

Concurrent Session

High-income Individuals: Chapter 11 by and for the People

James Patrick Shea, Moderator

Shea & Carlyon, Ltd.; Las Vegas

Debra I. Grassgreen

Pachulski Stang Ziehl & Jones LLP; San Francisco

Lee M. Kutner

Kutner Miller Brinen, PC; Denver

Hon. Geraldine Mund

U.S Bankruptcy Court (C.D. Cal.); Woodland Hills, Calif.

Patricia A. Redmond

Stearns, Weaver, Miller, Weissler, Alhadeff & Sitterson, PA
Miami

HIGH INCOME INDIVIDUALS: CHAPTER 11 BY AND FOR THE PEOPLE

AMERICAN BANKRUPTCY INSTITUTE

WINTER LEADERSHIP CONFERENCE

DECEMBER 2009

**Patricia A. Redmond
Stearns Weaver Miller
Weissler Alhadeff & Sitterson, P.A.
150 West Flagler Street
Miami, Florida 33130
Phone: (305) 789-3553
predmond@swmwas.com**

**James Shea
Shea & Carlyon
701 Bridger Ave, Suite 850
Las Vegas, Nevada 89101
Phone: (702) 471-7432
jshea@sheacarlyon.com**

**Debra Grassgreen
Pachulski Stang Ziehl & Jones LLP
150 California Street, 15th Floor
San Francisco, CA 94111-4500
Phone: (415) 263.7000
dgrassgreen@pszjlaw.com**

**Lee M. Kutner
Kutner Miller Brinen, P.C.
303 East 17th Avenue, Suite 500
Denver, Colorado 80203
Phone: (303) 832-2400
lmk@kutnerlaw.com**

While individuals could always file Chapter 11, not that many took advantage of it. Most individuals who had large amounts of unsecured debt simply filed under Chapter 7. This may not be possible where the individual has a large amount of *consumer debts*¹ and the individual is over the median income for the given state². If the individual does not qualify for Chapter 13, they will have to file under Chapter 11. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") amended the Bankruptcy Code to include a number of provisions that now bring a Chapter 11 case for individuals more in line with that of a case under Chapter 13. The most important changes for individuals and pre-filing considerations are as follows:

1. Individuals

- a. Property of the estate includes the individual debtor's post petition personal service income similar to a Chapter 13 case. Now, essentially all property that an individual debtor obtains while a chapter 11 case is pending is property of the estate. Although an individual debtor could presumably buy food as such a purchase would be in the ordinary course of the debtors business, many other transactions may not be. *See In re Michael Goldstein & Bridget Goldstein, 2007 WL 1970263 *2 (Bankr.C.D. Cal. 2007)* (ordinary course of business provision "authorizes a debtor to buy bread and probably to purchase a ticket to travel to a court hearing.") For example, in *In re Goldstein*, the bankruptcy court held that joint debtors who were filing for divorce after they filed their chapter 11 bankruptcy petition could not use their post -petition income to pay divorce counsel unless such an expense is authorized for property of the bankruptcy estate. *Id* at 2. Query: where is the line drawn between expenses in the ordinary course of business or out of the ordinary course of business? Will chapter 11 individual debtors need Court permission to use post-petition income to take a family vacation to the beach, pay for their children's' orthodontia, buy a new television?
- b. Whether the Chapter 11 filing is for an individual with primarily consumer or business debts, the individual must obtain a certificate demonstrating the individual attended a group or individual briefing on credit counseling and budget analysis. § 109(h)(1). The credit counseling session is required in order to be eligible for relief under Chapter 11 or any other Chapter. The individual debtor must also file copies of all payment advances or evidence of payment from an employer for the 60 days preceding the petition date.
- c. The plan must be funded with the individual debtor's post petition personal service income to the extent it is needed for the execution of the plan.

¹ See *Toibb v. Radloff*, 111 S.C. 157 (1991).

² Individual filings for doctors and other high net worth individuals which are most likely to be abusive will still be eligible for Chapter 7 because the debts are not primarily consumer debts.

