual in a Chapter 11 treats the case either like a grown up Chapter 13 or a Chapter 7 with a potential distribution to creditors. As the experienced practitioner realizes, nothing could be further from the truth because when the bankruptcy case is filed, both the debtor and the attorney are acting as fiduciaries for the benefit of the creditors. This forces the attorney to utilize an entirely different mindset in proceeding with the case, which can be difficult if the lawyer is not used to doing so. It is therefore crucial that your client understands prior to the filing that your client and you, as counsel, have that responsibility because not doing so in advance can lead to a strained relationship with your client.

In the following sections, I will illuminate when this type of issue arises.

I. PRE-BANKRUPTCY PLANNING IN CHAPTER 11

Before the bankruptcy is filed, you don't have a duty to your client's creditors except as to what is dictated in the rules of professional responsibility and case law. For example, as in any case, as counsel for the debtor, you cannot lie to creditors' counsel to garner an advantage for your client.

On the other hand, there may be a difference between how much pre-bankruptcy planning may be tolerated in an individual Chapter 7 versus in a Chapter 11. I really don't know, though I can advise you that unlike in a Chapter 7 in which you have to disclose what occurred, in the Disclosure Statement in a Chapter 11, you may have to explain the circumstances surrounding the planning to ensure that creditors fully understand what occurred. It goes without saying that this can be awkward.

Now let's talk about ethical issues in the plan itself.

II. ETHICAL ISSUES FOR AN INDIVIDUAL CHAPTER 11 PLAN

Can you engineer a separate class in advance of bankruptcy to procure an impaired change in this permanently necessary for confirmation of the case? By engaging in such pre-petition planning, similar to pre-bankruptcy planning, you are potentially reducing what creditors may receive and are directly benefitting the debtor to the detriment of his creditors.

I don't think there is a clear answer except that if your client engages in such conduct; that a) it needs to be fully disclosed in all bankruptcy filings; and b) the creation of the class has to have a valid business basis and cannot be simply contrived. That being said, it is difficult to know how far one can go as counsel, and what may be the better course of conduct is to spell out options for your client and then let the client select the alternative preferred by the client. For example, I believe there may be a difference between telling a client what to do and participating in that process versus outlining the options for the client and letting the client decide.

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III. CAN YOU INCORPORATE INAPPROPRIATE PLAN PROVISIONS?

A few years ago, when the real estate market was in the middle of the downward spiral and Chapter 11s were being filed at what presumably was a record rate, it became difficult for judges to *sua sponte* review the plans to confirm that they complied with all statutory parameters. As a result, many practitioners, who will remain nameless, incorporated provisions which were in direct violation of the Bankruptcy Code and succeeded. In most cases, the major creditors did not have the resources to review all of the reorganization plans and found their loans either being modified or avoided in what were oftentimes impermissible ways.

At first glance, the analysis is not complicated and one would assume that the attorney's conduct was inappropriate and, frankly, unethical.

This does not mean that you cannot adopt an aggressive position when the case law is unclear. There is nothing wrong with this tactic as long as it is not used surreptitiously. Furthermore, I have no problem with a debtor proposing a plan treatment which specifically asks a creditor to disregard a statutory right.

For example, in the heyday of individual Chapter 11 filings, my firm would oftentimes represent individuals who were facing large second mortgages on their personal residence, which were only secured as to a very small percentage of their balances. In those instances, we would incorporate into the plan a provision asking the creditors to accept the secured portion as settlement in full of their secured claims even though the creditors did not have to do so pursuant to the Bankruptcy Code. No creditors ever objected to such wording, though all of them were of course interested in negotiating the exact amount to be paid. Especially by 2010 and 2011, the major lenders were being beaten up so badly that the idea of receiving back even a percentage of their claims became far more attractive as the real estate market continued to collapse. If they did not cooperate, they ended up recovering nothing on their junior positions, which was a result they wanted to avoid.

