Plenary Session

Current Developments in Business and Consumer Cases

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Hon. Michael G. Williamson | U.S. Bankruptcy Court (M.D. Fla.) Tampa

Educational Materials

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Recent Developments in Business Bankruptcy

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I. FRAUDULENT TRANSFER

In re Tousa, Inc., 422 B.R. 783 (Bankr. S.D. Fla. 2009)

Key Holdings: Certain subsidiaries (the "*Obligor Subsidiaries*") of bankrupt parent company, Tousa, Inc. ("*Tousa*"), did not receive reasonably equivalent value in exchange for liens granted by the Obligor Subsidiaries to lenders on account of a new loan, the proceeds of which were used solely to settle litigation against the parent company and one of its wholly owned subsidiaries, Tousa Homes LP ("*Tousa Homes*"; together with Tousa, the "*Old Borrowers*"). The liens were, therefore, subject to avoidance as fraudulent transfers and the value of the Obligor Subsidiaries' assets for which liens were conveyed to the lenders would be recovered for the benefit of the Obligor Subsidiaries' estates.

The savings clauses in the underlying loan documents do not insulate the lenders from fraudulent transfer liability. Efforts to contract around section 548 of the Bankruptcy Code are invalid.

Additionally, Tousa is deemed to have acquired rights in its federal income tax refund on the first day in which it was eligible to claim a refund from the federal government, i.e. January 1, 2008, despite the fact that the after-acquired property clause giving the lenders a lien on the refund was entered into outside of the 90 day clawback period for preferences.

Factual Background: Tousa was a parent holding company that was a large residential land developer and homebuilder. On July 31, 2007, Tousa and several of its subsidiaries, including the Obligor Subsidiaries, became obligors, jointly and severally, under a $500 million loan facility (the "*New Loan*"). The New Loan was intended to satisfy a $420 million obligation of the Old Borrowers, under a settlement agreement resolving prior litigation involving the Old Borrowers' defaults under a previous loan (the "*Old Loan*"). The Obligor Subsidiaries were not liable to the old lenders under the Old Loan, but had granted security interests in all of their assets to the lenders of the New Loan (the "*New Lenders*") as security for the New Loan.

After Tousa filed for bankruptcy in January 2008, the Creditors Committee sought to: (i) avoid the $500 million in liens granted by the Obligor Subsidiaries to the New Lenders, (ii) recover the $420 million that was paid to the Old Lenders and (iii) avoid a $207 million lien on a tax refund received by Tousa in April 2008 that related to the year ended 2007, despite the fact that the lien was granted outside of the 90 day preference period set forth in section 547 of the Bankruptcy Code.

Among other things, the New Lenders asserted that the "savings clauses" in the loan documents saved them from fraudulent transfer liability because the savings clauses reduced the obligations incurred and liens granted by the Obligor Subsidiaries to the New Lenders to the extent necessary to prevent the Obligor Subsidiaries' insolvency.

Appeal: The New Lenders filed an appeal with the United States District Court for the Southern District of Florida on January 5, 2010 (the "*Florida District Court*"). No order has yet been entered by the Florida District Court.

II. DIRECTOR LIABILITY

In Tousa, Inc., 437 B.R. 447 (Bankr. S.D. Fla. 2010)

Key Holdings: The directors of an insolvent, wholly-owned subsidiary of a bankruptcy parent corporation that also serve as directors of the parent corporation, owe fiduciary duties to both the parent corporation and the subsidiary under Delaware law. These directors also have a duty to manage the subsidiary for the benefit of the insolvent subsidiary's creditors under Delaware law. As a result, when the insolvent subsidiary is harmed as a result of a director's breach of fiduciary duties, the harm is suffered by the subsidiary corporation and its creditors, therefore, have a derivative claim for a breach of fiduciary duties.

Moreover, a director is not shielded from liability for breaches of fiduciary duty simply because he abstained from voting on the challenged transaction. Delaware law does not *per se* protect an director that abstains from voting on a transaction from liability when he plays a role in the negotiation, structuring or approval of the transaction in question that led to a purported breach of the director's fiduciary duties.

