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Consumer Track

The Small Business Owner's Chapter 13

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The Small Business Owner's Chapter 13

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Part 1: Getting Started - Eligibility Issues for Small Businesses

1. Introduction: Chapter 13 for Worm Diggers.

Chapter 13 provides small business owners with unique options and streamlined procedures not available under other chapters. Chapter 13 debtors can bifurcate claims, cram-down plans, and obtain discharges while paying creditors less than in full, without the need to satisfy the absolute priority rule or a voting process. These unique advantages come with somewhat narrow eligibility requirements which make it difficult for many small business owners to obtain relief in Chapter 13.

The present-day Bankruptcy Code updated Chapter 13 of the old Bankruptcy Act in important ways to make it more accessible, attractive, and easier for debtors to work out repayment plans. Among the changes, Congress expanded the class of individuals who are eligible for Chapter 13 relief to include individuals with stable and regular income, including individuals who operate businesses as sole proprietors. See *Matter of Pearson*, 773 F.2d 751, 753 (6th Cir. 1985).

According to legislative history, by substituting "individual with regular income" for "wage earner," the Bankruptcy Reform Act of 1978 extended Chapter 13 eligibility to small businessmen who are self-employed because:

> "The distinction between a barber, grocer, or worm digger who is self-employed from one who is an employee is slight. [The proposed change to Chapter 13] eliminates the distinction, in order to afford small sole proprietors as well as wage earners an alternative to Chapter 11."

H.R. Rep. No. 595 at 119; reprinted in 1978 U.S. Code Cong. & Ad. News at 6079.

The function of section 109(e) is to separate those small sole proprietors who should have the benefit of Chapter 13 from those larger businesses who should not. *Matter of Pearson*, 773 F.2d at 753–54. Congress opened the door for some small businesses to use Chapter 13 to reorganize their debts. But most worm diggers will find some aspect of Chapter 13 eligibility challenging.

2. Chapter 13 Eligibility

The code limits Chapter 13 relief to a debtor that:

1. Is an individual

2. Has regular income; and
3. Has total secured and unsecured debts less than the respective statutory debt limits for each category of debt.

11 U.S.C. § 109(e).

The majority view is that these eligibility requirements are not jurisdictional, but create a gateway into the bankruptcy process, not an ongoing limitation on the jurisdiction of the bankruptcy courts." *In re Fishel*, 583 B.R. 474, 476 (Bankr. W.D. Wis. 2018), citing *Glance v. Carroll* (*In re Glance*), 487 F.3d 317, 321 (6th Cir. 2007).

Because § 109(e) contains no internal enforcement provision, lack of eligibility is usually raised in a motion to dismiss "for cause" under § 1307(c). See *In re Pratola*, 589 B.R. 779, 787 (N.D. Ill. 2018). Some courts have exercised discretion to allow a debtor to continue in Chapter 13 notwithstanding ineligibility under § 109(e), finding inherent discretion to decline to dismiss a case under §§ 1307(c) and 105. "The decision to convert or to dismiss a Chapter 13 case is a matter of discretion for the bankruptcy court." *Fishel*, 583 B.R at 478 (citations omitted). Other courts found that § 109 constrains the court's discretion. "While § 1307(c) does provide for discretion on the part of the bankruptcy court in deciding whether to dismiss or convert a Chapter 13 case for cause, the exercise of this discretion cannot contravene the plain language of [§ 109(e)]." *Pratola,* 589 B.R. at 793.

(a) <u>The debtor's status as an individual.</u>

"Individual" is defined in the bankruptcy code as … wait, it isn't defined. The dictionary definition is "a single human being as distinct from a group, class or family." Of course, married couples are able to proceed in a joint case under the code, including in Chapter 13, provided they are otherwise eligible (regular income and debt limits). See 11 U.S.C. § 302.

An individual that operates a business as a sole proprietorship is therefore eligible for Chapter 13, but interestingly, the sole proprietorship itself is not. In fact, a sole proprietorship on its own isn't eligible for any form of bankruptcy relief. "A sole proprietorship is not a 'person' for purposes of the Bankruptcy Code because it is neither an individual, nor a partnership, nor a corporation. Since it is not a 'person,' a sole proprietorship is ineligible to be a debtor in bankruptcy." *In re KRSM Properties, LLC*, 318 B.R. 712, 717 (B.A.P. 9th Cir. 2004).

If an individual fits the code's definition of either "commodity broker" or "stockbroker," Chapter 13 is not an option. See 11 U.S.C. § 109(e). Subchapter III of Chapter 7 provides special protections for customers of stockbrokers. These special protections would not be available to customers if a stockbroker were to file a Chapter 13, which is why stockbrokers are ineligible to file a Chapter 13. See *In re Schave*, 91 B.R. 110, 112 (Bankr. D. Colo. 1988).

Note that, under the definitions (§ 101(6) and (53A)), a person engaged in the sale of securities with only one customer can be considered a broker. An employee of a brokerage doesn't necessarily meet this definition. *In re Berry*, 22 B.R. 950, 953 (Bankr. N.D. Ohio 1982). The definition of "stockbroker" used in § 109 is derived from a combination of the definitions of

"broker" and "dealer" in the SIPA, encompasses both brokers and dealers. *In re Schave*, 91 B.R. at 112. The term does not encompass an employee who acts for a principal that "effects" transactions or deals with the public, because such an employee will not have a "customer". *Id*., quoting H.R. Rep. No. 95–595, 95th Cong., 1st Sess. 314 (1977); S. Rep. No. 95–989, 95th Cong. 2d Sess. 27 (1978) U.S. Code Cong. & Admin. News pp. 5787, 5812, 6271.

> **Practice Tip:** if you represent a debtor employed by a brokerage firm that engages in the sale of securities, don't list the debtor's occupation on Schedule I as "stockbroker." The debtor bears the burden to demonstrate eligibility under § 109 in order to confirm her plan, and an indication in the schedules that the debtor is a stockbroker may trigger a presumption that the debtor must then rebut, putting the debtor in the awkward position of having to prove the negative (e.g., that she is *not* a stockbroker). See *In re Hayter*, No. 09-20448-TLM, 2010 WL 1258162, at *1 (Bankr. D. Idaho Mar. 26, 2010).

