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Thorny Issues in Individual Chapter 11 Cases

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THORNY ISSUES IN INDIVIDUAL CHAPTER 11 CASES

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I. DECIDING TO FILE THE CASE

- a. Chapter 7 v. Chapter 13 v. Chapter 11
- b. Restructuring Options
- c. Dischargeability Issues
- d. Priority Claims
- e. Obtaining Information

II. OPERATING IN CHAPTER 11

- a. Fiduciary Duties
- b. DIP accounts
- c. Insurance
- d. Tax Payments & Returns
- e. Operating, Tax and other Reports
- f. Operating Businesses v. Real Estate cases
- g. Interacting with the U.S. Trustee, including UST Guidelines
- h. Initial Interactions with the Court - Status Conferences

III. RETENTION OF PROFESSIONALS

- a. Limits on representation of Chapter 11 counsel
- b. Potential conflicts
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- e. Legal activities unable to be paid for out of Estate funds

IV. CHAPTER 11 TRUSTEES

- a. Cause for appointment
- b. Avoiding a Chapter 11 Trustee
- c. Effect of Appointment
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VI. CONFIRMING A PLAN OF REORGANIZATION

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- c. Contents/Combined Plan and Disclosure Statement
- d. Feasibility
- e. Absolute Priority
- f. Confirmation
- g. Discharge

CHAPTER 11 TRUSTEES

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Frequency of Appointment

- ▶ Individual (Non-Business) Chapter 11 Filings Extremely Rare
 - ▶ In 2017 - 563 out of 399,492 non-business filings were under Ch. 11 (0.14%)
- ▶ Trustee Appointments Even Rarer
 - ▶ Only 4 cases had a Trustee appointment in 2010
 - ▶ Only 2 cases had a Trustee appointment in 2013
- ▶ Appropriate Remedy is Dismissal or Conversion
 - ▶ - US Trustee Handbook at 3-12.2

Cause for Appointment

- ▶ Section 1104 of the Bankruptcy Code governs appointments
 - ▶ Appointment is for cause:
 - ▶ Fraud
 - ▶ Dishonesty
 - ▶ Incompetence
 - ▶ Gross Mismanagement
 - ▶ Interest of Creditors and the Estate

Examples of Where a Chapter 11 Trustee Has Been Appointed In An Individual Case

- ▶ *In re Vaughan*, 429 B.R. 14 (Bankr. D.N.M. 2010)
 - ▶ Pre-petition Ponzi scheme.
 - ▶ Refused to testify at §341 meeting.
 - ▶ Omitted assets on schedules.
- ▶ *In re Clemente*, 409 B.R. 288 (Bankr. D.N.J. 2009)
 - ▶ Commingled personal and business assets.
- ▶ *In re Russell*, 60 B.R. 42 (Bankr. W.D. Arkansas 1985)
 - ▶ Fraudulent pre-petition transfer and retained secret interest in assets.
 - ▶ All “badges of fraud” present.

Avoiding a Chapter 11 Trustee

▶ Don't Provide Cause In the First Place

- ▶ Cooperate
- ▶ Avoid Fraud

▶ If A Trustee Is Appointed, Get Him/Her Dismissed

- ▶ Force the Court to Terminate Appointment
- ▶ *In re Clemente* - Indentured servitude (peonage) violated 13th Amendment, forcing Court to terminate Trustee and convert case.

Effect of a Trustee Appointment

▶ Effect on the Debtor:

- ▶ No standing to dismiss or convert case.
- ▶ Detailed record keeping.
- ▶ Monthly income/expense reports.

▶ Effect on the Trustee:

- ▶ Little guidance re: controlling Debtor's monthly expenses.
- ▶ Difficulties preparing personal monthly operating reports.
- ▶ Lack of cooperation from Debtor.