Because the Creditors Committee has properly alleged breaches of the duties of loyalty, good faith and due care, the Business Judgment Rule will not shield the defendants at the pleading stage. Any director that has breached any of the duties of loyalty, good faith or due care loses the protection of business judgment under Delaware law.

Therefore, the Creditors Committee has pled facts sufficient to survive a motion to dismiss the alleged claims against various directors, officers and managers of the subsidiary corporations for a breach of fiduciary duties, including the duty of due care and loyalty, and aiding and abetting a breach of fiduciary duties.

Factual Background: The Creditors Committee brought an adversary proceeding against various directors, officers and managers of Tousa and its various subsidiaries for breaches of fiduciary duty and for aiding and abetting those breaches of fiduciary duties (collectively, the "*Breach Claims*"). Among other things, the Creditors Committee claimed that these directors and officers had breached the duties of loyalty, good faith and due care to the Obligor Subsidiaries by authorizing the pledge of the Obligor Subsidiaries' assets as security for a $500 million New Loan which would solely benefit the parent corporation, Tousa and one of its wholly owned subsidiaries, Tousa Homes.

The defendants filed a motion to dismiss these Breach Claims asserting, among other things, that (i) they did not owe any duties to the Obligor Subsidiaries or their creditors, (ii) even if any duties were owed by the defendants to the creditors of the Obligor Subsidiaries, the complaint failed to plead facts sufficient to survive a motion to dismiss, (iii) the exculpatory provisions in Tousa's certificate of incorporation prohibits any claims against them for a breach of the duty of care, (iv) the claims were direct creditor claims for breaches of fiduciary duties, which are prohibited under Delaware law; and, as to at least one of the directors of the parent corporation (v) the director's abstention from voting on the Old Loan protects him from liability arising as a result of such decision.

III. THE ABSOLUTE PRIORITY RULE

In re DBSD North America, Inc., 2010 WL 4925878 (2d Cir. Dec. 6, 2010) (opinion pending)

Key Holding: A plan that provided for the distribution of value to equity holders over the objection of a non-consenting class of creditors violated the absolute priority rule even where the bankruptcy court had concluded that the distribution to equity represented a gift by an undersecured creditor with a lien on substantially all of the debtors' assets.

Factual Background: The bankruptcy court confirmed a plan, which provided for 94.85% of the equity in the reorganized entity to be distributed to certain of the debtors' secured creditors, 5% of the stock to be distributed the Debtors' non-bankrupt corporate parent and sole equity holder, and .15% of the stock to be distributed to the Debtors' general unsecured creditors. In permitting a distribution to equity over the objection of an intervening class of creditors, the bankruptcy court relied on the so-called "gifting doctrine," and concluded that the Debtors' undersecured creditors were entitled to receive all of the equity in the reorganized entity, and could thus "gift" a portion of their recovery to existing equity without running afoul of the absolute priority rule.

In an order dated December 6, 2010, the Second Circuit reversed, concluding that "the plan violated the absolute priority rule," and indicated that an opinion explaining its reasoning would follow in due course.

IV. INTERCREDITOR AGREEMENTS

In re Ion Media Networks, Inc., 419 B.R. 585 (Bankr. S.D.N.Y. 2009)

Key Holding: Second lien lender lacked standing to challenge first lien lenders' claim to FCC licenses under the terms of intercreditor agreement even though the first lien lender may not have been able to acquire a valid security interest in the licenses under applicable FCC regulations. Since the intercreditor agreement prevented attacks on "purported" collateral, second lien lender was bound by the terms of the contract.

Factual Background: Ion Media Networks and its affiliates ("*Ion*") owned and operated the largest group of broadcasting television stations in the United States. Prior to its bankruptcy filing, Ion entered into a $1.03 billion financing transaction, with both first and second priority tranches, secured by liens on substantially all of the debtor's property. The related security agreement expressly included "FCC Licenses" as a part of collateral package, but separately excluded from the security interest "any permit, lease, license agreement or other personal property . . .to the extent that any requirement of law . . . prohibits the creation of a security interest therein."