(b) The regular income requirement.

As noted above, Congress expanded eligibility for Chapter 13 when it replaced "wage earner" with "individual with regular income."

> The definition encompasses all individuals with incomes that are sufficiently stable and regular to enable them to make payments under a chapter 13 plan. Thus, individuals on welfare, social security, fixed pension incomes, or who live on investment incomes, will be able to work out repayment plans with their creditors rather than being forced into straight bankruptcy. Also, self employed individuals will be eligible to use chapter 13 if they have regular income....

House Report at 311-12, 1978 U.S. Code Cong. & Ad. News at 6269; S. Rep. No. 95-989, 95th Cong. 2d Sess. 24 (1978), reprinted in [1978] U.S. Code Cong. & Ad. News 5787, 5810 ("Senate Report").

An "individual with regular income" is an "individual whose income is sufficiently stable and regular to enable such individual to make payments under a plan under chapter 13." 11 U.S.C. § 101(30). "The benchmark for determining whether an individual has regular income for purposes of section 101(30) ... is not the type or source of income, but its stability and regularity." *In re Bartelini*, 434 B.R. 285, 292 n. 11 (Bankr. N.D.N.Y. 2010). The income need only be regular and stable enough to ensure that a debtor is able to make payments under a Chapter 13 plan. See *In re Wilhelm*, 6 B.R. 905, 908 (Bankr.E.D.N.Y.1980). Case law interpreting this provision has held that the burden of establishing the regularity and stability of income is on the debtor. See *In re Culp*, 545 B.R. 827, 839–40 (D. Del. 2016), aff'd, 681 F. App'x 140 (3d Cir. 2017), citing *In re Antoine*, 208 B.R. 17, 19 (Bankr. E.D.N.Y. 1997).

(c) Debt limits.

The current debt limits (as of April 1, 2019) are $419,257 for unsecured, and $1,257,850 for secured debts. The next adjustment to debt limits will occur on April 1, 2022.

i. *Secured versus unsecured debts*.

Whether and to what extent a claim is secured or unsecured for purposes of the debt limits is determined by 11 U.S.C. § 506(a). See *In re Day*, 747 F.2d 405 (7th Cir. 1984).

When a claim is undersecured, the unsecured portion is counted as unsecured for 11 U.S.C. § 109(e) eligibility purposes. *Scovis v. Henrichsen*, 249 F.3d 975, 983 (9th Cir. 2001). That is so even if the debtor is barred from bifurcating the claim under Chapter 13's so-called "anti-modification" clause. See *In re Brammer*, 431 B.R. 522 (Bankr. D.D.C. 2009), If the lien is totally unsecured, and can be stripped, it will be counted as an unsecured debt, whether or not the debtor actually take steps to strip the lien. See *In re Smith*, 435 B.R. 637 (B.A.P. 9th Cir. 2010).

ii. *Married couples and doubling the debt limits*.

Some courts allow doubling of the debt limits for married individuals, but there is a split of authority on this point. Compare *In re Miller*, 493 B.R. 55 (Bankr. N.D. Ill. 2013) (spouses must aggregate debts) with *In re Werts*, 410 B.R. 677, 686-87 (Bankr. D. Kan. 2009) (spouses receive separate debt allowances). In the *Miller* case, Judge Goldgar did not find support for a doubling of the debt limits in the statutory language, or the reasoning of *Werts*:

> But *Werts* never explains how section 109(e) can be interpreted to permit a joint case even though the aggregate debt limit is exceeded, as long as each debtor would be separately eligible to file an individual case. For that matter, *Werts* never explains why an interpretation of the statute is necessary at all. *Werts* concludes that "a more reasonable reading" of section 109(e) is one that permits joint chapter 13 cases under these circumstances, but bases that conclusion entirely on its own view of bankruptcy policy, not on the statutory language.

In re Miller, 493 B.R. 55, 59 (Bankr. N.D. Ill. 2013) (citation omitted).

Perhaps *Werts* goes further that *Miller* suggests, parsing the statutory language to hold that a reasonable reading of 109(e) does in fact permit a doubling of the debt limits:

> The Court finds that the statute in question does not mandate that married persons combine their unsecured debt (regardless which spouse has personal liability for that debt) for purposes of the debt limits in § 109(e). Rather, § 109(e) provides for two groups of people who can be Chapter 13 debtors. The first of these groups includes individuals with regular income who meet the debt limits. If an individual has regular income, and that individual's debts are below the limits established by § 109(e), then that individual qualifies to be a Chapter 13 debtor.
>
> The second group provided for under § 109(e) includes individuals with regular income and their spouse, provided their aggregate debts do not exceed the debt limits. This additional provision is necessary to avoid situations where married couples would prefer to file a joint Chapter 13 proceeding, but only one spouse has regular income. Without specifically including the spouse of an individual with regular income in § 109(e), single

> income couples could be precluded from filing a joint Chapter 13 case because the spouse without regular income would not qualify.
>
> The Court finds that a more reasonable reading of the statute, and one that furthers the goal of encouraging Chapter 13 filings, is that the provision dealing with "an individual with regular income and such individual's spouse" is intended to apply in those cases where the spouse could not otherwise be a Chapter 13 debtor, because he or she is not "an individual with regular income." If each spouse has regular income, and each spouse separately qualifies under the debt limits of § 109(e), then each spouse should be entitled to file his or her own Chapter 13 case—even if the debts of both spouses together would exceed the debt limits.
>
> If a husband and wife can each file separate Chapter 13 proceedings, where their own individual debt is within the § 109(e) limits, the Court can think of no reason why a husband and wife could not file a joint petition, as authorized by § 302(b)….
>
> Of course, in any of these cases, a trustee's objection could be overcome by having the spouses file separate petitions. However, "machinations" such as forcing the Debtors to pay a second filing fee, file another set of schedules and plan, and arrange a new set of hearings "elevates form over substance." …

In re Werts, 410 B.R. 677, 687–89 (Bankr. D. Kan. 2009).