General Duties of a Chapter 11 Trustee

- ▶ Collect and reduce to money property of the estate;
- ▶ Be accountable for property received;
- ▶ Examine proofs of claim and object to improper claims;
- ▶ Make final reports and account for administration of estate;
- ▶ Provide specific notice re: claims for domestic support obligations;
- ▶ File periodic monthly operating reports.

Specific Duties of a Chapter 11 Trustee in an Individual Case

- ▶ File list of creditors if Debtor has not done so;
- ▶ Investigate acts, conduct, assets and liabilities of Debtor;
- ▶ File a statement of any investigation conducted pertaining to fraud, dishonesty, incompetence, irregularity;
- ▶ File Chapter 11 plan or a report why Trustee will not file a plan;
- ▶ File tax returns;
- ▶ File additional reports as necessary.

Attorney - Client Privilege Issues

Can a Trustee step into a Debtor's shoes and control or waive the attorney-client privilege?

- ▶ If a Corporate Debtor- Yes. [Commodity Futures Trading Comm'n v. Weintraub](#)
- ▶ If an Individual Debtor -
 - ▶ Some courts say No - [In re Hunt](#), [In re Silvio De Lindegg Ocean Dev. of America, Inc.](#)
 - ▶ Some courts say a Chapter 7 Trustee can waive the privilege. Reasoning may also apply to Chapter 11 Trustee. See [In re Eddy](#), [In re Miller](#), [In re Foster](#)

Extent of Control Over Individual Expenses

- ▶ What right or obligation does a Chapter 11 Trustee have to control a debtor's day-to-day expenses?
 - ▶ Debtor's income from personal services is property of the estate.
 - ▶ Trustee may use estate property in "ordinary course of business".
 - ▶ Are day-to-day expenses "ordinary course of business"?
- ▶ US Trustee Handbook - Trustees should not impose budgetary requirements on Chapter 11 debtors. But if evidence of unusual spending arises, Trustee should seek to dismiss or convert the case.

CHAPTER 11 TRUSTEES

By: Charles Forman, Esq.

FORMAN HOLT

1. Frequency of Appointment

Individual (non-business) chapter 11 cases are extremely rare. As of September 2017 only 563 non-business chapter 11 cases were filed out of 399,492 non-business bankruptcy filings (0.14%). <https://www.abi.org/newsroom/bankruptcy-statistics>

Chapter 11 Trustee appointments in individual cases are even rarer. In most cases, if there is cause to appoint a trustee, there is cause to convert or dismiss a case, which is usually what happens.

A 2010 study revealed that in the thirty-four jurisdictions that accounted for nearly 72% of the bankruptcy filings revealed that only four individual chapter 11 cases resulted in the appointment of a Trustee, and only two individual chapter 11 cases resulted in the appointment of a trustee in 2013. American Bankruptcy Institute Law Review, *National Study of Individual Chapter 11 Bankruptcies*, (Winter 2017) by Hynes, Lawton, Howard.

The Office of the United States Trustee states in the US Trustee Handbook that the “appropriate remedy” in an individual chapter 11 case for debtor misconduct is “most often” conversion or dismissal although “some cases warrant the appointment of a Chapter 11 trustee”. US Trustee Handbook at 3-12.2.

2. Cause for Appointment

Section 1104 of the Bankruptcy Code governs the appointment of a chapter 11 trustee. It provides:

(a) At any time after the commencement of the case but before confirmation of a plan, on request of a party in interest or the United States trustee, and after notice and a hearing, the court shall order the appointment of a trustee—

(1) for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case, or similar cause, but not including the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor; or

(2) if such appointment is in the interests of creditors, any equity security holders, and other interests of the estate, without regard to the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor.

Examples of where a chapter 11 trustee has been appointed in an individual chapter 11 case:

In re Vaughan, 429 B.R. 14 (Bankr. D.N.M. 2010)

- Debtor operated a Ponzi scheme prior to bankruptcy filing through deceit, misrepresentations, omissions and outright lies to investors.
- Debtor refused to testify at §341 meeting of creditors and invoked 5th Amendment privilege against self-incrimination 121 times.
- Debtor did not file accurate schedules, omitted assets from his schedules.
- Debtor had a history of transferring millions of dollars between and among other companies he owned, and refused to testify or disclose those transfers.