IV. ISSUES WITH LEGAL FEES

Just as in the case of a corporate Chapter 11, but even more pronounced with individual 11s, you need to remember that the legal fees you are being paid are for the benefit of the administration of the Chapter 11 case, not for the betterment of the individual debtor. Be very sensitive to this issue because if you place an individual into a Chapter 11 and a Complaint is filed under § 523, a high likelihood exists that if you try to use your retainer or the debtor's post-petition income to defend the non-dischargeability litigation, you could be violating your ethical duty to the creditors. I have discovered over the years that this has become a very hot topic for seminars and presentations, but I have not experienced a lot of lawyers, on behalf of creditors, actually forcing the issue.

V. FAILING TO RECOVER PREFERENTIAL AND FRAUDULENT TRANSFERS

Recovering preferential and fraudulent transfers helps facilitate a Chapter 11 debtor's obligation to ultimately ensure creditors are treated fairly and receive the maximum dividend under the circumstances. A Chapter 11 debtor therefore has an obligation to pursue any such recoveries even if the recipient is a friend or insider or if doing so will lead to potential detrimental ramifications as a result. In certain instances, the questionable payment may have been towards a non-dischargeable debt or priority claim that otherwise had to be paid. Or, sometimes such recovery could trigger a non-dischargeable claim brought by a creditor which otherwise wouldn't have such a claim if not for the debtor's recovery of the payment. A lawyer representing an individual Chapter 11 debtor needs to be fully aware that the debtor has to try to recover such amounts even if not in the debtor's best interest, which creates an ethical quandary for the lawyer.

VI MANIPULATING INCOME

In most instances, a Chapter 11 individual debtor's payment obligation is tied into disposable income which in many instances creates incentive for the debtor to try to minimize income. This encourages the debtor to keep his income as low as possible until the Chapter 11 Plan is confirmed and then adjust his income accordingly.

Since the debtor and his counsel are reposed with a statutory duty for the benefit of creditors, engaging in such tactics may be inherently inconsistent with the debtor and his lawyer's obligations under the Bankruptcy Code. In other instances, the Chapter 11 debtor may deliberately park monies in that individual's business entity with the same goal in mind.

VII. MANUFACTURING EXPENSES

This strategy is the inverse of the prior one in that instead of decreasing income, the Chapter 11 debtor tries to maximize expenses. The Chapter 11 debtor does so hoping that if the Plan is confirmed based upon "inflated" expenses, post-confirmation, those monies will not be earmarked towards paying creditors, but instead the debtor can use those funds at his discretion. Once again, the lawyer for the debtor can find himself in a horrendous position in that he of course wants to fulfill his ethical obligation, but doesn't want to do so while aggravating his client.

VIII. PRIORITIZING PREFERRED DEBT

In certain instances, a debtor wants to make sure that a creditor is paid back in advance of other creditors. This may be the case in situations in which the creditor otherwise has a non-dischargeable debt or has a relationship with the debtor.

If the debtor is not in a position to pay the debt in full and then wait the statutory preference period, a debtor can prioritize a general unsecured debt by granting that creditor a lien on secured property, waiting the preference period, and then agreeing to pay back the debt as a secured one, which ensures payment at least up to the value of the collateral securing the obligation.

Since ultimately doing so reduces what other creditors may receive through the Plan, an issue arises as to whether an attorney has an ethical conundrum in either advising or allowing a debtor to engage in such conduct.

IX. DIVORCING IN ADVANCE OF BANKRUPTCY

In certain instances, a divorcing couple can defer or protect monies otherwise vulnerable, especially because child support and spousal maintenance are both 100% exempt by law in most jurisdictions. Based on the assumption that a couple can benefit by a divorce or legal separation, the question becomes whether taking that unusual step in itself is improper and an attorney can at least advise a client of that option and not run awry of ethical considerations.

X. USING A CHAPTER 11 TO DIVEST THE DEBTOR OF OTHERWISE NON-EXEMPT ASSETS

If a client files a Chapter 11 with a substantial amount of non-exempt assets and uses the protection of the Chapter 11 to spend those amounts, is this appropriate or could the attorney be in trouble for advising a client to consider this option?

XI. CAMPING IN CHAPTER 11 WITHOUT THE ABILITY TO REORGANIZE

I have always followed a practice of not filing a Chapter 11 for any client unless the client has reasonable prospects of reorganizing. As a result, my firms and I have turned down scores of cases over the years which other practitioners quickly took on without any hesitation.