Another case citing *Werts* finds its interpretation of Section 109(e) persuasive:

> The language of Section 109(e) similarly recognizes petition filers as individuals. It sets forth debt ceilings for "an individual" "debtor." These nouns are singular, not plural.
>
> It would be inconsistent with the plain meaning of the language of Sections 302(a), 302(b), and 109(e) to treat joint filers as a consolidated entity, whose debts taken together may not exceed the Section 109(e) ceilings, rather than two separate individuals who must separately each qualify as a debtor pursuant to Section 109(e). It would also be inconsistent with the exemption of assets to treat joint filers as a consolidated entity rather than separate individuals. Each debtor in a joint case may claim exemptions separately.

In re Scholz, No. 6:10-BK-08446-ABB, 2011 WL 9517442, at *2 (Bankr. M.D. Fla. Apr. 11, 2011).

The split of authority, and absence of circuit-level authority on this issue, may provide the basis to proceed in Chapter 13 under certain circumstances. That said, the approach is more tenuous in community/marital debt states, where most obligations incurred by spouses are deemed joint debts of each spouse, and thus the aggregate of the claims would not be divisible among the spouses in any meaningful way.

iii. *The "potential" debts of an individual owner of a liability-limiting entity*.

It is common practice to advise an individual owner of a liability-limiting entity to list any and all creditors of the entity as potential creditors in the individual bankruptcy, to ensure that those creditors don't seek to hold the individual liable for the debts of the entity. The legal theories for such a claim, including "veil piercing" or similar theories, may involve allegations of fraud or other conduct, e.g. not the "garden variety" debts covered by the general discharge for unscheduled debts. *In re Guseck*, 310 B.R. 400, 403–04 (Bankr. E.D. Wis. 2004). Listing the potential claims in the individual's schedules may be necessary to protect the individual. But for purposes of the § 109(e) debt limits, does an individual owner of a corporate entity count the debts of the entity for which the individual could eventually be held personally liable, under "veil piercing" or other legal theories? At least one court has answered that, when examining such claims in light of eligibility under the debt limits:

> …(1) a debtor's good faith assertion as to how much is owed is ordinarily accepted at face value and should "normally" be determined by the debtor's schedules; and (2) that as to any asserted amounts other than those in the schedules, the inquiry can go outside the schedules, but, ultimately only to the extent it appears from said inquiry as a "legal certainty," that such are debts of debtors, should they be utilized in determining eligibility (notwithstanding that debtors may have filed the schedules in good faith). …[T]he nature of the threshold eligibility issue is such that it should not be one that is lengthy, involved, or so deeply evidentiary as to go to the point of having the Court substantially dispose of the question of whether or not the Debtors or either of them are ultimately and legally liable for each of the debts the existence or amount of which may have some bearing on the eligibility issue…
>
> In an individual case where eligibility depends in whole or in part upon the extent to which the debts of a corporation owned by that individual are also to be considered debts of that individual, utilizing piercing the corporate veil theories, it would be a rare case indeed where such could be concluded as a matter of legal certainty, without a full blown trial on the issue. A full blown trial is exactly what the case law says is inappropriate in an eligibility inquiry—hence the relatively high legal certainty standard.

In re Odette, 347 B.R. 60, 62-63, 64 (Bankr. E.D. Mich. 2006).

In the *Odette* case, the debtor apparently was not counseled to list all corporate debts as potential claims against the debtor, but instead that theory was advanced by the creditor. Since *Odette* says courts should first look to the schedules as a threshold analysis, practitioners need to be careful what the schedules say about these sorts of potential claims. One practice is to note that a creditors is listed for "notice only," or similar language, though as pointed out by *Odette*, this practice has its drawbacks[1].

[1] The practice in such situations of listing a corporate debt and creditor and stating it is done for "notice only" is at once interesting, intriguing and puzzling. Aside from the fact that enabling notice to be given to the interested parties is one of the prime functions of the schedules, if the point of including a corporate creditor in an individual bankruptcy schedule, is to attempt to obtain a discharge of the potential individual liability for that corporate debt, why would one undermine that potential by the phrase "for notice only" which, arguably at least, tends to indicate you are seeking something different (less) in the bankruptcy with respect to that particular debt, than you are seeking with the other listed debts on that same schedule which are not accompanied by the "for notice only" notation.

Marking the debt as "disputed" doesn't help, because a "dispute" does not remove the debt from the debt limit aggregation—only contingent and unliquidated claims are excluded. Section 109(e) does not mention "disputed" debts. *Matter of Knight*, 55 F.3d 231, 234 (7th Cir. 1995). It is also unlikely that the claims are contingent, since veil piercing and similar legal theories depend the debtor's committing specific acts or continuing practices in operating the corporation.

That leaves the debtor to assert that the claims are unliquidated. As the discussion from *Odette* notes, whether a claim may be had against and individual or its amount is far from a certainty, and courts may rule that certain portions—but not the entirety—of an otherwise liquidated claim may be attributable to certain conduct of the individual making her liable for the debts of the entity. Given the equitable, and therefore to some degree indeterminate, nature of such claims, noting that they are of "unknown" amount, and unliquidated, is likely the best option to avoid their inclusion in the aggregate debt limits when scheduling such claims. Of course, this assumes that such a claim has not been assigned a determined value (e.g., by final judgment, settlement agreement, etc.).

iv. *Individual guaranty of corporate debt*.

Owners of small businesses often personally guarantee the obligations of their entities, including secured and unsecured debts of the entity. What portion of the guaranteed obligations count toward the debt limits, and does it matter that the entity pledged collateral for the debt?

At the outset, a guaranty is, by its very nature, a contingent liability. Even though most guaranties contain language suggesting that the guarantor's liability is "absolute," "unconditional," or even "joint and several," this does not alter the secondary nature of guarantor liability. The absolute or unconditional nature of a guaranty only becomes relevant once the primary obligor is in default. See *Glaubitz v. Grossman*, No. 10-C-927, 2011 WL 147931, at *1 (E.D. Wis. Jan. 18, 2011). "The fundamental principle that a guarantor's promise of payment is secondary, meaning that his liability does not ripen until the debt has come due and the primary obligor is in default, is not a contractual condition that may be altered or dispensed with at the whim of the parties." *In re Clore*, 547 B.R. 915, 922 (Bankr. C.D. Ill. 2016).