In re Clemente, 409 B.R. 288 (Bankr. D.N.J. 2009)

- Chapter 11 trustee appointed where debtor owned a medical practice and creditors feared he would coming personal funds with business funds.

Both cases above were ultimately converted to chapter 7.

In re Russell, 60 B.R.42 (Bankr. W.D. Arkansas 1985)

- Debtor owned multi-million dollar assets including a time share development and shopping center worth \$9 – 10 million. Debtor sold these assets one month before filing for bankruptcy for less than \$2 million and entered into an agreement with the purchaser whereby debtor would provide “consulting” services in exchange for 3% of all gross sales generated from the assets.
- Creditor’s committee moved for the appointment of a chapter 11 trustee and the Court granted the motion.
- Court held that all of the “badges of fraud” were present including grossly inadequate consideration for the sale of an asset, insolvency of the transferor, retention by the transferor of substantial personal benefit from the sale of the property, and a transaction that occurred outside of ordinary business practices.

3. Avoiding a Chapter 11 Trustee

a. Don’t Provide Cause for a Chapter 11 Trustee in the First Place

Debtors in possession can avoid the appointment of a chapter 11 trustee by cooperating fully with the Office of the United States Trustee, the Court, creditors and other parties in interest.

They should avoid fraud, gross mismanagement, and material omissions on their schedules.

b. If a Chapter 11 Trustee Is Appointed, Get Him/Her Dismissed

Debtors can, in some circumstances, force the courts to terminate a chapter 11 trustee appointment after one is appointed.

In In re Clemente, the debtor was required to use his post-petition income to fund his chapter 11 plan. The debtor moved to convert his case to one under chapter 7, but did not have standing to convert because a chapter 11 trustee was appointed. The debtor argued that this result forced into indentured servitude in violation of the Thirteenth Amendment. This conundrum forced the Bankruptcy Court to use its equitable powers under Sections 105 to terminate the appointment of a chapter 11 trustee under

Section 1105 so the debtor in possession could then immediately convert the case to one under chapter 7.

4. Effect of Appointment

a. Effect on the Debtor:

- Debtor is no longer a debtor in possession and does not have standing to dismiss or convert a case.
- Debtor is required to keep detailed records of all financial transactions, and provide detailed income and expense reports to the trustee.

b. Effect on the Trustee:

The law is not clear as to how a chapter 11 trustee should manage an individual debtor's finances. Are individual debtor's monthly expenses for rent and groceries "administrative expenses" or payments in the ordinary course of business? What amount of control does a trustee have over monthly expenses? Can a trustee tell a debtor what to buy or not buy?

Monthly operating reports can be difficult to prepare. Does a trustee report the estate's income and disbursements by attaching bank statements and receipts? Does the debtor need to cooperate closely with the trustee and provide the information? And will they cooperate if the reason for the trustee's appointment in the first place was the debtor's fraud and non-cooperation?

5. Duties of a Chapter 11 Trustee Generally.

The general duties of a chapter 11 trustee are set forth in Bankruptcy Code Section 1106 and incorporate by reference certain obligations imposed by Bankruptcy Code Section 704. These duties include:

- To collect and reduce to money property of the estate;
- To be accountable for property received;
- To examine proofs of claims and object to improper claims;
- To furnish information as requested;
- To make final reports and accounts of the administration of the estate;
- To provide specific notice regarding claims for domestic support obligations;
- To file periodic reports and summaries of the operation of the debtor's business, including a statement of receipts and disbursements, and such other information as required by the court or United States Trustee.