By means of an intercreditor agreement, the first and second lien lenders agreed that "none of the Second Priority Secured Parties shall . . . (vi) oppose, object to, or vote against any plan of reorganization or disclosure statement the terms of which are consistent with the rights of the First Priority Secured Parties under the Security Agreement." The intercreditor agreement

further provided that the parties' relative priorities with respect to the collateral would not be affected by "any nonperfection of any lien purportedly securing" any of the obligations.

During the bankruptcy case, one of the second lien lenders filed a series of objections arguing that the Debtors' FCC Licenses were not subject to the first-lien lenders' security interest because applicable FCC regulations prohibit the creation of a security interest in an FCC license. Ultimately, the bankruptcy court declined to rule on the merits of that argument, concluding instead that the intercreditor agreement prohibited the second lien lenders from mounting a challenge to the validity of the first lien lenders' purported security interest in the FCC licenses.

V. CREDIT BIDDING

In re Philadelphia Newspapers, LLC, 599 F.3d 298 (3d Cir. 2010)

Key Holding: Secured creditors do not have an absolute right to credit bid when their collateral is sold pursuant to a plan of reorganization, as long as they receive the "indubitable equivalent" of their claims under section 1129(b)(ii)(A)(iii) of the Bankruptcy Code.

Factual Background: On August 20, 2009, Philadelphia Newspapers LLC and its various debtor entities proposed a joint plan that provided for the sale of substantially all of their assets. The Debtors also filed a motion seeking approval of bid procedures that, among other things, prohibited secured creditors from credit bidding.

The Debtors' senior lenders objected to the proposed bid procedures on the ground that, where a plan involves the sale of collateral, the Bankruptcy Code requires the preservation of a secured creditor's right to credit bid. The Third Circuit rejected that argument and held that a plan providing for the sale of a secured creditor's collateral may be confirmed over the creditor's objection so long as it provides for the creditors to receive the "indubitable equivalent of [their] claims," which will not always require a right to credit bid.

VI. BANKRUPTCY REMOTE ENTITIES

In re Gen. Growth Props. Inc., 409 B.R. 43 (Bankr. S.D.N.Y. 2009)

Key Holdings: Chapter 11 filings by bankruptcy-remote special purpose entities ("*SPEs*") were filed in good faith despite the fact that the individual entities were solvent, cash flow positive, and not facing any imminent loan defaults.

Factual Background: General Growth Properties ("*GGP*") was the ultimate parent company to approximately 750 subsidiaries, joint-ventures and affiliates, including SPEs, whose primary business was shopping center ownership and management. GGP had incurred significant debt and its capital structure depended on its ability to refinance this debt, which was severely threatened by the credit crisis. As a result GGP, along with many of its solvent SPEs, filed for bankruptcy.

Several creditors of the SPEs filed motions to dismiss the SPE bankruptcy cases arguing that: (a) the bankruptcy cases were premature since there was no imminent threat to the financial viability of the SPE Debtors, which were cash flow positive, and (b) the SPE bankruptcy filings were in

bad faith since there was no possibility of confirming a plan over the creditors objections, and because the SPE debtors replaced their independent managers just prior to the bankruptcy filing.

In rejecting these arguments, the bankruptcy court noted, among other things, that: (i) the Bankruptcy Code does not require that a debtor be insolvent prior to filing for relief, (ii) the SPE debtors were permitted, and perhaps even required, to consider the interests of their parent company, GGP, in deciding to file for bankruptcy; (iii) there is no requirement that a borrower negotiate with its lender prior to filing for bankruptcy, and (iv) the replacement of the independent managers by the SPE debtors did not constitute bad faith since it did not violate any provisions of their corporate documents. In short, the Court concluded that even though the SPE creditors had been inconvenienced by the bankruptcy filings, the fundamental protections of the SPE structure had been honored, even if the creditors had not expected the possibility of a filing.

VII. TRANSATLANTIC CONFLICTS OF LAW

The Lehman Brothers bankruptcy and administration cases have provided vivid examples of how different courts in the US and UK can reach different conclusions regarding identical or near-identical questions of law.