This leads to the question of whether an attorney can place an individual in a Chapter 11 if the attorney has objective reasons to know that the case cannot succeed. Of course, the vast majority of lawyers will claim that they filed the 11 thinking that the case was not destined for failure, but common sense disproves this contention in many cases.

So, if the lawyer knows from day one that a 99% chance exists that the case will fail, can a lawyer file a Chapter 11, knowing that doing so will potentially run roughshod on creditors and will deplete the bankruptcy estate, thereby resulting in less money available to the very creditors that the case was supposed to protect?

XII. CONFLICTS WITH MARRIED COUPLES FILING CHAPTER 11

As a preliminary matter, even when a couple is getting along famously, the attorney representing both of them in a Chapter 11 probably needs conflict waivers to be safe. Or, if the lawyer is just placing one spouse in bankruptcy, especially in a community property state in which the filing of one spouse will bring in all community assets into the bankruptcy estate, the non-filing spouse needs to be advised to talk to independent counsel and in many instances, actually needs to speak with somebody.

In a situation in which the attorney suspects that the spouses may not be getting along for any reason or are contemplating divorce or are getting divorced, then the attorney without question needs to make sure that each spouse has independent counsel. A plethora of issues will arise if one attorney tries to represent both of those individuals, ranging from who is responsible for the Plan payment to dischargeability issues to the impact of spousal maintenance and child support on the Chapter 11 to practical issues as to who is to be awarded what assets. Interestingly enough, I have tried to represent married couples in individual Chapter 11s in which the couples are not getting along that well and have never been successful without either involving other counsel or eventually having to withdraw.

Author: Alan Halperin

FRAUDULENT TRANSFERS AND PREFERENCES

Fraudulent transfers and preferences are transfers or payments that are prohibited under the Bankruptcy Code and can therefore be reversed. These prohibitions were designed to ensure that individuals contemplating bankruptcy do not dispose of their property to place it outside the reach of creditors, or pick and choose certain creditors to pay, whether intentionally or unintentionally. There are, however rules to these provisions that must be followed in order to reverse the transfer, and understanding them is critical whether you seek to reverse them, or structure to prevent reversal.

In broad terms, a fraudulent transfer is any transfer of property for which either (a) inadequate consideration is received at a time in which the transferor is insolvent or rendered insolvent by the transfer, left undercapitalized, or unable to pay debts incurred (a constructive fraudulent transfer), or (b) there was an intent to hinder or defraud creditors (an intentional fraudulent transfer). The Bankruptcy Code contains its own fraudulent transfer provision (section 548), and it provides for a two year look back. However, every state in the country has its own fraudulent transfer law, and another Bankruptcy Code section (544) allows a debtor to use those laws to recovery a fraudulent transfer. These state laws typically have a longer look back period that the Bankruptcy Code provision.

If a transfer occurs within the applicable look-back period, the debtor has the right to recover the property or an amount equivalent in cash from the transferee. In the instance of an intentional fraudulent transfer, the debtor can also recover its legal costs from the defendant. In the instance of a constructive fraudulent transfer, the value provided is a defense to the amount, and the defendant is entitled to a reduction of the judgment for the amount of value given. Insolvency is generally defined as having debts that exceed your assets.

A preference is a payment made within 90 days of bankruptcy on account of an old debt and in the case of insiders, within one (1) year of bankruptcy. There are exceptions to this rule, but if a preferential payment is made, the Chapter 11 debtor may recover the payment from the recipient. A preferential payment does not have to be in the form of cash; any transfer received from a third party within the statutory guidelines on account of an old debt can create a preference.

As between the 2 types of avoidance actions, preferences are the far more common. As detailed in the attached outline, they frequently follow a process in bankruptcy, and understanding that process as well as the relevant issues attendant in each part of the process can help understand their impact and to plan for them.

In certain instances you may want to delay the bankruptcy filing if a crucial vendor or lender has received what would be a preferential transfer which the debtor does not want to have to reverse. When possible, it may be desirable to wait to file in order to take the transfer outside the preference period. This can facilitate future dealings with that creditor

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and prevent a business disruption. Alternatively, there are times where a debtor does not want a transfer to stand (for example, an involuntary transfer by way of seizure), and in those cases a debtor may want to be sure to file before the period runs. Though it is possible to do so, it is far harder to delay filing to avoid a fraudulent transfer as there is a much longer look back period.