6. Specific Duties of a Chapter 11 Trustee In Individual Cases.

In chapter 11 cases involving individuals, a trustee must also undertake the following additional duties:

- File a list of creditors, if the debtor has not done so;

- Except to the extent that the court orders otherwise, to investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business, and any other matter relevant to the case or the formulation of the plan;
- To file as soon as practical a statement of any investigation conducted including any facts ascertained pertaining to fraud, dishonesty, incompetence, misconduct, mismanagement or irregularity in the management of the affairs of the debtor, or to a cause of action available to the estate and to provide a summary of the report to any committee, and to any other entity as the court requires;
- As soon as practicable, to file a chapter 11 plan, or a report why the trustee will not file a plan, or recommend a conversion or dismissal of the case;
- For any year in which the debtor has not filed a tax return, furnish such information as may be required by the governmental unit with which such return was to be filed, in light of the condition of the debtor's books and records and the availability of such information; and
- After confirmation of a plan, to file such reports as necessary or ordered.

7. Additional Actions By A Chapter 11 Trustee

The Trustee has additional duties beyond those specified in Bankruptcy Code Section 1106. Among other things, the trustee must make diligent inquiry into any professional's eligibility to be employed and compensated, to protect money of the estate, to give notice to any person or entity holding money or property of the estate, to file tax returns, to withhold state and local taxes as required, to meet with a creditors committee, and to undertake such further actions as necessary or required to satisfy his fiduciary obligation to protect the bankruptcy estate for all parties.

In that regard, the trustee will undertake the following additional actions in connection with the administration of the case:

- Review of the case file;
- Meet with the US Trustee, creditors, committees, or employees of the debtor;
- Examine the debtor's books and records;
- Employ additional professionals to the extent necessary;
- Review pleadings filed in the case;
- Review monthly operating reports;
- Examine the Debtor pursuant to Section 341 and to seek further information from the debtor and others as necessary pursuant to Rule 2004;
- Assume control of all bank accounts;
- Secure other physical assets of the estate;
- Obtain and maintain proper insurance; and

- Prepare quarterly reports and calculate quarterly US Trustee fees.

The chapter 11 trustee also has the power to bring avoidance actions, to commence or continue litigation, to operate the debtor's affairs in the ordinary course of business, and to seek approval to sale assets outside the ordinary course of business.

8. Attorney-Client Privilege Issues.

The Supreme Court ruled in *Commodity Futures Trading Commission v. Weintraub*, 471 U.S. 343 (1985), that a trustee holds a corporate chapter 11 debtor's attorney-client privilege and can waive that privilege over the objection of the debtor's pre-petition management. However, the Supreme Court did not extend its reasoning to an individual chapter 11 debtor's attorney-client privilege, as that issue was not before the Court in the *Weintraub* case.

With regard to an individual chapter 11 debtor, some courts have held that a chapter 11 trustee cannot waive the attorney client privilege. See *In re Hunt*, 153 B.R. 445 (Bankr. N.D. Tx 1992); *In re Silvio De Lindegg Ocean Dev. of America, Inc.*, 27 B.R. 28 (Bankr. S.D.Fla. 1982).

Other courts have held that a chapter 7 trustee may waive a debtor's attorney-client privilege in certain circumstances. Those courts balance the potential harm of disclosure against the need of the trustee to maximize the value of the estate. See *In re Foster*, 188 F.3d 1259 (10th Cir. 1999); *In re Benun*, 339 B.R. 115 (Bankr. D.N.J. 2006); *In re Eddy*, 304 B.R. 591 (Bankr. D.Mass 2004); *In re Miller*, 247 B.R. 704 (Bankr. N.D. Ohio 2000). Since Section 1106 confers upon a chapter 11 trustee the same duties as a chapter 7 trustee under Section 704, it can be inferred that these courts could give a chapter 11 trustee the same ability.