§1123(a)(8). Consider whether state law wage exemptions apply. While a portion of post petition earnings are exempted out of the estate, a portion of the exempt earnings may have to be used to fund the plan. Some courts in jurisdictions with unlimited homestead exemptions and otherwise liberal exemption schemes have concluded that debtors cannot satisfy the absolute priority rule in the context of a cram down plan and while retaining exempt property. *See In re Gosman*, 282B.R. 45, 49 (Bank. S.D. Fla. 2002). *But see In re Henderson*, 321 BR. 550 (Bankr. Fla. 2005) (where the Court finds the right to remain in possession of exempt property does not violate the absolute priority rule imposed by Section 1129 (b)(2)(B)(ii) and *In re Bullard*, 358 B.R. 541, 544 (Bankr. D. Conn. 2007) (same). See also #4, below, "*Cram Down for Individuals*", for recent cases construing the application of the absolute priority rule to individuals.

- i. Consider further the questions involving the debtor's use of exempt personal service income prior to and following confirmation of a plan. All of the income is property of the estate, however the debtor retains an exemption pursuant to state law. It would appear the debtor may be able to use the exempt portion of the income as he or she sees fit prior to plan confirmation. The cram down provisions of §1129(b)(2)(B)(ii) have been amended to allow the debtor to retain personal service income in the event of a cram down on unsecured creditors. However, once the plan is confirmed, the debtor may have to commit the exempt income to plan funding in order to meet the requirements of §1129.
- d. The plan may be modified at any time after confirmation but before payments are completed, regardless of whether the plan is substantially consummated to increase or decrease payments or the timing or duration of payments. Adequate disclosure of an amendment is required. §1127(e).
- e. If an unsecured creditor objects to confirmation of a plan, the debtor must either distribute property of a value not less than the projected disposable income, as defined at §1325(b)(2), for the longer five years or the term of the plan. §1129(a)(15). The test is different than the disposable income requirement under § 1325(b)(2) of the Code. §1325(b)(1) provides that if the Trustee or the holder of an allowed unsecured claim objects to the confirmation of the Plan, then the court may not approve the plan unless, as of the effective date of the plan -
 - i. the value of the property to be distributed under the plan on account of such claim is not less than the amount of such claim; or
 - ii. the plan provides that all of the debtor's projected disposable income to be received in the applicable commitment period beginning on the date that the first payment is due under the plan will be applied to make payments to unsecured creditors under the plan.

21st Annual Winter Leadership Conference

In Chapter 11 the test does not require periodic payments. In fact, the statutory language provides that under §1129(a)(15), upon the objection of an unsecured creditor, the debtor must provide creditors the value of its disposable income stream for either five (5) years or the term of the plan, whichever is longer. Thus, the Chapter 11 test creates a second floor in addition to the best interest of creditors test for determining the amount of value which must be distributed to holders of unsecured claims.

Further, projected disposable income in connection with plan confirmation for a chapter 11 individual means current monthly income received by the debtor less amounts reasonably necessary to be expended for the maintenance or support of the debtor or a dependant of the debtor. 11 U.S.C. §§ 1129(a)(15)(B) and §1325(b)(2). At least two courts have held that the Code allows the calculation of disposable income for a chapter 11 debtor to be determined based upon judicially determined standards, as opposed - which is what one creditor had argued - to the chapter 7 means test deductions specified by §1325(b)(3). See *In re Roedemeier*, 374 B.R. 264 (Bankr. D. Kan. 2007) and *In re Gray*, 2009 WL 2475017 (Bankr. N.D.W.Va. 2009).

- f. An individual will not receive a discharge until all plan payments are completed. There are provisions that would allow the debtor to apply for a discharge before all payments are made if payments sufficient to pay unsecured creditors what they would have received in a Chapter 7 case have been made. §1141 (d)(5).
2. **Confirmation Issues.** §1129 now includes a number of changes to the elements required to be met in order to gain confirmation of a Chapter 11 plan. Most of these issues arise in cases involving individuals.
 - a. **Post Petition Personal Service Income.** Property of the estate includes the individual debtor's post petition personal service income, similar to a Chapter 13 case. Property of the estate is defined in §1115 (the Chapter 11 equivalent to §1306) to include 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 ... " §1115(a)(2). Note that the exclusion of such earnings from the estate found at §541 (a)(6) is not changed by BAPCPA but will only apply in a Chapter 7 case.
 - b. **Plan Funding.** §1123 "Contents of plan" has been amended to account for the funding of an individual's plan with earnings acquired post-petition. The plan must "provide for the payment to creditors under the plan of all or such portion of the individual debtor's post petition personal service earnings "or other future income" to the extent it is "necessary for the execution of the plan". §1123(a)(8). This section appears to provide some latitude as to funding a plan by an individual. The following choices seem to be available:

- i. Monthly payments are not required, only enough to provide for execution of the plan;
 - ii. All earnings are not required, only enough to provide for execution of the plan;
 - iii. No earnings are apparently required if the plan can be funded out of "other future income". There is no limit to what this may mean, but it does provide flexibility for individuals who do not have periodic income or may be able to develop or are entitled to receive income out of an alternative source to traditional earnings. This is an important provision because it may make Chapter 11 the only available option to an individual who does not have "regular income", is therefore ineligible for Chapter 13 under §109(e), and who fails the means test.
 - c. **Other property acquired post-petition.** In addition to post-petition personal service income, §1115 also includes in the individual debtor's Chapter 11 estate, "all property of the kind specified in section 541 that the debtor acquires after the commencement of the case but before the case is closed, dismissed, or converted to a case under chapter 7, 12, or 13 ... " §1115(a)(1).
3. **Confirmation requirements.** Only in the case of an individual, if a creditor holding an "allowed unsecured claim" objects to confirmation of a plan, the debtor must either: 1) distribute property of a value, as of the effective date of the plan, equal to the "amount of such claim"; or 2) fund the plan with property of a value not less than the projected disposable income of the debtor, as defined at §1325(b)(2), for the longer of five years "beginning on the date that the first payment is due under the plan" or the term of the plan, whichever is longer. §1129(a)(15). This provision raises a number of issues, namely:
- a. If the objecting creditor holds a disputed claim, will the court be inclined to hold a hearing within the time frame required for confirmation of a plan in order to determine whether the claim should be allowed?
 - b. While case law concerning §1325(b)(1), the Chapter 13 corollary, may be of assistance, can the debtor find a way within the plan to simply pay the objecting creditor claim in full and not run afoul of §§1122 and 1123(a)(4)?
 - c. Can the debtor defer the first payment due under the plan for a period of time to increase or decrease the amount required to be paid to creditors or to meet the best interest test, since funding with disposable income is for five years from the date the first payment is due under the plan, not the effective or confirmation date?
 - d. What if the debtor commits the "disposable income" under the plan for 5 years under §1325(b)(2) and the debtor has little or no disposable income? Note that "disposable income" means "current monthly income". §1325(b)(2)(B) also

21st Annual Winter Leadership Conference

allows a deduction from disposable income for debtors engaged in business of "expenditures necessary for the continuation, preservation, and operation of such business." (This appears to be a case where Congress has borrowed heavily on Chapter 13 without adjusting for the fact that Chapter 13 is only available for individuals with periodic income which is not the case in Chapter 11). What if the debtor has no disposable income?