A. Is A Non-Debtor Party Obligated to Perform Following a Breach by the Debtor?

Joint Administrators of LBIE –and- (1) JFB First Rixson, Inc., (2) FR Acquisitions Corporation (Europe) Ltd., (3) Beig Midco Ltd. KP Germany Zweite GMBH, before Mr. Justice Briggs, [2010] EWHC 3372 (Ch) (21/12/2010)

Key Holdings: Non-defaulting swap counterparty's obligation to make payments under an ISDA was suspended by virtue of the debtor's bankruptcy filing, which constituted an event of default. The non-defaulting counterparty is likewise not required to designate an Early Termination Date for the ISDA by any particular date, but may instead wait and hope for an improved market or the natural expiration of the swap.

Factual Background: Lehman Brothers International (Europe) ("*LBIE*") was the defaulting party under an ISDA by reason of its bankruptcy, but was "in-the-money" on the various interest rate swaps governed by the ISDA. In reliance on LBIE's default, several non-defaulting counterparties ceased making the periodic payments required by the ISDA, and also failed to designate Early Termination Dates under section 6(a) of the ISDA.

This opinion by the U.K. court stands in stark contract to Judge Peck's Metavante decision in the U.S. bankruptcy proceedings of Lehman Brothers Holdings Inc. ("*LBHI*"), in which the U.S bankruptcy court held that: (i) a non-debtor counterparty was obligated to render performance under the ISDA if it did not elect to terminate; and (ii) the failure to designate an Early Termination Date in a timely fashion could result in a waiver of that right.

B. Enforcement of Ipso Facto Clauses

Lehman Bros. Special Fin. Inc. v. BNY Corp. Trust Servs. Ltd., 422 B.R. 407 (Bankr. S.D.N.Y. 2010)

Key Holdings: The contractual subordination of LBSF's rights to collateral held by BNY following a bankruptcy filing by LBHI was an unenforceable *ipso facto* clause under US law, even though the same clause would be given effect under English law, which governed the documents.

Factual Background: BNY held collateral for the benefit of several different creditors of an SPE. Under the applicable transaction documents, LBSF's rights to the collateral were superior to those of another creditor prior to the occurrence of an event of default. Upon a default by LBSF, however, including the bankruptcy of its credit support provider, the priorities shifted, giving the other creditor a superior right to the collateral.

The English courts held that the priority altering provisions of the transaction documents were enforceable under English law, which was specified as the governing law in the documents. After consideration of the English court's decision, the bankruptcy court declined to extend comity due to the United States' strong interest in enforcing the protections of the Bankruptcy Code, and ultimately concluded that the clause in question was an unenforceable *ipso facto* clause.

VIII. ADMINISTRATIVE PRIORITY

GFI Wisconsin v. Reedsburg Utility Commission, 2010 U.S. Dist. LEXIS 122681 (W.D. Wis. Nov. 10, 2010)

Key Holding: Electricity qualifies as "goods" under section 503(b)(9) of the Bankruptcy Code because it is movable, tangible, consumable, has physical properties and can be sold in the marketplace as required by section 2-105 of the Uniform Commercial Code.

Legal Analysis: While noting that the definitions set forth in the UCC may not always be coextensive with the Bankruptcy Code, the Court found that the definition of goods set forth in section 2-105 of the UCC was appropriate for purposes of section 503(b)(9). To constitute a "good" for purposes of section 503(b)(9), the thing at issue must be movable, identifiable, have value and be received by the debtor during the 20 day period prior to the petition date.

In this case, court concluded that the literal movement of electrons through the transmission network was sufficient satisfy the first prong of the test. The court further concluded that because electricity is movable, tangible, and consumable, has physical properties and is bought and sold in the marketplace, it qualifies as goods for the purposes of the UCC and the Bankruptcy code.

In so doing, the court rejected the notion that sections 366 (governing utility providers) and 503(b)(9) were intended to be mutually exclusive. In other words, simply because a seller of goods is a utility entitled to protection under section 366 of the Bankruptcy Code does not prohibit the utility provider from seeking administrative expense priority under section 503(b)(9)

for any goods delivered within the statutory period. The court likewise rejected the argument that section 503(b)(9) priority should be limited to claimants that would otherwise be entitled to reclamation under section 546 of the Bankruptcy Code.