9. Extent of Control Over Individual Expenses.

An issue exists as to the extent of a trustee's right or obligation to control the day-to-day expenses of a chapter 11 debtor. Bankruptcy Code Section 1115 makes an individual chapter 11 debtor's income from personal services property of the estate. An issue exists as to what obligation, if any, a chapter 11 debtor has to seek authorization to pay ordinary living expenses and what duty a trustee has with regard to such expenditures. While Bankruptcy Code Section 363 provides that a trustee (or debtor-in-possession) may use estate property "in the ordinary course of business", an individual's living expense are not typically considered business expenses, rendering the applicability of Section 363 in issue.

The United States Trustee Handbook states in Section 3-12.2 that "United States Trustees should not take steps to impose budgetary requirements on individual chapter 11 debtors." However, the Handbook also cautions that "if evidence of unusual and unjustified spending arises, the United States Trustee should seek an appropriate order, such as conversion or dismissal."

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DECIDING TO FILE THE CASE:

A. Which Chapter to File

1. Jurisdictional Issues: Section 109(e)
Secured debt - \$1,184,200
Unsecured debt - \$394,725
2. Claim must be non-contingent and liquidated
 - a) Must consider unsecured portion of collateralized debt. *See*, Bankruptcy Code Section 506(a), *In re Scovis*, 249 F.3d 975 (9th Cir. 2001)
 - b) Claims are determined as of the petition date rather than by post-petition events. *See, e.g., In re Scovis*, 249 F.3d 975 (9th Cir. 2001) *Slack v. Wilshire Ins. Co. (In re Slack)*, 187 F.3d 1070 (9th Cir., 1999) (as amended 1999 WL 694990)

B. Dischargeability issues:

1. Are there potential Section 523(a)(6) claims? *See* Section 1328(a)(2), (a)(3) and (a)(4).
2. Ability to defend a Section 523 action as part of representation in a Chapter 11 case.
3. Ability to confirm a plan with non-dischargeability proceedings pending.

C. Ability to cure arrears – *See* Section 1123(a)(5)(G) and (H), Section 1322(b)(3) and (b)(5).

D. Ability to restructure obligations. *See* Section 1123(b)(5) regarding the ability to modify the interest rate and terms of secured claims, other than those secured by debtor's personal residence.

1. On the issue of the date used for determining whether the real property is debtor's residence, *See, BAC Home Loans Servicing, LP v. Abdelgadir (In re Abdelgadir)*, 455 B.R. 896 (9th Cir. BAP 2011) (Whether the real property is debtor's residence is determined as of the petition date); *In re Benafel*, 461 B.R. 581 (9th Cir. BAP 2011) (same analysis with respect to Section

1322(b)(2)) But, *See, In re Abrego*, 506 B.R. 509 (Bankr. N.D. Ill 2014) (Determination is based upon the time of the loan transaction); *In re Hustler*, 2016 Bankr. LEXIS 4361 (Bankr. W.D. Mo. 2016) (applying the same test under Section 1322(b)(2)).