- e. Note that neither a creditors committee nor the US Trustee may raise this issue, only a creditor holding an allowed unsecured claim may object to plan confirmation on this basis.
4. **Cram Down for Individuals.** The fair and equitable test with respect to gaining confirmation of a plan over the dissent of a class of unsecured creditors has been modified with respect to individuals. §1129(b)(2)(B)(ii) allows the debtor to "retain property included in the estate under section 1115" subject to the required payment of post-petition domestic support obligations. At least two courts have interpreted §1129(b)(2)(B)(ii) and §1115 together to indicate that Congress intended to exempt individual chapter 11 debtors from the absolute priority rule. See *In re Roedemeier*, 374 B.R. 264 (Bankr. D. Kan. 2007) and *In re Tegeder*, 369 B.R. 477, 480-81 (Bankr. D. Neb. 2007). Therefore, according to these courts, a chapter 11 debtor may retain prepetition and postpetition property and still cram down a plan of reorganization over the objection of a creditor. However, as noted previously, the *Gosman* court in the Southern District of Florida has determined that an individual debtor may not satisfy the absolute priority rule while retaining exempt property. Despite the amendment to §1129, the *Gosman* case may still be good law. Section 1129 only permits the chapter 11 debtor to retain property included in the estate under §1115. Exempt property is not property included in § 1115.
 5. **Domestic Support Obligations.** §1129(a)(14) provides that a debtor who is required to pay a domestic support obligation by virtue of a judicial or administrative order or statute, must have paid all post-petition payments required to be paid before the plan may be confirmed. This provision is new verbage but in reality it always existed. A postpetition obligation is an administrative expense claim which always had to be paid on the effective date of the plan. §1129(a)(9).
 6. **Tax Provisions.** §1129(a)(9)(C) has clarified the payment of priority tax payments under a plan. It is now clear that the claim holder must receive: a) "regular installment payments in cash"; b) of a total value as of the effective date of the plan, equal to the allowed amount of the claim; and c) over a period not longer than 5 years after the date of the order for relief. No longer will the debtor and counsel have to puzzle over the 6 year from the date of assessment provision and the differing payment terms it created for taxes assessed in different years. In addition, the payments must be made in a manner "not less favorable than the most favored nonpriority unsecured claim provided for by the plan". Given the likely treatment of unsecured creditors this should not be a hard test to meet.

7. **Small Business Cases.** In certain cases, an individual's case may be considered a small business case. The Code generally defines a small business case as generally including a person engaged in commercial or business activities with total debt under \$2 million. §101(51 D). §1129(e) requires that in a small business case, the court "shall confirm a plan" that complies with applicable provisions of Title 11 and is filed in accordance with §1121(e) within 45 days of the date on which the plan is filed, unless the time for confirmation is extended under §1121(e)(3). A small business case is defined at §101(51C and D) to generally include a debtor engaged in business activities, excluding those whose primary business is ownership or operation real estate, with noncontingent, liquidated, secured and unsecured debt of not more than \$2 million (excluding debts to affiliates and insiders).
- a. §1121(e)(1) is the exclusivity period for small business cases. It provides that only the debtor may file a plan for the first 180 days of the case, unless extended or the court orders otherwise. §1121(e)(2) goes on to provide that the plan and a disclosure statement, if any, shall be filed not later than 300 days following the entry of the order for relief. These provisions appear to mean that while the debtor may enjoy the exclusivity period for the first 180 days of the case, a plan does not have to be filed within this period. One court interpreting this provision has held that the requirement that a plan be filed within 300 days following the entry of the order for relief applies only to a plan filed by the debtor and that there is no statutory deadline for filing a reorganization plan by any party in interest other than the debtor. *In re Florida Coastal Airlines, Inc.*, 361 B.R. 286, 290-91 (Bankr. S.D. Fla. 2007). The issue of a creditor's competing plans raises constitutional issues including a violation of the 13th Amendment. Theoretically a creditor could propose a plan which subjects the debtor's disposable income, for a minimum of 5 years, to distribution in favor of creditors against the debtor's will. Query, however, whether or not the debtor would remain income-producing through employment or otherwise during the term of the plan.
 - i. These time periods may only be extended if the debtor demonstrates, following notice to parties in, interest, that "it is more likely than not" that the court will confirm "a plan" within a reasonable period of time. The debtor must prove this point by a preponderance of the evidence. The order extending time must be entered before the existing deadline expires and the court must set a new deadline when the order is signed.
 - ii. Timing is everything in these cases. The plan confirmation hearing must occur within 45 days of the date on which the plan is filed. The disclosure statement may be conditionally approved and final approval may occur at the confirmation hearing. However, a conditionally approved disclosure statement must be mailed to creditors no later than 25 days before the confirmation hearing. Assuming the plan and disclosure statement are filed on the same day, the disclosure statement must be conditionally approved and mailed within 20 days. Creativity may get you around this problem. Try filing the disclosure statement with the plan attached as an

exhibit. This would eliminate the 45-day problem and give you time to gain conditional or final approval of the disclosure statement at which time the plan can be filed and the 45-day period commenced.