Suffice it to say, there are intricacies to the preference and fraudulent transfer statutes as well as exceptions and defenses. Therefore it is wise to consider these issues before filing for bankruptcy.

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PREFERENCE LAW; APPLICATION AND PRACTICAL CONSIDERATIONS ©

This outline is intended to identify some of the issues vendors, service providers and other businesses ought to keep in mind when they are confronted with a "preference" claim under bankruptcy law. There may be ways to minimize exposure to such claims if you are aware of the issues ahead of time. In that vein, the following is intended to provide you with a basis from which to formulate basic strategies for protecting yourself from preference liability. The discussion is not intended to be an exhaustive legal analysis, and each case must be thoroughly examined and all factors carefully evaluated.

What Is a Preference Payment?

A "preference" is a statutory creation of bankruptcy law intended, in theory, to prevent any one creditor from receiving favored treatment over other creditors when a debtor is on the verge of bankruptcy. Specifically, the law is designed to enable a debtor (or trustee) to recover payments made to a creditor within the 90 day period prior to the commencement of a bankruptcy case, theoretically, to level the playing field among creditors so that no one creditor is preferred over another in the often chaotic days before a debtor files. The elements of a preference are found in section 547(b) of 11 U.S.C. § 101 et seq. (the "Bankruptcy Code") and are as follows:

(i) the payment (or transfer of other type of asset) was made by the debtor;
(ii) to the creditor;
(iii) on account of an "antecedent debt" (*e.g.*, payment of debt where credit had been extended);
(iv) made while the debtor was insolvent[1];
(v) made within 90 days before the filing of the bankruptcy petition; and
(vi) that enables the creditor to receive more on account of the debt than it would have received on that debt had the debt been a claim in a chapter 7 liquidation.

Once these six elements are satisfied, the debtor or trustee has met its burden of proving a preference case. The burden then shifts to the creditor to prove that the payments it received are exceptions and are, therefore, not recoverable.

In most cases, after a bankruptcy case is filed, the viability of preference actions is analyzed and a decision is made to either pursue them or waive them based upon the anticipated defenses. When a preference claim is pursued, a debtor or trustee will first send a demand letter to the creditor seeking repayment without court intervention. Usually, creditors ignore this effort or refuse to repay the alleged preference. However, responding to the demand letter with a well-reasoned outline of your defenses may help avoid costly and time-consuming litigation. If no response is received to the demand letter or a

[1] "Insolvency". There is an underlying presumption under the Bankruptcy Code that the debtor was insolvent during the preference period. There is nothing a creditor can do prior to bankruptcy with respect to the debtor's solvency but it can seek to "rebut the presumption" that the debtor was insolvent when it made the transfers sought to be recovered as preferences, though litigating this issue may require expert testimony and can be very costly.

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resolution cannot be reached, the debtor will commence a lawsuit in the bankruptcy court (called an adversary proceeding) to recover the preference payment. Sometimes, a debtor will simply commence litigation without first circulating a demand letter, especially when the deadline to commence preference actions is fast approaching[2].

Preference Defenses

There are two general methods of defending a preference claim: (i) show that the payment fails to meet any one of the basic elements so that it is not actually a preference; or (ii) demonstrate that one of the specific defenses set forth in section 547(c) of the Bankruptcy Code (discussed below) apply to the payments sought to be recovered.

(i) ***Attacking the Elements of a Preference***

Pursuant to section 547(b) of the Bankruptcy Code, in order for a payment to be a preference, each of the six criteria set forth above must exist. Thus, for example, if the payment was not made on account of an antecedent debt or the debtor was not insolvent at the time of transfer, there is no preference in the first instance.

Therefore, to the extent possible, if a creditor is concerned about a customer's financial condition, it should focus on avoiding an element of a preference before the customer reaches bankruptcy to prevent preference liability. While some may be outside of a creditor's control, here are some suggestions to consider.

