



AMERICAN  
BANKRUPTCY  
INSTITUTE

# 2017 Mid-Atlantic Bankruptcy Workshop

## *Consumer Track*

## **Turning the Page to the Next Chapter: Individual Chapter 11 Cases**

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# Turning the Page to the Next Chapter: Individual Chapter 11 Cases

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# INTRODUCTION

- **Who (or What) is a Peon?**
  - Peonage is a subset of involuntary servitude
  - Peonage is defined as “the status or condition of compulsory service, based upon the indebtedness of the peon to the master.”
    - *Clyatt v. United States*, 197 U.S. 207, 215-16 (1905)
  - The “essence [of peonage] is compulsory service in payment of a debt. A peon is one who is compelled to work for his creditor until his debt is paid.”
    - *Bailey v. Alabama*, 219 U.S. 219, 242 (1911)
  - Congress initially refused to enact amendments to the Bankruptcy Act that would require Chapter XIII petitions instead of Chapter VII petitions in part because “[t]o force unwilling wage earners to devote their future earnings to payment of past debts smacked to some of debt peonage . . . .” Report of the Commission on the Bankruptcy Laws of the United States, Part I at 159, H. Doc. 93-137, 93d Cong. 1<sup>st</sup> Sess. (1973)

## INTRODUCTION (con't)

- **When Chapter 13 of the Bankruptcy Code was enacted in 1978:**
  - Only an individual (not a corporation) could be a chapter 13 debtor
    - 11 U.S.C. § 109(e)
  - There is no statutory basis for filing an *involuntary* chapter 13 case
    - 11 U.S.C. § 303(a) (“An involuntary case may be commenced only under chapter 7 or 11 of this title . . .”).
  - Property of the estate did include postpetition wages and income
    - 11 U.S.C. § 1306(a)(2)
  - Postpetition wages and income were required to be contributed towards payments under a chapter 13 plan
    - 11 U.S.C. § 1325(b)(1)(B)
  - Under section 1322(a) of the Bankruptcy Code, however, a chapter 13 debtor’s plan must provide for submission of all or such portion of future earnings or other future income of the debtor to the supervision and control of the trustee as is necessary for the execution of the plan.”
    - 11 U.S.C. § 1322(a)(1)
  - Congress initially refused to enact amendments to the Bankruptcy Act that would require Chapter XIII petitions instead of Chapter VII petitions in part because “[t]o force unwilling wage earners to devote their future earnings to payment of past debts smacked to some of debt peonage . . . .” Report of the Commission on the Bankruptcy Laws of the United States, Part I at 159, H. Doc. 93-137, 93d Cong. 1<sup>st</sup> Sess. (1973)

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## INTRODUCTION (con't)

- **The 2005 Bankruptcy Abuse Protection and Consumer Protection Act**
  - Prior to the enactment of BAPCPA, an involuntary conversion from chapter 7 to chapter 11 would typically provide no benefit to creditors because property of a chapter 7 estate was the same as property of a chapter 11 estate
    - With an individual's chapter 11 case, the debtor's postpetition wages and income *were not* considered property of the estate
    - An individual chapter 11 debtor was entitled to a discharge upon confirmation of the chapter 11 plan
  - BAPCPA, however, added section 1115 to the Bankruptcy Code:
    - Section 1115(a)(2) provides that postpetition wages and income are included within the scope of "property of the estate" under section 541
  - Now, a chapter 11 plan of an individual must include future earnings from personal services
    - 11 U.S.C. § 1123(a)(8)
  - Upon an objection of the holder of an allowed unsecured claim, an individual chapter 11 debtor must contribute his or her projected disposable income over a five-year period to payments under any chapter 11 plan
    - 11 U.S.C. § 1129(a)(15)
  - With the addition of section 1115 to the Bankruptcy Code, an involuntary chapter 11 (*i.e.*, one without the consent of the debtor) could result in a debtor "pay[ing] future wages to a creditor" thereby "impos[ing] involuntary servitude" on the chapter 11 debtor
    - *Toibb v. Radloff*, 501 U.S. 157, 166 (1991)