IX. THE NEW VALUE DEFFENSE

In re Circuit City Stores, Inc., 2010 WL 4956033 (Bankr. E.D. Va. Dec. 1, 2010)

Key Holding: A supplier cannot claim both an administrative expense claim under section 503(b)(9) for the value of goods delivered to the debtors within 20 days prior to the petition date and also utilize the value of those same goods as the basis of a new value defense under section 547(c)(4) of the Bankruptcy Code in a preference action.

Factual Background: The debtors commenced an adversary proceeding seeking to return of certain preferential transfers from the defendant. In response, the defendant claimed that the amounts sought to be avoided must be reduced because, subsequent to the preferential transfers, the defendants provided new value to the debtors, including the value of the goods that formed the basis for the defendant's allowed administrative expense claim under section 503(b)(9), the full amount of which had already been paid into a reserve escrow pending the outcome of the preference action.

In rejecting the defendant's new value defense, the court noted that the defendant's 503(b)(9) claim would be paid in full out of the reserve fund, which effectively eliminated the defendant's ability to use that claim as "new value."

X. ATTORNEYS' FEES

In re Adelphia Communications Corp, 2010 Bankr. Lexis 3915
(Bankr. S.D.N.Y. Nov. 18, 2010) (*Gerber, J.*)

Key Holding: Creditors may be compensated pursuant to section 1123(b)(6) of the Bankruptcy Code for legal fees incurred litigating with other creditors to increase their personal recoveries even when no substantial contribution can be shown to the debtor's estate.

Factual Background: The debtors sought to sell substantially all of their assets pursuant to a chapter 11 plan as opposed to a section 363 sale. The sale documents, however, required that a plan be implemented by a specific deadline. Intercreditor disputes jeopardized the debtors' ability to meet the stated deadline. The various creditors eventually came to a settlement and, as a part of that global settlement, the parties agreed that the estate would bear the fees incurred by the creditors for, among other things, fees incurred to resolve intercreditor disputes and for the creditors' general participation in the debtors' bankruptcy cases, by means of granting these creditors administrative claims.

In approving the payment of fees without requiring a showing of substantial contribution, the Court reasoned that, sections 503(b)(3) and (4) of the Bankruptcy Code did not affirmatively prohibit recovery of attorneys' fees by creditors in the absence of a showing of substantial contribution and were not intended to be the exclusive means for recovery of creditor fees and expenses. The Court further noted that section 1123(b)(6) of the Bankruptcy Code permits a

plan to "include any other appropriate provision not inconsistent with the provisions of this title." And, since the payment of creditor fees was not prohibited by any other provision of the Bankruptcy Code, it represented a permissible use of section 1123(b)(6).

XI. DEFINITION OF "CLAIM"

In re Grossman's Inc., 607 F.3d 114 (3d Cir. 2010) (en banc)

Key Holding: Overruling its prior decision in In re M. Frenville Corp., 744 F.2d 332 (3d Cir. 1984), the Third Circuit held that a "claim" arises within the meaning of section 101 of the Bankruptcy Code when an individual is exposed to a product or conduct pre-petition giving rise to an injury, which underlies a "right to payment" under the Bankruptcy Code.

Factual Background: The claimant purchased asbestos-containing products from Grossman's in 1977. In 1997, Grossman's filed for bankruptcy, and the Bankruptcy Court confirmed its chapter 11 plan that same year. The claimant failed to file a proof of claim because she had not yet manifested symptoms related to her asbestos exposure at the time of the bankruptcy filing. In 2006, after the claimant was diagnosed with an asbestos-related cancer, she filed an action in NY state court against Grossman's successor-in-interest, Jeld-Wen. Jeld-Wen moved to reopen the chapter 11 case arguing that the claims were discharged by the confirmed Plan. The bankruptcy court had held, in reliance on the Third Circuit's Frenville opinion, that the chapter 11 plan did not discharge the asbestos-related tort claims filed by the claimant because the claims arose after the effective date of the chapter 11 plan. Under Frenville, the Third Circuit had previously held that a "claim" arises when the state law cause of action accrues and, therefore, under New York law, a cause of action for an asbestos-related injury does not accrue until the injury manifested itself.