> Negating "Antecedent Debt". The most commonly used method of eliminating preference liability is avoid the creation of an antecedent debt by demanding payment on or before delivery, *i.e.*, eliminate the credit terms. In addition, a vendor may demand that the debtor pre-pay for certain goods or services, which similarly does not create an antecedent debt. The ability to demand payment on a C.B.D. or a C.O.D. basis or a pre-payment arrangement will often depend upon the creditor's bargaining position relative to the debtor.
>
> "Chapter 7 Distribution". Preference liability may also be avoided if a creditor can obtain collateral or a letter of credit to secure or backstop a debtor's obligations to the creditor. The creditor's receipt of a payment that is equal to or less than the value of the collateral will not enable it to receive more than it would have received in a liquidation under chapter 7 because if the creditor had not received the payment, it could have simply liquidated its collateral, or drawn on the letter of credit, and been paid in full in any event. Similarly, if a creditor avails itself of any statutory lien rights, such as a mechanic's or materialman's lien, it might be able to challenge the preference claim by showing it would have received payment in full on account of the lien in a chapter 7 scenario as well. It is important to note, however, that receipt of a letter of credit or a collateral

[2] A preference action must be commenced before the bankruptcy case is closed or dismissed and be filed before the later of (a) 2 years after the order for relief is granted by the Bankruptcy Court, which is the day the voluntary bankruptcy case is commenced or the day the Bankruptcy Court approves the bankruptcy petition in an involuntary case, or (b) 1 year after a trustee is appointed in the case if the appointment occurred with the 2 year period after the order for relief is granted by the Bankruptcy Court. If the action is not commenced within this timeframe, it is barred by the statute of limitations.

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interest itself or perfecting a statutory lien within the 90 day preference period can constitute a preference because preferential transfers are not limited to transfers of money but any form of property of the debtor.

"Payment by the Debtor". To the extent the creditor can obtain payment from a third party, the payment is not from the debtor, and thus does not constitute a preference.

(ii) Preference Defenses

If all the elements of a preference are established, creditors still have certain defenses available to them. These defenses are listed in section 547(c) of the Bankruptcy Code. Although there are several defenses, only three (3) apply to general unsecured trade creditors: (i) the new value defense of section § 547(c)(4), (ii) the contemporaneous exchange of value defense of section 547(c)(1), (ii) and (iii) the ordinary course of business defense of section 547(c)(2).

New Value. Generally, "new value" means that after the date on which a preference payment is made, the creditor provided the debtor with new goods or services for which the creditor was either not paid or was paid but that payment is recoverable as a preference.

For example, assume that a creditor receives a $10,000 payment on December 1st, provides $7,500 worth of goods on credit on December 15, and the debtor files for bankruptcy on December 30th. If the debtor did not pay the creditor for the $7,500 in goods by the time the debtor filed for bankruptcy, the creditor is entitled to a new value credit of $7,500 and the preference exposure would be reduced to $2,500.

It is important to note that courts in some jurisdictions will only count unpaid new value as a defense, meaning that if the debtor actually paid the creditor for the goods or services provided after the preference payment was made, no new value credit will be granted regardless of whether that payment itself is recoverable as a preference.

For example, assume that a creditor receives a $10,000 payment on December 1st for goods previous delivered to the debtor, provides $7,500 worth of goods on credit on December 15th, receives a payment on December 25th in the amount of $7,500 for the good delivered on December 15th and the debtor files for bankruptcy on December 30th. In jurisdictions that require new value to remain unpaid, the creditor would not have a new value defense because it received a $7,500 payment for the goods delivered on December 15th. In jurisdictions that do not require new value to remain unpaid, the creditor would be entitled to a new value credit of $7,500 against the $10,000 preference if the $7,500 payment itself is recoverable as a preference.

Contemporaneous Exchange. This defense is available when a creditor and the debtor traded dollars for new goods or service contemporaneously. It is critical to this defense that the debtor be paid for the goods or services simultaneously or close in time and that the debtor and creditor intended for the transaction to be done contemporaneously.

For example, assume that the creditor has an outstanding balance, that the debtor desires additional goods and that the creditor is hesitant to deliver more goods to the debtor

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because it does not wish to increase its aggregate exposure. The creditor can notify the debtor that it will only sell additional goods to the extent it receives a payment for those goods. If the creditor delivers goods or service based upon its expectation of receiving payment and actually receives the payment from the debtor around the time the goods or services were delivered, the creditor may be able to establish a contemporaneous exchange defense. The exchange need be only *substantially* contemporaneous, i.e., it need not happen at the same moment or even on the same day but the closer together in time that the exchange occurs, the stronger the defense.