## INTRODUCTION (con't)

- **For individual chapter 11 debtors, BAPCPA created a “hybrid chapter 13” as follows:**
  - Section 1115 included postpetition wages and income as property of the estate
    - 11 U.S.C. § 1115(a)(2)
  - A chapter 11 plan must include such postpetition wages and income to render the plan “feasible”
    - 11 U.S.C. § 1129(a)(11)
  - At least one impaired class under the plan, must vote to accept the plan
    - 11 U.S.C. § 1129(a)(10)
  - If no impaired class of creditors votes for the plan, the debtor could be forced to abandon all property in order to satisfy the absolute priority rule
    - 11 U.S.C. § 1129(b)(2)(B)(ii)
  - Individual debtors must file certain operating reports with the U.S. Trustee and pay U.S. Trustee’s fees
  - Discharge is delayed until confirmation
    - 11 U.S.C. § 1141(d)(1)(A)
  - The exclusive period for the debtor to file a chapter 11 plan is limited
    - Upon termination of exclusivity, creditors can propose a plan
  - The individual chapter 11 debtor without primarily consumer debt, does not have an absolute right to dismiss a chapter 11 case or to convert it to another case under chapter 7 or chapter 13
    - If a chapter 7 petition is determined to be substantial abuse, consent of the debtor is required to convert to chapter 11 or chapter 13, but only if the debtor’s debts are primarily consumer debts
      - 11 U.S.C. § 707(b)
  - The chapter 11 plan could be modified post-confirmation
    - 11 U.S.C. § 1127(b)

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## INTRODUCTION (con't)

- **BUT a chapter 13 plan that includes postpetition wages and income is *constitutional* because:**
  - Involuntary cases cannot be filed under chapter 13
    - In other words, an individual debtor cannot be forced to subject a portion of wages and income to pay creditors in exchange for a discharge
    - H.R. Rep. No. 95-595, at 120 (1977) (“As under current law, Chapter 13 is completely voluntary. This committee firmly rejected the idea of mandatory or involuntary Chapter XIII in the 90th Congress. *The Thirteenth Amendment prohibits involuntary servitude.*”).
  - A chapter 13 debtor has the right to dismiss his or her chapter 13 case or to convert it to chapter 7 in order to avoid subjecting a portion of wages and income to pay creditors
  - Only a chapter 13 debtor can file a plan
  - Only a chapter 13 debtor may modify a chapter 13 plan prior to confirmation
    - Creditors of the chapter 13 debtor may object to confirmation but cannot propose a chapter 13 plan

## Voluntary Chapter 13 vs. Involuntary Chapter 11 Cases

### ***Toibb v. Radloff*, 501 U.S. 157 (1991)**

- The Supreme Court in *Toibb* discussed the difference between a voluntary chapter 13 where an individual debtor agrees to contribute future earnings to pay creditors and an involuntary chapter 11 where an individual, recalcitrant debtor refuses to contribute future earnings to pay creditors
- The Supreme Court addressed the differences between future earnings of a voluntary chapter 13 debtor and the future earnings of an individual, recalcitrant chapter 11 debtor, writing:

We find these concerns overstated in light of the Code's provisions for dealing with recalcitrant Chapter 11 debtors. If an involuntary Chapter 11 debtor fails to cooperate, this likely will provide the requisite "cause" for the bankruptcy court to convert the Chapter 11 case to one under Chapter 7. *See* § 1112(b). In any event, the argument overlooks Congress' primary concern about a debtor's being forced into bankruptcy under Chapter 13: that such a debtor, whose future wages are not exempt from the bankruptcy estate, § 1322(a)(1), would be compelled to toil for the benefit of creditors in violation of the Thirteenth Amendment's involuntary servitude prohibition. *See* H. R. Rep. No. 95-595, at 120. Because there is no comparable provision in Chapter 11 requiring a debtor to pay future wages to a creditor, Congress' concern about imposing involuntary servitude on a Chapter 13 debtor is not relevant to a Chapter 11 reorganization. *Toibb*, 501 U.S. 157, 165-66.

- *Toibb* was decided *before* the enactment of section 1115 of the Bankruptcy Code in 2005.

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## RELEVANT STATUTES

### Thirteenth Amendment to U.S. Constitution:

“Neither slavery nor involuntary servitude, except as a punishment for crime whereof the party shall have been duly convicted, shall exist within the United States, or any place subject to their jurisdiction.”

### Section 706(b):

“On request of a party in interest and after notice and a hearing, the court may convert a case under this chapter to a case under chapter 11 of this title at any time.”