On appeal, the Third Circuit overruled Frenville and clarified the standard for determining when a claim arises, but remanded for further consideration of whether the particular claim involved in this case had been discharged based on the lower court's consideration of whether the claimant had received constitutionally sufficient notice.

XII. REQUIRED DISCLOSURES UNDER BANKRUPTCY RULE 2019

Rule 2019 of the Federal Rules of Bankruptcy Procedure requires creditors that come together to form a committee, or who are represented by the same counsel, to disclose information relating to, among other things, (a) the claims or interests held by such creditors, (b) the amounts of such claims or interests, (c) when such claims or interests were acquired, (c) amounts paid for such claim or interest and (d) any sales or dispositions of such claims or interests. See Fed. R. Bankr. P. 2019.

Chapter 11 debtors often use the required Bankruptcy Rule 2019 disclosures to thwart the formation of various unofficial committees that may have a greater voice in the chapter 11 process than individual claimholders or interestholders.

In recent years, courts have debated whether various ad hoc groups of creditors or interestholders formed within a bankruptcy case are subject to the disclosures required by Bankruptcy Rule 2019.

A. In re Northwest Airlines Corporation, 363 B.R. 701 (Bankr. S.D.N.Y. 2007)

In Northwest Airlines, Judge Allan Gropper of the United States Bankruptcy Court for the Southern District of New York held that an ad hoc committee of hedge funds and other stockholders were required to publicly disclose details of their trades in the debtor's claims and stock.

B. In re Scotia Development, LLC, Case No. 07-20027 (Bankr. S.D. Tex. Apr. 18, 2007)

By contrast, Judge Richard Schmidt of the United States Bankruptcy Court for the Southern District of Texas denied the debtor's motion requesting that members of an ad hoc group of noteholders be compelled to make detailed disclosures relating to their individual trading histories, prices paid and received for the debtors' securities. Judge Schmidt held that the noteholder group was not a "committee" as defined under Bankruptcy Rule 2019 and, therefore, the 2019 disclosure requirements did not apply.

C. Third Circuit Bankruptcy Courts Split Over 2019 Disclosure Requirements

In 2009 and 2010, the bankruptcy courts within the Third Circuit weighed in on the issue of whether ad hoc groups must make detailed disclosures of their claims and interests and came to differing conclusions:

1. In re Washington Mutual, Inc., 419 B.R. 271 (Bankr. D. Del. 2009)

Judge Walrath aligned herself with Judge Gropper's decision in Northwest and held that a group of noteholders was indeed an ad hoc committee and, therefore, required to provide detailed trading and other information as required under Bankruptcy Rule 2019.

2. In re Premier Int'l Holdings, Inc., 423 B.R. 58 (Bankr. D. Del. 2010)

By contrast, Judge Sontchi declined to follow the Northwest Airlines and Washington Mutual decisions and instead held that, under the plain meaning of Bankruptcy Rule 2019, an informal committee of noteholders was not a "committee representing more than one creditor" as set forth in Bankruptcy Rule 2019 because the informal group was made up of "a self-appointed subset of a larger group."

3. In re Philadelphia Newspapers, LLC, 422 B.R. 553 (Bankr. E.D. Pa 2010)

Judge Raslavich agreed with the reasoning in Premier International Holdings and held that a self-styled steering group of pre-petition lenders was not required to comply with the disclosure requirements of Bankruptcy Rule 2019 because the steering group had no legal identity apart from its members and was not appointed by any larger deliberative body.

Therefore, the steering group was not either an "entity" or a "committee" for purposes of Bankruptcy Rule 2019.

XIII. BREAK UP FEES

Historically, three different standards have emerged for evaluating the propriety of break-up fees and topping fees pursuant to a bankruptcy sale under section 363 of the Bankruptcy Code or a chapter 11 plan.