Most debts covered by a guaranty of payment (as opposed to a guaranty of collection) will be deemed liquidated. "If the debt is contingent on collection against other persons or collateral, such as a guaranty of collection, it may also be unliquidated until those collection proceedings have been concluded. But where a guaranty is not contingent upon the exercise of other collection remedies, such as an absolute and unconditional guaranty of payment, the existence of collateral or the liability of other parties does not cause the claim against the guarantor to be unliquidated." *In re Clore*, 547 B.R. at 924.

If the guaranteed debt is liquidated (as most are), and also no longer contingent, because liability is triggered by default of the primary obligor, can a debtor still argue that the debt is "secured" because the primary obligor has pledged collateral for the debt? As noted above, the analysis of

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In re Odette, 347 B.R. 60, 63 n.1 (Bankr. E.D. Mich. 2006)

which portion of a debt is "secured" for purposes of § 109(e) is governed by § 506(a), which provides in relevant part:

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

Because § 506(a) values the creditor's secured claim with reference to the estate's interest in property securing the claim, non-estate property doesn't factor. For purposes of determining how much of a claim in an estate is secured, one must look at the creditor's interest in the "estate's interest" in the property in question. The estate's interest in property is essentially coextensive with the non-exempt property interests held by the debtor at the time of filing his or her petition in bankruptcy. *In re Tomlinson*, 116 B.R. 80, 82 (Bankr. E.D. Mich. 1990).

However, some courts have taken a different approach, finding that in some instances collateral of a non-debtor should count toward the secured portion of the debt, and reduce the unsecured portion attributed to the debtor for purposes of the § 109(e) debt limits.

In *Branch Banking & Trust Co. v. Russell*, 188 B.R. 542 (E.D.N.C. 1995); the court began with the proposition that a debt may be secured only to the extent of the estate's interest in the subject collateral, but found that the property at issue was estate property because, even though it is owed by a corporation, that corporation was wholly owned by the debtor. However, most courts would take issue with the holding of *Branch Banking* to the extent that court holds that property which is owned by a separate corporation can be considered property of the shareholder's bankruptcy estate.

In *In re Belknap*, 174 B.R. 182 (Bankr. W.D.N.Y. 1994), the court found enough difference between "secured claim," as the term is used in § 506(a), and "secured debt," as that term is used in § 109(e) to read those as different terms, concluding that the term "secured debt" is not defined in the Code. Thus, it read "secured debt" under § 109(e) to mean any debt which is secured by property, of the estate or otherwise. But that reading is contrary to Supreme Court guidance that Congress intended "that the meanings of 'debt' and 'claim' be coextensive." *Pennsylvania Dept. of Public Welfare v. Davenport*, 495 U.S. 552, 110 S.Ct. 2126, 109 L.Ed.2d 588 (1990).

In *In re White*, 148 B.R. 283 (Bankr. N.D. Ohio 1992), the court found that an obligation was a secured debt even though the property securing the debt was property of a third party. The *White* court suggested that it would be unfair to burden the debtor with the full amount of a debt without the protection of the full value of the collateral.

Part 2: Supporting the Schedules: Documents, documents, documents.

Once the practitioner and client have worked through the pre-petition considerations and a plan of action has been reached and executed in the form of a Chapter 13 petition being filed, it is time to "show your support", i.e. provide supporting documentation to the Chapter 13 Trustee for review against the pleadings and to establish feasibility, best effort, and good faith. In some cases you may also be providing proof of eligibility. Best practices dictates that you will have reviewed these documents yourself as part of the evaluation and pre-petition planning and therefore have most, if not all, of the documents the Trustee will predictably want to review.

Of course, just as case decisions vary from judge to judge, individual document requirements will differ to some degree depending on the client, their business, and the Chapter 13 Trustee. A poll of trustees from different districts reveals that while each district likely has generalized practices in these matters, each Trustee may have their own requirements as well.

Disclosure, because we're all attorneys: Any references to 'local rules' are references to local bankruptcy rules unless otherwise noted.

Broad Strokes

It is likely that the trustee(s) of the district will have a common list of documents he or she will expect in a case where the debtor owns a business. For instance, in the Eastern District of Michigan, Local Bankruptcy Rule 2003-2 identifies the initial documents that must be forwarded to the assigned trustee in every bankruptcy case and specifically provide that in the case of a Chapter 13 debtor with a business that "business financial statements and business tax returns for the past three years, and business bank statements for the past six months" must also be provided. LBR 2003-2(c)(4) (ED MI). In contrast, the trustees[2] for the Western District of Wisconsin require complete business tax returns or business schedules filed with personal returns, a business budget for the coming year, a completed business questionnaire provided by the trustees, information necessary to complete a Business Attachment to Standing Trustee which is filed with the court by the trustee, information on staff and employees of the business, licensing and insurance information, and loan and lien documents.

The Northern District of Indiana requires that every debtor

> …who operates a business under any chapter of the Bankruptcy Code shall file a monthly statement of the cash receipts and disbursements no later than twenty-one (21) days after the end of the calendar month. This report shall include:
>
> (1) A summary of all income and expenses for the reporting period;
>
> (2) A statement of the use of, reductions and additions to raw materials and inventory, crops, livestock or other items held or produced for sale;

[2] No known local rule exists in the Western District of Wisconsin relevant to the subject matter herein. The Western District of Wisconsin has just five local rules.

> (3) A statement of the collection of and addition to accounts receivable;
>
> (4) A reconciliation of all income and expenses while operating under Title 11;
>
> (5) An itemized statement of all unpaid post-petition obligations;
>
> (6) A statement of insurance coverage;
>
> (7) Proof or certification of payment of all post-petition taxes due, including taxes withheld or collected from others; and
>
> (8) A statement identifying any federal or state tax returns filed during the reporting period, including verification of tax deposits.

ND Ind LBR B-2015-1 (ND IN).