### Section 707(b)(1):

“the court, on its own motion or on a motion by the United States trustee, trustee (or bankruptcy administrator, if any), or any party in interest, may dismiss a case filed by an individual debtor under this chapter whose debts are primarily consumer debts, or, with the debtor’s consent, convert such a case to a case under chapter 11 or 13 of this title, if it finds that the granting of relief would be an abuse of the provisions of this chapter.”

### Section 1115(a):

“(a) In a case in which the debtor is an individual, property of the estate includes, in addition to the property specified in section 541—

\* \* \* \*

(2) earnings from services performed by the debtor after the commencement of the case but before the case is closed, dismissed, or converted to a case under chapter 7, 12, or 13, whichever occurs first.

### Anti-Peonage Act (42 U.S.C. § 1994 ):

“The holding of any person to service or labor under the system known as peonage is abolished and forever prohibited in any Territory or State of the United States; and all acts, laws, resolutions, orders, regulations, or usages of any Territory or State, which have heretofore established, maintained, or enforced, or by virtue of which any attempt shall hereafter be made to establish, maintain, or enforce, directly or indirectly, the voluntary or involuntary service or labor of any persons as peons, in liquidation of any debt or obligation, or otherwise, are declared null and void.”

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## RECENT CASES

### ***In re Gordon*, 465 B.R. 683 (Bankr. N.D. Ga. 2012)**

- Background and Key Facts

A former employer with a \$335,000 judgment against an individual chapter 7 debtor filed a motion to convert the former employee's chapter 7 case to one under chapter 11. The debtor argued that section 706(b) did not apply to individual debtors with primarily non-consumer debts because it violates the Thirteenth Amendment to U.S. Constitution and the Anti-Peonage Act. The U.S. Attorney General intervened and argued that the debtor did not have standing to raise the constitutional issues and that the determination of such issues was not ripe for the Court's consideration.

- Holding

The Court found that conversion to chapter 11 was an appropriate exercise of the Court's discretion. The Court rejected the constitutional challenges to conversion by the individual debtor with primarily *non*-consumer debts finding that he lacked standing to raise such issues and that such challenges were not "ripe" for the Court's consideration.

- Analysis

The *Gordon* Court reviewed the factors under section 1112(b) of the Bankruptcy Code (with respect to conversion from chapter 11 to chapter 7) and found that it was in the best interest of creditors to convert the case to one under chapter 11. The Court also concluded that the debtor had the ability to confirm a chapter 11 plan because of his "ability to earn funds sufficient to make payments to his creditors." Because the Court found the "genesis of the Thirteenth Amendment was to prohibit slavery," Court ruled that "the mere conversion of the case from one under Chapter 7 to one under Chapter 11 does not require the Debtor to work for a particular employer," and does not to protect an individual chapter 7 debtor with non-consumer debt from the potential "parade of horrors" associated with chapter 11. As such, the Court agreed with the U.S. Attorney General that the individual chapter 7 debtor did not have standing to raise the constitutional challenges to conversion to chapter 11 and that such challenges were not "ripe" for the Court's consideration.

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## RECENT CASES (con't)

### *In re Decker*, 535 B.R. 828 (Bankr. D. Alaska 2015)

- Background and Key Facts

The U.S. Trustee moved to convert an individual chapter 7 bankruptcy case of a married couple to a chapter 11 case on the grounds that the debtors' monthly net income should be used to pay creditors over five years pursuant to a chapter 11 plan.

The chapter 7 debtors argued that because their debts were not primarily consumer debts, that they were excepted from the "means test" of section 707(b) of the Bankruptcy Code and were entitled to remain in chapter 7 and obtain the benefit of the discharge without having to fund a chapter 11 plan over five years. The debtors argued that they could not be forced to fund a chapter 11 plan and that husband would simply retire and live off their considerable retirement income, which is exempt from the reach of creditors.

- Holding

The *Decker* Court found that conversion from chapter 7 to chapter 11 was warranted in the "sound discretion of the court," 11 U.S.C. § 706(b), as being in the best interests of creditors and the debtors.