One standard has been set forth in In re 995 Fifth Avenue Associates, L.P., 96 B.R. 24 (Bankr. S.D.N.Y. 1989), which applies a variation of the business judgment rule and analyzes three criteria for determining the validity of a breakup fee: (i) whether the fee was tainted by self-dealing or manipulation, (ii) whether the fee hampered bidding and (iii) whether the fee was reasonable when compared to the proposed purchase price.

Another standard which has emerged is the "best interests of the estate" standard set forth in In re American West Airlines, Inc., 166 B.R. 908 (Bankr. D. Ariz. 1994). Under this standard, fees are evaluated based on whether the interests of all affected parties are best served by approving the requested break-up fee.

Finally, the Third Circuit set forth a third test for evaluating the propriety of break-up fees in In re O'Brien Environmental Energy, Inc., 181 F.3d 527 (3d Cir. 1999), where the Third Circuit held that break-up fees must be shown to be actually necessary to preserve the value of the debtor's estate as required under section 503(b) of the Bankruptcy Code.

A. In re Kelson Channelview LLC v. Reliant Energy Channelview LP, 594 F.3d 200 (3d Cir. 2010)

Key Holding: The Third Circuit reaffirmed its holding in O'Brien and held that a break-up fee would be upheld only if it was necessary to preserve the value of a debtor's estate under the standards of section 503(b) of the Bankruptcy Code. A break-up fee preserves the value of a debtor's estate if the fee (i) induces a stalking horse bidder to make its bid or (ii) induces the stalking horse bidder to adhere to its bid even after the bankruptcy court orders that an auction be conducted.

Factual Background: Kelson Channelview LLC ("*Kelson*") made a successful bid for the debtors' largest asset and entered into an Asset Purchase Agreement (the "*APA*") with the debtors. The APA provided that the debtors would immediately seek an order from the bankruptcy court authorizing the sale of the asset to Kelson without an auction and, in the event that the bankruptcy court ordered an auction of the asset, approving certain bid protections for Kelson, including, among other things, a $15 million break-up fee which was about 3 percent of Kelson's bid, as well as a $5 million overbid requirement. The Bankruptcy Court ultimately required that an auction be held for the asset.

One of the other unsuccessful bidders that had previously bid for the asset prior to the auction objected to the debtors' request for approval of the bid protections claiming that the $15 million break-up fee and the $2 million expense reimbursement deterred the alternative bidder from

submitting a "higher and better" bid at the auction. The bankruptcy court ultimately upheld the $5 million overbid requirement but denied the $15 million break-up fee.

The bankruptcy court found that Kelson submitted its bid without the assurance of a break-up fee and, therefore, the fee was not necessary to induce Kelson to bid. Additionally, the bankruptcy court believed that the break-up fee would deter additional purchasers from bidding on the asset and that the fee would overshadow any possible benefit to be gained from keeping Kelson committed to its bid. Therefore, the Third Circuit held that the bankruptcy court did not abuse its discretion in denying the break-up fee to Kelson.

B. In re Philadelphia Newspapers, LLC, No. 09-11204SR, 2009 WL 3242292 (Bankr. E.D. Pa. 2009)

Key Holdings: Break-up fees that are proposed to be paid to insiders are subject to a heightened level of scrutiny. When a stalking horse bid is not required to serve as a catalyst for additional bids and the stalking horse did not expend time and expense to formulate and submit a bid, a break-up fee is unwarranted.

Factual Background: The debtors had entered into an APA with a stalking horse bidder that was partially comprised of the debtors' former owners. The stalking horse, therefore, had virtually unfettered access to the debtors' records and other information for purposes of formulating its bid and had to do very little diligence, or incur significant expenses, to prepare its stalking horse bid.

The APA provided for, among other things, a $1 million break-up fee and a maximum of $500,000.00 expense reimbursement. Pursuant to certain bid procedures set forth in the debtors' disclosure statement and plan, the debtors required that all additional bids be in cash, preventing the secured lenders from credit bidding the value of their debt facility at the auction.

The bankruptcy court found that the break-up fee was unwarranted as a financial inducement to bid because the debtors clearly preferred that the stalking horse obtain the asset and the stalking horse did not have to perform any significant diligence or engage in arms-length negotiations to successfully bid for the asset.