It is worth noting that the Southern District of Illinois does have a Chapter 13 Practice Manual which advises that "[u]nless required by the Chapter 13 Trustee, § 1304(c) shall not apply." (Chapter 13 Procedures Manual,[3] Page 12, No. 18)

The Western District of Michigan does not appear to have any local rules regarding required documentation specific to a Chapter 13 debtor engaged in business. A review by this author, who is not admitted to such districts[4], indicates that no such specific rules exist in the Eastern District of Wisconsin; the Central, Northern, or Southern District of Illinois, the Southern District of Indiana; or the Northern[5] or Southern Districts of Ohio. No additional information regarding business-debtors in Chapter 13 was secured as of the submission of these materials.

The Detail Work

In addition to the foregoing, individual trustees may ask for items more specifically pertinent to the business involved. Some trustees may require:

- profit and loss statements,
- balance sheets,
- operating agreements,
- proof of claimed expenses,
- post-petition bank statements,

[3] http://www.ilsb.uscourts.gov/sites/default/files/forms/13PlanInstruct_04-2017.pdf
[4] It is advisable that one carefully review the applicable Local Rules rather than rely on the cursory review conducted by this author as a conclusory source.
[5] Author is admitted to the ND OH but has not reviewed the local rules for practice since being admitted sometime in the preceding decade.

- K-1s,
- depreciation schedules to the extent not included in the income tax returns,
- information on loans from shareholders and distributions to shareholders, and/or
- historic and/or on-going monthly or quarterly operating reports.

The pertinent documents do not necessarily have to have been professionally prepared, but it is recommended that one evaluate the candor of the client in comparison to the business the client reports to operate when assessing the sufficiency of the proffered records.

Based on the foregoing, and a practitioner's own experience, it is prudent to consider the nature and size of the business enterprise when evaluating the client's case to most accurately forecast what a trustee will ask for in support of the Schedules. To best illustrate from one end of the spectrum to the other, let's take a look at some examples:

Tom C. Lient is a barber and has been self employed as such for over ten years though he has never formally established a business entity. He rents a chair in a local shop and has fallen behind on his car payments. Having reviewed his circumstances, he has elected to proceed in a Chapter 13. In this case, at a minimum, the practitioner should provide Tom's complete income tax returns, including all schedules, and a list of Tom's income and expenses on a month by month basis for at least the last 6 months. If Tom deposits his earnings in the bank, 6 months of bank statements should also be provided as proof of the income. To be most proactive, it is also advisable to gather proof in support of such income and expenses so it is already in the file should it be necessary to provide that information. That proof may be in the form of additional bank statements showing deposits, receipts issued by Tom to his customers or to Tom from his landlord at the barber shop, receipts or bank entries showing the purchase of supplies and equipment, etc. In the author's case, one such client maintained his records in a simple black and white composition book he purchased at a drug store and that was sufficient to show a history of such record keeping and satisfy the trustee's need for business records. Affidavits may also be a useful tool to supplement or fill any holes in a client's record-keeping for a simple situation such as this.

Compare the previous situation with that of Rosalind Ebtor. Rosalind, through her corporate entity, owns 3 party stores in metro Detroit. Due to a downturn in the economy and the simultaneous need for renovations to one of the stores, several years ago the corporation granted a security interest in the other two stores and Rosalind signed a personal guarantee for a business loan that remains in performing status and current. Rosalind however has had to drastically cut her personal income from the corporation as the neighborhoods are still recovering from the original economic downturn. As a result, Rosalind is behind on her mortgage and two auto loans. She would like to save both her home and the vehicles. Rosalind's company has 3 full time W2 employees but she is paid on a draw. What types of documents should a practitioner be looking for in this case?

Well, given the complexity of Rosalind's business situation compared to Tom, it is likely that the practitioner will spend much more time gathering and evaluating documents in

Rosalind's case than was necessary in Tom's. Here, one should expect the trustee to require, at minimum, the following:

- Complete income tax returns for the corporation and Rosalind individually, including all schedules, K1s, and wage statements,
- Business and personal bank statements for 6 – 12 months including check register and/or cancelled checks,
- Identification of all credit for which Rosalind has a personal liability,
- Profit and loss statements for the past 6 – 12 months,
- Accurate valuation of the business which should include building, equipment, inventory, etc., and deducting for any and all financial obligations of the business, whether Rosalind has a personal obligation or not. In this case, it may be prudent to have a business appraisal completed prior to filing.

Why does the trustee want these documents? What might a trustee in your district also seek? Would such a request be reasonable? How does one evaluate the reasonableness in the context of a Chapter 13?

Conclusion

The goal of the practitioner should be to understand what the trustee is trying to ascertain. Remembering that the trustee's goal is to a) make sure all the t's are crossed and the i's are dotted, b) evaluate the truthfulness and accuracy of the schedules, c) confirm that the debtor is committing all available funds to the Chapter 13 plan, and d) confirm that the debtor can afford to fund the plan based on the known or predictable economic situation of the debtor, will help the practitioner become more perceptive and thus preemptive in gathering and providing documents in support of the schedules and plan.

Ultimately, though not exhaustive, these materials and the accompanying presentation should leave the practitioner with a better understanding of the range of documents a Chapter 13 Trustee may request or require in order to evaluate the Chapter 13 debtor's schedules and plan.

Additional Reference

One may also wish to review the materials presented by an ABI panel in 2012 entitled Bankruptcy for the Self-Employed, by DiCicco, Shapiro, and Conti Schmidt.