- Analysis

The *Decker* Court found that because the debtors had sufficient monthly income to pay their creditors, the "means test" under section 707(b) of the Bankruptcy Code did not preclude conversion under section 706(b) of the Bankruptcy Code. Moreover, because the debtors had the monthly net income to successfully reorganize, the Court concluded that it was in the best interest of creditors to convert the case to one under chapter 11. The Court also concluded that it was in the best interests of the debtors to convert because it would enable them to resolve their longstanding debt, a portion of which was nondischargeable. Finally, because the debtors could also be entitled to relief under chapter 13, the Court deferred entry of its order converting the case for two weeks to "give the Debtors the option to elect to convert to chapter 13, should they choose to do so."

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## RECENT CASES (con't)

### ***In re Parvin*, 538 B.R. 96 (Bankr. W.D. Wash. 2015)**

- Background and Key Facts

The U.S. Trustee moved to convert an individual chapter 7 bankruptcy case to a chapter 11 case on the grounds that the debtor had sufficient disposable income to repay his unsecured creditors pursuant to a chapter 11 plan. The individual debtor opposed the motion on the grounds that conversion would “forc[e] him to enter peonage, which violates the Thirteenth Amendment’s prohibition against involuntary servitude.” The debtor also argued that conversion to chapter 11 impacted his constitutional rights because, pursuant to section 1115(a)(2) of the Bankruptcy Code, his postpetition wages and income were included as property of the estate without his consent.

- Holding

The *Parvin* Court found that conversion from chapter 7 to chapter 11 was warranted based on its determination that conversion would “most inure to the benefit of all parties.” The Court rejected the constitutional challenges to conversion by the debtor finding that he lacked standing to raise such issues and that such challenges were not “ripe” for the Court’s consideration, writing that the “Debtor has not shown that, as an individual debtor with primarily non-consumer debt seeking bankruptcy relief, he is within the class of persons intended to be benefited by the Thirteenth Amendment.”

- Analysis

The Court found the debtor’s arguments to be premature because federal courts are limited to “deciding cases and controversies under Article III of the Constitution.” Because conversion did not *require* individual chapter 11 debtors to pay their earnings to creditors, the *Parvin* Court concluded that the debtor had neither constitutional nor prudential standing to challenge the constitutionality of the proposed conversion. Accordingly, the *Parvin* Court concluded that conversion to chapter 11 would provide a “benefit to *all* parties in interest, not just the Debtor.”

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## SECTION 1115

### Constitutional Issues under Section 1115 of the Bankruptcy Code

- Does section 1115(a)(2) of the Bankruptcy Code violate the U.S. Constitution by including postpetition wages and income as “property of the estate?”
- Is it fair to require an involuntary, individual debtor to continue to work for 5-years, 11 U.S.C. § 1129(a)(15), instead of choosing to “simply retire and walk away from his job?” *Decker*, 535 B.R. at 840
  - Retirement income is exempt from the reach of creditors
- Is requiring an individual debtor to contribute his or her projected disposable income over a five-year period to payments under any chapter 11 plan the type of coercion that serves the basis for “involuntary servitude?”
- Does a Court order compelling a recalcitrant, involuntary chapter 11 debtor to comply (or punishing the debtor for contempt if he or she does not comply) violate the 13<sup>th</sup> Amendment or the Anti-Peonage Act?

## CHAPTER 11 TRUSTEE

### **Is the Appointment of a Chapter 11 Trustee in an Individual Chapter 11 Case Constitutional?**

- Should an involuntary, individual debtor be required to fund the costs of a chapter 11 trustee—one appointed for “cause” by the Court to investigate the conduct of the debtor?

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## CONVERSION

### **Does the Involuntary Conversion of an Individual Debtor's Chapter 7 Case to Chapter 11 Case Violate the 13<sup>th</sup> Amendment to the U.S. Constitution?**

- Thirteenth Amendment prohibits slavery, involuntary servitude and “peonage”
  - According to the Supreme Court, Peonage is:

“a term descriptive of a condition which has existed in Spanish America, and especially in Mexico. The essence of the thing is compulsory service in payment of a debt. A peon is one who is compelled to work for his creditor until his debt is paid.”
  - *Baily v. Alabama*, 219 U.S. 219, 242 (1911).
- Is requiring an individual debtor to contribute his or her projected disposable income over a five-year period to payments under any chapter 11 plan the type of coercion that serves the basis for “involuntary servitude?”
- Is it appropriate for the Courts that avoid the constitutional issues on the grounds of “ripeness” and “standing”?



QUESTIONS?

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