2. On the issue of whether a property qualifies as debtor's principal residence, *See, Wages v. J.P. Morgan Chase Bank, N.A. (In re Wages)*, 508 B.R. 161 (9th Cir. BAP 2014) (The court found that the anti-modification exception applied to any loan secured only by real property that the debtor uses as a principal residence property, even if the property served other purposes – in that case a home office and use by a trucking business); but, *See, Scarborough v. Chase Manhattan Mortg. Corp. (In re Scarborough)*, 461 F.3d 406 (3rd Cir. 2006).
 3. On the issue of determining the appropriate rate of interest, *See, Till v. SCS Credit Corp*, 541 U.S. 465, 124 S. Ct. 1951 (2004) (applying a formula rate of prime plus a risk premium); but *See, e.g. Apollo Global Mgmt., LLC v. Bokf, NA (In re MPM Silcones, LLC)*, 2017 App. LEXIS 20596 (2nd Cir. 2017) (holding that the formula rate in *Till* is not required in a Chapter 11, and instead utilizing a market rate approach to determine the rate of interest.)
- E. Ability to lien strip under Section 506(a). Decisions on the date of valuation for lien stripping or cramdown purposes vary. *See, e.g. In re Gutierrez*, 503 B.R. 458 (Bankr. C.D. Cal. 2013 (valued as of date of filing); *DiMauro v. Wilmington Trust Co. (In re DiMauro)*, 548 B.R. 645 (Bankr. Del. 2016)
- F. Discharge issues: *See* Sections 1141(d)(5) and 1328
- G. Dealing with Priority Claims: *See* Sections 1129(a)(9)(c)
- H. Is there non-exempt equity to protect and can you satisfy the best interests tests if a creditor objects. *See* Sections 1129(a)(7) and 1325(a)(4)
- I. Do you have an exit strategy? *See, In re Johnson*, 565 B.R. 417 (Bankr. C.D. Cal. 2017) (court denied Chapter 11 trustee's motion for structured dismissal of Chapter 11 case that paid administrative creditors but was not in debtor's interest.)

CONFIRMING A PLAN OF REORGANIZATION:

A. Timing for Filing a Plan:

1. Small Business debtor – *See* Section 101(51D) and Section 1121(e)
2. Local Rules or practice

B. Contents of a Plan – See Section 1123.

1. Is there a combined form plan and disclosure statement? Are you required to use it? If not, should you use it?
2. Seeking to cure any default. *See, Pacifica L 51 LLC v. New Invs Inc. (In re New Invs. Inc.)*, 840 F.3d 1137 (9th Cir. 2016) (cure of a default does not eliminate accrued default interest under the contractual provisions)
3. Valuing real property for confirmation purposes. *See, In re Sunnyslope Hous. Ltd. P'ship*, 859 F.3d 637 (9th Cir. 2017) (as amended June 23, 2017) (court accepted debtor's argument that the property should be valued with the low income covenant in place, and rejected lender's argument that the court should take into account that a foreclosure would eliminate the housing restriction)

C. Feasibility of the Plan:

1. What are the assumptions or conditions for performance
2. Feasibility requires only that the Debtor demonstrate that the plan has a reasonable probability of success. *Beal Bank USA v. Windmill Durango Office, LLC (In re Windmill Durango Office, LLC)*, 481 B.R. 51 (9th Cir. BAP 2012).
3. How will the debtor establish feasibility if there is a challenge?

D. The Absolute Priority Rule

1. Necessitated by a cramdown under Section 1129(b)(2)(B)(ii)
2. Absolute priority rule applies in individual Chapter 11 case. *Zachary v. Cal. Bank & Trust*, 811 F.3d 1191 (9th Cir. 2016), overruling *In re Friedman*, 466 B.R. 471 (9th Cir. BAP 2012).
Circuit Courts outside of the Ninth Circuit are in accord: *See, Ice House Am., LLC v. Cardin*, 751 F.3d 734 (6th Cir. 2014); *In re Lively*, 717 F.3d 406 (5th Cir. 2013); *Dill Oil Co., LLC v. Stephens (In re Stephens)*, 704 F.3d 1279 (10th Cir. 2013); *In re Maharaj*, 681 F.3d 558 (4th Cir. 2012)
Not necessary to satisfy the rule if all classes of creditors consent to proposed plan or are unimpaired under the plan. Section 1129(a)(8)
3. Satisfying the Absolute Priority Rule

E. Confirmation

1. Meeting the standards of Section 1129
2. Will you have an impaired consenting class?
3. Retaining claims.
4. Establishing the facts for confirmation.

5. Section 1129(a)(15)(A) – the value to be distributed under the plan is not less than the projected disposable income for the five years beginning with the first plan payment.

F. Discharge

1. Delayed discharge pursuant to Section 1141(d)(5)
2. Providing for the re-opening of the case for entry of the discharge