Part 3: The Post-Confirmation Small Business Debtor

1. Debtor's post-confirmation powers and duties under §1304 – Debtor Engaged in Business.

a. §1304(c) obligates the debtor to perform all of the duties of a trustee arising under 704(a)(8) [the obligation to file periodic operating reports during the case, including post-confirmation, and anything else the UST requires].

   i. What the Chapter 13 trustees require a "debtor engaged in business" to provide in the way of "periodic operating reports" varies dramatically from district to district.

   ii. The debtor's failure to provide the periodic operating reports required by §1304(c) and §704(a)(8) can constitute "cause" for dismissal under §1307.

b. §1304 duties only apply to a debtor that is: (i) self-employed, **and** (ii) incurs trade debt in the production of income from such employment.

   i. "Self-employed" is not defined in Bankruptcy Code. At least one court has determined that "self-employed" under §1304 means "sole proprietorship" and doesn't include a debtor operating a business as a single-member LLC. *See* ***In re McCormick***, 381 B.R. 594, at 599-600 (Bankr. S.D. NY 2008).

   ii. "Trade credit" isn't defined in the Bankruptcy Code, either.

   iii. A self-employed debtor who incurs no trade debt in the production of income is not subject to the requirements of §1304. *See* ***In re Whitcomb***, 310 BR 428 (Bankr. W.D. Ark. 2004) (debtors provided personal services for which they did not incur any debt).

   iv. Arguably, a debtor who operates an LLC of which she is the sole member, even if considered "self-employed", doesn't meet the §1304 definition if the LLC, not the debtor *individually*, incurs trade debt in the production of income.

c. §1304(c) obligates the debtor to perform all of the duties of a trustee arising under 704(a)(8) [the obligation to file periodic operating reports during the case, including post-confirmation, and anything else the UST requires]. What the Chapter 13 trustees require a "debtor engaged in business" to provide in the way of "periodic operating reports" varies dramatically from district to district.

d. §1303 grants all Chapter 13 debtors the powers of a trustee (and exclusive of the trustee) under §363(b), 363(d), 363(e), and 363(f).

i. 363(b) – trustee, after notice and hearing, may use, sell…, other than in the ordinary course of business, property of the estate.

ii. 363(d) – trustee's right to use, sell…property of the estate of a corp. or trust that is not a moneyed business….

iii. 363(e) – Court, with or without a hearing, can grant adequate protection to a party with an interest in estate property.

iv. 363(f) – trustee may sell property of the estate free and clear of interest under certain conditions, including notice and a hearing if under 363(b).

e. In addition to the trustee powers granted to all Chapter 13 debtors, §1304 grants "debtors engaged in business" the trustee's powers under §363(c), also exclusive of the trustee.

i. §363(c)(1) allows trustee, unless the court orders otherwise, to enter into transactions, including the sale or lease of property of the estate, in the ordinary course of business, without notice or a hearing, and may use property of the estate in the ordinary course of business without notice or a hearing.

ii. 363(c)(2) allows trustee to use cash collateral with consent of secured party or after notice and a hearing.

1. Caution: §1304 debtor's unauthorized use of cash collateral during Chapter 13 can give rise to a 523(a)(4) non-dischargeability cause of action. *See* ***In re Kjoller***, 395 B.R. 845 (Bankr. W.D. NY 2008) (Chapter 13 debtor who met definition of §1304 collected and spent $40,000ish in receivables without court approval or secured bank's consent. Case converted to Ch 7 and bank filed 523(a)(4) action for debtor's breach of fiduciary duty in unauthorized use of cash collateral. Court held that §1304 debtors are fiduciaries for creditors holding liens on cash collateral and allowed adversary case to proceed.)

2. Whose cash collateral is it? If the debtor operates an LLC and the cash collateral is property of the LLC, debtor is not bound by the cash collateral requirements of §363(c). *See* ***In re Jones***, 2010 Bankr. LEXIS 3225.

- Issue of *whose cash collateral is it?* can get cloudy if debtor operates an LLC against whom a lender has cash collateral lien, but debtor deposits the LLC's cash in his individual bank account. Best to advise the debtor against using an individual account under such circumstances.

2. Post-Petition Tax Issues of Small Business Debtors:

a. Generally speaking, all Chapter 13 debtors must file all post-petition tax returns or risk conversion or dismissal under §521(j) on the motion of a taxing authority. In many districts, the standard order confirming Chapter 13 plans includes a provision requiring the debtor to file all post-petition tax returns on time or with an extension and to provide the Chapter 13 trustee with a copy of the return when filed.

b. Treatment of post-petition tax claims under §1305.

i. Failure to pay post-petition taxes often results in §1305 claims.

ii. Many debtor's lawyers mistakenly conflate §1305 claims with priority claims under 507(a)(8) that must be paid in full in order for the debtor to successfully complete her plan.

1. §1305 itself does not grant priority status to claims filed thereunder. ***United States v. Fowler (In re Fowler)***, 394 F.3d 1208, at 1214 (9th Cir. 2005).

2. Nothing in the Bankruptcy Code requires a Chapter 13 debtor to pay post-petition taxes, unless the plan or the order confirming the plan includes that requirement. *See* ***In re Ambrosius***, 536 B.R. 814 (Bankr. E.D. Wis. 2014).

iii. Consider including a Special Provision in the plan along the lines of:

"Separate Classification of Post-Petition Claims under §1305(a): Claims filed under §1305(a) shall be classified separately from all other classes of claims and shall be treated as a separate class of general, unsecured, non-priority claim holders (the "§1305 Class"). No disbursements shall be made to holders of §1305 Class claims and claims in the §1305 Class shall not be discharged in this bankruptcy case."

Purpose: To provide an opportunity for your debtor to successfully complete her Chapter 13 case, then address the delinquent post-petition taxes, possibly through another Chapter 13.

3. Filing of claims: Unlike Chapter 11, where only unscheduled creditors and creditors disputing the accuracy of their claim in the schedules need to file claims in order to have an allowed claim, in Chapter 13 trustee can only disburse funds to the holders of timely filed claims.

a. The deadline for filing proofs of claim applies to both unsecured and secured creditors. FRBP 3002(a).

b. Debtor's counsel should review the claims register post-confirmation (and pre-confirmation) to ensure that secured and priority claims that the debtor needs to pay in full in order to successfully complete his plan are timely filed. Small business debtors often owe taxes, and it's important to make sure the tax claims are timely filed so that they can be paid through the plan

   i. The bar date for filing claims in Chapter 13 cases was shortened in December 2017 for the holders of non-governmental claim from 90 days following the first date set for the meeting of creditors to 70 days from the date of the order for relief, effectively shortening the non-governmental claims filing deadline by 50 days.

   ii. Accordingly, it's less common now that a plan is confirmed before the non-governmental claims filing deadline, but the bar date for filing claims of a governmental unit is still 180 days from the order for relief, so if the plan is confirmed less than 180 days from the date of the order for relief, debtor's counsel still needs to review the claims register post-confirmation to ensure all 507(a)(8)(C) claims [tax required to be collected or withheld and for which debtor is liable; ex. employee withholding taxes and sales taxes] and probably all other priority tax claims are filed.[6]

   iii. Debtor can file a proof of claim on behalf of any creditor within 30 days after the creditor's claims bar date, if the creditor hasn't timely filed its own claim. FRBP 3004.