8. **Discharge Issues.** §1141 has been substantially amended under BAPCPA to add several provisions with respect to the discharge of individuals under Chapter 11. §1141(d)(5).
 - a. **Payments before discharge.** Unlike a corporation or other business entity that receives a discharge upon confirmation of a plan, an individual will not receive a discharge until all plan payments are completed. This will generally take 5 years, although it is easy to contemplate plans extending beyond this time frame. This is a substantial change from prior law under which individuals also received a discharge upon plan confirmation. An issue arises as to whether the case must remain open for the 5 years with the debtor paying quarterly fees to the UST, or whether the debtor may close the case following plan confirmation with the right to reopen at the end of 5 years. Who then would monitor the debtor's compliance and bring defaults to the attention of the court? It seems this issue has been considered by at least four courts, with varying results. The Northern District of West Virginia, in *In Re Ball*, rejected the debtor's request for a discharge and to close the plan prior to the completion of all payments under the plan. 2008 WL 2223865 (Bankr. N.D.W.Va. 2008). Similarly, in *In re Belcher*, the Western District of Virginia denied an individual debtor's motion for an early discharge and simultaneously found that it was inappropriate to close the case prior to the completion of all payments. 410 B.R. 206 (Bankr. W.D.Va. 2009). Compare these cases to *In re Sheridan*, 391 B.R. 287 (Bankr. E.D.N.C. 2008) and *In re Johnson*, 402 B.R. 851 (Bankr. N.D. In. 2009), in which the *Sheridan* court granted a discharge upon confirmation and the *Johnson* court closed the case prior to the completion of plan payments, thereby eliminating the requirement of quarterly payments to the UST.
 - b. **Early relief.** The debtor may apply for a discharge, on notice and hearing, before all payments are made under the plan if several elements are met: a) the value of property already distributed to unsecured creditors is equal to what they would have received in a Chapter 7 case, as of such date; b) modification of the plan is not practicable; and c) the court finds after notice and hearing 10 days before discharge, §522(q) provisions relating to securities law crimes are not applicable. (Note that the debtor does not have to have been convicted.) The test is less stringent than the Chapter 13 test which additionally requires the debtor to demonstrate that the failure to complete payments is due to circumstances beyond the debtor's control.
 - c. **§523 applicable.** Chapter 11 does not discharge an individual debtor from any debt excepted from discharge under §523. §1141(d)(2). §523 has been expanded to include a number of new and expanded exceptions to discharge.

9. **Plan Modification.** The plan may be modified at any time after confirmation but before payments are completed, regardless of whether the plan is substantially consummated to increase or decrease payments or the timing or duration of payments. Adequate disclosure of an amendment is required. §1127(e). This provision applies only to cases involving individuals. The modifications may be requested by the debtor, the UST or a creditor holding an allowed unsecured claim.
- a. It should be noted that a tension will exist between §1129(a)(15) and §1127(e) in that §1129 addresses confirmation of a plan that commits the debtor to pay an amount to creditors based on "projected" income as of the confirmation date. Does a creditor then have the right to seek modification of a plan to recover actual income received in excess of projections? This excess is allowed to be retained by the debtor under §1129(b)(2). Interim Bankruptcy Rule 3019 governs the notice and hearing procedure for post-confirmation amendments.
10. **Dismissal.** The grounds for dismissal or conversion of a Chapter 11 case are found at §1112. Many of the grounds for dismissal or conversion include actions that impact an individual case, These selected grounds include the failure of the debtor to: a) maintain appropriate insurance that poses a risk to the estate or to the public; b) unexcused failure to satisfy timely any filing or reporting requirement established under Title 11 or the Bankruptcy Rules; c) failure to attend a 341 meeting or Rule 2004 examination, without good cause shown by the debtor; d) failure to timely provide information or attend meetings reasonable requested by the US Trustee; e) failure to timely pay taxes owed post-petition or file post-petition tax returns; and f) failure to pay any domestic support obligation that first becomes payable after the date of the filing of the petition.
- a. §1112(b)(1 and 2) appear to make it clear that conversion or dismissal should not be ordered absent findings that such action is in the best interests of creditors and the estate especially if the debtor or another party in interest establishes that there is a reasonable likelihood that a plan will be confirmed within the timeframes established under sections 1121(e) and 1129(e), or if these time periods don't apply, within a reasonable time.