Many creditors release goods for payments against old invoices. Courts have held that the funds paid must have been intended for the new goods shipped rather than old invoices, thus internal application of the funds may be of great importance in an evidentiary dispute. However, contemporaneous exchange issues are typically resolved via negotiation before the matter ever reaches trial.

Ordinary Course of Business. The underlying theory of preference law is to prevent the debtor from preferring some creditors over others and instead ensure that creditors in the same boat get an equal share. Often, this follows the old maxim that the squeaky wheel gets the oil and the creditor who hounds a debtor for payment should not get more than another creditor who did not or could not do so. Therefore, a creditor can rebut that it did anything extraordinary by demonstrating that its payment was not made as a result of undue pressure, but rather was made in the ordinary course of business consistent with historical practice between the parties in terms of timing, terms and method of payment. Under the Bankruptcy Code, the ordinary course defense can be established either vertically or horizontally, meaning that the transfers are either (a) ordinary course as between the debtor and the creditor or (b) that they fall within the ordinary course of the industry in which the debtor and creditor were transacting.

As an example, if a debtor pays a creditor during the preference period 60 days after the invoice date when the invoice provided for 30 day terms, the payment will not be recoverable as a preference if the creditor can show that (a) it always provided the debtor with goods or services on 30 day terms and that the debtor historically paid the creditor on average within 60 days, or (b) that the industry generally provides for 30 day terms but customers like the debtor usually pay within 60 days.

Ordinary course practice between the debtor and the creditor is easier to prove since the parties should have all requisite information to support their positions. Establishing the ordinary course of the industry becomes more difficult and expensive because it is usually based upon expert testimony.

Any unusual activity with respect to the payment sought to be recovered as a preference weakens the ordinary course defense. For example, if a credit manager goes after a delinquent account and presses the debtor to make a payment or the account is paid by a wire transfer to speed the process or a check is delivered overnighted where it would usually be mailed, the ordinary course defense is weakened. Of course this would be frustrating to a credit manager who is trying to perform his job effectively but, unfortunately, it may weaken this defense.

While the new value and contemporaneous exchange defenses are generally clear (either you have them or you don't), the "ordinary course" defense is more fluid. Absent an absolute consistency in payment history, mechanics and terms (which is uncommon in the business world), the defense is not iron clad and will be subject to negotiation.

Threshold Amount for Preference Suits

Preference payments sought to be recovered currently must aggregate at least $6,225 or no preference action may be commenced. Also, while a debtor or trustee usually commences preference actions in the state in which the bankruptcy case in pending, currently they must commence the action in the *creditor's* home jurisdiction if suing for preference payments less than $12,475. These numbers are subject to adjustment for inflation from time to time.

State Law Preferences

Some states have their own preference statutes (*e.g.*, Wisconsin, Florida, Maryland, New Jersey, Texas and others) independent of the Bankruptcy Code. Section 544 of the Bankruptcy Code allows the debtor or trustee to commence an action against a creditor (or include additional counts in the general preference action) based upon state preference statutes. In addition, the creditor may be subject to preference attack in state court proceedings where a preference statute exists. Frequently, the elements of a preference under the state laws are different from the Bankruptcy Code. For example, some state preference laws do not provide for the same defenses as the Bankruptcy Code and provide for a longer preference period, thereby creating greater exposure.

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SMALL BUSINESS CASES AND INDIVIDUAL CHAPTER 11 CASES: CHOSING THE CHAPATER THAT FITS CHAPTER 11 VS. CHAPTER 13

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I. General Overview.

Clients who are facing serious financial difficulties but may not be eligible for Chapter 7 need to consider from the onset whether they are willing to proceed under Chapter 11 or 13 of the Bankruptcy Code. In determining whether to choose either of those options, clients need to understand the ramifications of each because if for whatever reason reorganization is not acceptable to them, then they are left with having to settle with their creditors. Settlement may not be a horrible alternative, though that option requires clients to come up with money to settle and to also have to address potential tax ramifications since debt forgiveness can trigger taxable income at ordinary income rates.