4. Post-confirmation small business debtor issues that have pre-confirmation origins:

a. Issue: Debtor who owns rental real property individually wants the flexibility to possibly sell the property during a Chapter 13 case without a lot of complications, and would also prefer to avoid the periodic reporting requirements imposed on §1304 "debtors engaged in business."

   i. Strategy: Pre-petition, debtor forms single-member LLC, then deeds property into LLC of which debtor is sole member. Debtor's ownership interest with respect to the rental property is now in the form of a membership interest instead of an interest in real property. Then debtor files Chapter 13.

   ii. Potential benefits: Restrictions on transfers of property of the estate and on debtor's ability to refinance or incur debt maybe only extend to the debtor himself and his membership interest, not to the assets and debts of the LLC itself.

[6] While late or unfiled tax claims under 507(a)(8) may be dischargeable in a non-hardship discharge Chapter 13, I think it's still usually a good idea to get the claim filed for the taxing authority if they're late because not all Chapter 13s make it to plan completion. If your debtor doesn't ultimately make it and the case gets dismissed, getting the tax claim paid down from funds that would otherwise just go to dischargeable unsecured creditors is a good thing.

1. Arguably, debtor's LLC can sell or refinance its real property without requiring the trustee's or court's approval, as long as the debtor doesn't sell or transfer his membership interest.

2. Arguably, debtor can structure the financial life of the LLC such that the debtor individually does not meet the §1304 definition of "debtor engaged in business", thereby avoiding the periodic reporting requirements.

b. Issue: Debtor's landscaping business, a single-member LLC, is in financial distress and is being sued by customers and suppliers. Debtor intends to remain self-employed, but financial future of current LLC is bleak.

i. Strategy:

1. Pre-petition, debtor does the following:

- determines the fair market value of personal property of landscaping LLC,

- enters into a bill of sale for all of those items for their fair market value,

- pays the purchase price with secured seller financing in the form of the LLC taking an installment note for the purchase price from the individual buyer[7] and a perfected security interest in the purchased assets.

- debtor then forms new operating LLC to do future landscaping projects and enters into lease of personal property from company equal to installment payments on seller financing note.

2. Then debtor files chapter 13 and the following occurs:

- Debtor lists lease income from lease of personal property to new operational LLC,

- Non-operational LLC files a secured claim for the unpaid balance of the note.

[7] If the LLC's property is subject to a pre-existing secured debt, debtor could enter into a debt assumption agreement with the LLC as part or all of the consideration for the "purchase price" of the assets instead of or in combination giving a promissory note.

- Debtor's plan proposes to pay the secured claim of non-operational LLC in full over the term of the plan.
- Arguably secured claim is paid as any other secured claim.[8]
- Debtor lists non-operational LLC and all creditors of non-operational LLC as creditors on schedule F.[9]

ii. Potential benefits:

1. Personal property used for business operations is arguably protected by debtor's automatic stay;
2. Value of personal property in debtor's bankruptcy case is fairly easy to exempt, as it's all subject to the secured claim.
3. Strategy limits likelihood of fraudulent transfer claims on account of public confirmation that fair value given (in the form of the secured POC in the chapter 13).[10]

c. Issue: Debtor operates a single member LLC, taxed as a pass-through entity, as her primary source of income, but her financial problems arise from other sources, like the debts she's ordered to pay in connection with a recent divorce. The revenues from debtor's LLC fluctuate considerably throughout the year, resulting in a DMI calculation that's higher than what she projects her average monthly income will be in the foreseeable future. She's worried that the DMI calculation results in a minimum monthly plan payment that she can't afford.

i. Strategy: Advise debtor to talk to her tax professional about the pros and cons of converting the tax election of the LLC pre-petition from a pass-through entity to a C-corp. election.

ii. Potential Benefits: C-corp. election allows owner of LLC to be paid as W2 employee of LLC, meaning debtor gets a traditional paycheck in a fixed amount each month, thereby regulating the debtor's income and resulting in a DMI calculation that reflects the debtor's anticipated income.[11]

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[8] Be aware of §510(c) lien subordination possibility.

[9] Listing non-operational LLC as creditor arguably affects derivative claims (ex. creditors of non-operational LLC may have ability to assert fraudulent transfer claim on behalf of non-operational LLC against debtor/asset buyer, but including non-operational LLC as a creditor may later bar any claim the non-operational LLC has against the debtor/asset buyer, including for fraudulent transfer).

[10] Debtor must still be cognizant of successor liability issues and work to minimize them (ex. new operational LLC shouldn't collect receivables of non-operational LLC and shouldn't inform all customers of non-operational LLC that non-operational LLC has just "changed its name" to that of new operational LLC).

[11] This strategy may require waiting a period of time after making the C-corp. election before filing due to the 6-month lookback period in the DMI test.

5. Getting out of Chapter 13 when things are going bad (or really well) for the small business debtor.

a. Reasons Chapter 13 small business debtors may want to get out of Chapter 13 include:

i. Business fails and debtor needs a Chapter 7 discharge but can't convert due to negative fallout from:

1. 547 preferences (including to insiders);

2. 548 fraudulent transfers;

3. Non-exempt assets that would be administered by the Chapter 7 trustee.

ii. Debtor doesn't need a Chapter 13 anymore because purpose of Chapter 13 is no longer being served, including:

1. Workout or other restructure of the problem secured debt for which the Chapter 13 was filed,

2. Secured lender was granted relief from stay and took possession of the property debtor was trying to protect with the Chapter 13,

iii. Debtor has acquired a valuable asset post-petition (inheritance or legal claim) and would prefer to settle up with creditors outside of the bankruptcy context.

b. Problems with debtor getting out of Chapter 13 voluntarily:

i. §1307(b) provides as follows:

"On request of the debtor at any time, if the case has not been converted under section 706, 1112, or 1208 of this title, the court *shall* dismiss a case under this chapter. Any waiver of the right to dismiss under this subsection is unenforceable.

ii. **Caution**: Despite the seemingly mandatory nature of a voluntary dismissal under §1307(b), courts do not agree that §1307(b) gives debtor entitlement to voluntary dismissal of case.

1. The 9th Circuit held: "we conclude that the Court's rejection of the "absolute right" theory as to § 706(a) applies equally to §1307(b). Therefore, in light of *Marrama,* we hold that the debtor's right of voluntary dismissal under § 1307(b) is not absolute, but is qualified by the authority of a bankruptcy court to deny dismissal on grounds of

bad-faith conduct or "to prevent an abuse of process." ***Rosson v. Fitzgerald (In re Rosson)***, 545 F.3d 764, at 773-774 (9th Cir. 2008) (debtor had failed to comply with an order of the bankruptcy court to deliver the proceeds of an arbitration award, so bankruptcy court sua sponte entered an order for conversion of his debtor's case to a Chapter 7, but before the conversion order became effective debtor filed motion to voluntarily dismiss under §1307(b), which motion was denied).

2. The 5th Circuit held that the debtor does not have an entitlement to voluntary dismissal under §1307(b) if there is a competing motion to convert and the debtor has acted in bad faith. ***Jacobsen v. Moser (In re Jacobsen)***, 609 F.3d 647, at 661 (5th Cir. 2010) (debtor found to have concealed ownership of valuable non-exempt assets in Chapter 13 and after 13 trustee filed motion to convert to 7, debtor filed motion to dismiss under §1307(b). Bankruptcy court denied debtor's motion to dismiss and granted trustee's motion to convert to 7).

3. The 2nd Circuit has a pre-*Marrama* decision that is still good law and held that a debtor has entitlement to dismissal of her case, conditioned only on the explicit conditions contained in §1307(b). ***Barbieri v. RAJ Acquisition Corp. (In re Barbieri)***, 199 F.3d 616, 619 (2d Cir. 1999).

    - There's a case probably headed to the 2nd Circuit that would determine whether the 2nd Circuit thinks *Marrama* overruled *Barbieri*. *See* ***In re Burbridge***, 585 B.R. 16 (Bankr. N.D.N.Y. 2018).

4. Neither the 6th nor 7th Circuits have weighed in on whether §1307(b) provides a Chapter 13 debtor with (i) an entitlement to dismissal or (ii) a conditional right within the discretion of the court, but the following two cases within the 6th or 7th Circuit have followed the 5th Circuit's ***Jacobsen*** decision:

    - In re Haddad, 572 B.R. 661 (Bankr. E.D. Mich. 2017).
    - In re Valentine Hill Farm, LLC (Bankr. S.D. Ind. 2018)(case was a Chapter 12 decided under §1208(b), which is essentially identical to §1307(b)).

6. Issues for "legalized" marijuana industry small business debtors.

a. Many state and local governments have or are in the process of implementing state laws and ordinances legalizing some aspects of the marijuana industry, including Michigan.

b. Despite state and local governments decriminalizing certain aspects of marijuana production, distribution, and consumption, all of the foregoing remain illegal under the federal Controlled Substances Act.

c. Many traditional financial institutions won't lend to pioneers on the legal marijuana frontier, leading to many "mom and pop" entry level entrepreneurs looking for a piece of the growing market.

d. Generally speaking, the bankruptcy courts have declared themselves closed for business to Chapter 13 (and Chapter 11) debtors whose income is derived from the legalized marijuana industry.

e. ***In re Johnson***, a 2015 decision from the Bankruptcy Court for the Western District of Wisconsin, includes an excellent national review of bankruptcy decisions involving debtors engaged in the legalized marijuana industry. ***In re Johnson***, 532 B.R. 53 (Bankr. W.D. Mich. 2015).

    i. Jerry Johnson was a Chapter 13 debtor in his late 60s who filed 13 because he was behind on his house and truck payments. His income consisted of $1,200/mo from social security and $1,000/mo from growing and selling marijuana under Michigan's legalized marijuana law.

    ii. UST filed motion to dismiss due to illegal origin of debtor's income.

    iii. Bankruptcy court held that the debtor's trade, while legal under State law, was illegal under federal law and created two irreconcilable problems; (i) Federal Judicial officers take an oath to uphold federal law, and (2) trustees are statutorily required to comply with federal law, thereby prohibiting them from possessing contraband. Court gave debtor a choice: (i) divest yourself of your marijuana business and prove you've given it up, or (ii) your case will be dismissed. Debtor gave up his marijuana business and his plan was confirmed in July of 2015. His case was dismissed for failure to make plan payments in March 2016.

f. More recently, a Florida Bankruptcy Court took the ***Johnson*** prohibition to the next level. ***Arm Ventures, LLC***, 564 BR 77 (Bankr. S.D. Fla. 2017). The debtor in ***Arm Ventures, LLC*** did not directly participate in Florida's "legalized" marijuana industry, but owned a commercial building in which one of the three tenants was a retailer in the legalized marijuana industry. The Bankruptcy Court determined that a debtor participates in an activity illegal under federal law cannot propose a plan in good faith, as required by §1129(a)(3) and gave the debtor 14 days to propose a plan that did not involve revenue from the marijuana industry or the case would be converted.

g. Workarounds for small business debtors involved in the legalized marijuana industry:

i. Implement ownership structure with multiple levels between the debtor and direct participation in the marijuana industry. Gives debtor the opportunity to more easily divest himself of his connections to the marijuana trade by selling his stock or membership units to a non-debtor pre-bankruptcy. If trustees can't recover property involved in the marijuana trade, would be hard for them to attempt recovery of a fraudulent transfer or insider preference involving such property.

ii. Rely on state law insolvency mechanisms.

iii. Write your senator a letter.