Traditionally, individuals seeking reorganization would proceed under Chapter 13 as long as they were eligible. To be eligible, a potential debtor would need to have ordinary income and total secured debt of under $1,184,200 and unsecured debt of no more than $394,725. If those criteria were met, then Chapter 13 would often be a viable alternative.

Unfortunately, there are a number of problems with Chapter 13 as currently enacted. In almost all cases, a client proceeding under Chapter 13 will have to make monthly payments to a trustee for three (3) to five (5) years subject to a possible "Hardship Discharge" allowed in §1328(b). That payment would consist of the difference between that client's income and allowed monthly expenses, which are regulated to ensure that a Chapter 13 debtor can maintain a minimal lifestyle. Even more importantly, the number is an adjustable one, which means if a client's disposable income increases either because that client's income goes up or expenses are reduced, then the monthly payment can be adjusted, though normally it is adjusted upwards. Finally, Chapter 13 clients have to remain in Chapter 13 for three to five years even if a third party is willing to lend them the money so they can pay off the Plan early or even if the client has non-exempt assets that that client could access to pay off the Plan. This effectively places a Chapter 13 client in a situation in which he is handcuffed for that period of time because of the restrictions imposed on that client by bankruptcy law.

Chapter 11 is another form of reorganization which is really designed for companies and bigger cases, but can be utilized by individuals. This of course raises the question of why would an individual consider a Chapter 11 since it is more expensive, far more burdensome than a Chapter 13, requires more extensive paperwork to be filed, not just initially but throughout the case, and requires a far more complicated procedure for approval of a Plan of Reorganization. The answer is based upon certain aspects of Chapter 11 which can actually make it far more attractive than Chapter 13 for certain individuals.

An individual Chapter 11 can easily cost $20,000 to $25,000 (or more), which is three to four times more than many Chapter 13's. Nevertheless, Chapter 11 may be far more beneficial than a Chapter 13 for the following reasons:

1. A prospective debtor may not qualify for chapter 13 if the debtor has too much debt.

2. A Chapter 11 debtor may have greater flexibility in structuring payments to creditors under a chapter 11 plan, both in terms of amount and timing, leaving the debtor with more cash each month. Even if that difference is only $500 a month over the course of a 60-month Plan, this translates to $30,000 of additional money available to a debtor.

2. Whereas in a Chapter 13 the statute specifically provides for a procedure for annual adjustments of the monthly Plan payment, in a Chapter 11, once the Plan is confirmed, there is little chance the debtor would even have to increase his payments. [See §1127(e) for specifics relating to individuals]

3. Probably most importantly, there does not appear to be any prohibition in permitting a Chapter 11 debtor to pay off a Plan early. This option could allow a Chapter 11 debtor to extricate himself from bankruptcy much earlier if that individual can raise the money to pay off the Plan early.

4. The Debtor's Plan payment does not commence until confirmation of the Plan which may not be for many months from the original filing date.

5. A Chapter 11 does not require the appointment of a Chapter 13 trustee which eliminates that individual's statutory percentage which can be as much as 11% of the payments disbursed.

6. In 2016, the Ninth Circuit ruled that individuals in Chapter 11 have to abide by the Absolute Priority Rule. This requires individuals seeking relief under that Chapter to contribute an amount to be determined by the Court as new value in return for being able to retain assets in the bankruptcy case. In almost all instances, this will increase what a Chapter 11 debtor has to pay to creditors, though it's unclear at this time as to exactly how much more debtors will have to pay to comply with this statutory requirement. Though this obligation in itself is not sufficient to compel an individual to seek Chapter 13 relief when Chapter 11 is also an option, it is a factor which should make a difference in cases which are close calls.

II. A No Nonsense Analysis Of Which Is Preferable For Your Client.

1. What is the purpose of the bankruptcy? Liquidation of property to satisfy creditors, find relief from interest and penalties, obtain a payment plan over time, deal with remaining non-dischargeable debts after a Chapter 7…
2. What can the client afford?
    a. Legal fees and administrative costs of an 11-
        i. Legal fees are usually no less than $20,000
        ii. US Trustee Quarterly Fees- $325-$975/quarter (can be significantly more if the quarterly disbursements of the debtor are significant)
    b. Legal fees and administrative costs of a 13-
        i. Legal fees are usually $6000 or less under a RARA
        ii. Ch 13 Trustee's fees in a 13- up to 11% of what Trustee administers
3. Administrative requirements/Debtor Responsibilities-
    a. Ch 11-
        i. DIP files their own reports/maintains proper accounting for the estate (including maintenance of various DIP required accounts)

ii. Negotiates a plan, typically with creditors, or at least significant creditors, and payments commence on the effectiveness of the plan. During the pendency of the chapter 11, debtor must pay creditors currently for debts incurred after the filing of bankruptcy, pre-petition debts await confirmation of a plan.

iii. acts as a fiduciary to their creditors- Are there any ethical, criminal, civil issues/allegations that may preclude your client from serving as a DIP/triggering a motion to appoint a trustee? Will client be willing to bring preference actions and fraudulent transfer actions against friends/family [§1107(a)]

b. Ch 13- Trustee administers the case and Debtor need only make a single monthly payment to the Trustee and turn over tax returns and any refunds yearly

4. How much time does the client have?

a. Having to turn over disposable income immediately in a 13 vs not-so-immediately in an 11

b. Limit of 60 months in 13 vs possibly more time in an 11. In a chapter 11 there really is no limit to the timing, it can be as short or as long as provided for in a plan and approved by the creditors voting on the plan.

   c. Equal monthly payments in 13 [§1325(a)(5)(B)(iii)] vs more flexible payments in an 11

5. "Codebtor stay"-
   a. Ch 11- No co-obligor stay unless special circumstances apply
   b. Ch 13- Co-obligor stay for consumer debts allowing one debtor to keep credit "clean" while debt is reorganized/resolved [§1301(a)]
6. Disposable Income Requirements-
   a. Ch 11- Less concern over luxury/non-essential budget items (i.e. more than "necessary" vehicle expenses, private school tuition,. However, there are limits [§1129(a)(15)], and it is not uncommon to see disputes over what an individual debtor should be allowed to spend in chapter 11. But this typically is left to creditors, and there is not automatically a trustee in the case that oversees the expenditures.
   b. Ch 13- Trustees typically will object to anything over and above the means test allowances as not being "reasonable and necessary" and no "luxury" or "non-essential" expenses items will be allowed. For over the median debtors, the projected

disposable income on the means test determines the minimum to be paid to unsecured creditors and even then, the Court has discretion with under the median debtors to adjust the allowed expenses.

7. Planning for the worst…Dismissal vs. Conversion-
   a. Ch 11- Court approval needed to dismiss case and could be converted to 7 instead by UST or party in interest [§1112(b)]
   b. Ch 13- Debtors can voluntarily dismiss [§1307(b)]
8. Type of Discharge Needed-
   a. Ch 11- No "Super-discharge" like that of a 13 [§1141(d)(2)]
   b. Ch 13- Gives a debtor a "Super-discharge" which can discharge various items not discharged in 11 (i.e. family court obligations other than support/equalization payments, unscheduled debts in prior cases, etc.) [§1328(a)]

III. Proper Pre-Bankruptcy Planning To Ensure Your Client Receives The Full Benefit Of Any Reorganization.

1. Timing of the filing
2. Eligibility issues- Meeting §109(e) limits
   a. Paying down debt before filing
   b. Securing unsecured debts before filing

c. Noncontingent & Unliquidated analysis- just because a client has a million dollar "claim" against them doesn't mean they don't qualify to file a 13

3. Exemption Planning-

   a. Non-exempt assets used to meet eligibility issues

   b. Non-exempt to exempt

4. Transfer Actions/Preference Actions- waiting out certain time periods to avoid such actions or filing before a possible action expires

5. Reorganizing before reorganization-

   a. Incorporating a small sole proprietorship before filing can often simplify your individual debtor's post-bankruptcy life

   b. In a chapter 11, figuring out the creditor classes and determining if you have the necessary votes to secure confirmation of a plan. Considering a pre-pack or pre-negotiated plan.