Individual Debtors in Chapter 11

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Jacksonville Bankruptcy Bar Association

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* * *

Individual Debtors in Chapter 11

by

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INTRODUCTION

Bankruptcy courts nationwide have experienced a significant increase in individual chapter 11 filings. This increase is partly attributable to the changes brought by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"). BAPCPA made it difficult for individuals with significant earnings to pass the onerous means test of 11 U.S.C. § 707(b), while at the same time, it left unchanged the chapter 13 debt limitations codified in § 109(e). The net effect has been that while BAPCPA intended to force high-earning individuals to file chapter 13 instead of chapter 7, in some cases it forced them right past 13 and into chapter 11 with its more complex requirements.

The more significant reason for the recent increase in individual chapter 11 filings, however, has been the economic downturn, and specifically, the significant drop in real estate values. Now more than ever, when the individual with high earnings or high debt levels declares bankruptcy, that individual may still have significant assets—especially real estate—left to salvage in a chapter 11. From this view, the complexities (and pitfalls) of post-BAPCPA individual chapter 11 cases have been lurking since 2005. They are just now coming to light more frequently as those who have significant and salvageable assets find themselves needing to reorganize their debt.

And finally, it has become clear that the post-BAPCPA chapter 11 provisions for individuals are not merely a "high-end" version of chapter 13. There are significant consequences to filing an individual chapter 11 petition. Those consequences and the critical differences between chapter 11 and chapter 13 for individuals are presented below.

I) SPECIFIC PROVISIONS FOR AN INDIVIDUAL CHAPTER 11 DEBTOR

A. Estate Property

1. According to the definition in § 1115(a).

In a case in which the debtor is an individual, property of the estate includes, in addition to property specified in § 541 –

(1) *all property of the kind specified in § 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, whichever occurs first; and*

(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.*

2. Thus, in an individual chapter 11 case, property of the estate includes both the pre-petition property specified in § 541 and also all post-petition personal service income and property that the debtor acquires during the life of the plan. (Note: this mirrors the chapter 13 definition found in § 1306.)

3. **Post-Petition Expenses:** If all pre- and post-petition earnings and property belong to the estate, how can the individual debtor pay expenses prior to plan confirmation? Won't "[t]he debtor and his or her dependents have to consume property of the estate for living expenses and to pay domestic support obligations, among other things[?]"[1]

a) Living Expenses – "Ordinary Transactions" Only

(1) § 363(c)(1) allows the debtor to, without notice and a hearing, "*enter into transactions . . . and [to] use property of the estate in the ordinary course of business . . . .*"

(2) At least one court has noted that § 1115(a), when combined with § 363(c), deprives most individual debtors of the ability to use post-petition property and income to pay for "non-ordinary" transactions—e.g., payment for divorce counsel. *In re Goldstein*, 383 B.R. 496, 499 (Bankr. C.D. Cal. 2007).

> The combined provisions authorize an individual chapter 11 debtor "to buy bread and probably to purchase a ticket to travel to a court hearing. However, the hiring of divorce counsel is not typically a transaction in the ordinary course of business." *Id.*

b) Administrative Expenses - Some expenses may qualify as administrative expenses under § 503(b)(1)(A)(i) if they are "*actual, necessary costs and expenses of preserving the estate.*"

(1) These would probably include maintenance payments on assets, housing, clothing, food, dependent support, etc., as long as a court could find them "necessary to preserve the estate."[2]

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[1] NCBJ 84th Annual Meeting - New Orleans, panelist materials for *Don't Supersize Me! Individual Chapter 11 - More than a Really Big Chapter 13*, October 14, 2010, at 3 (Peter M. Lively, Sally S. Neely, and Riley C. Walter, Panelists; Hon. Mary Grace Diehl, Moderator).

[2] NCBJ panelist materials, *supra* note 1 at 4.

(2) It is less clear whether vacations, club memberships, and other "luxury" expenses would qualify as necessary.[3]

c) Legal Fees – As noted above, payments for legal services may not be considered "in the ordinary course of business" or necessary "to preserve the estate."

(1) For chapter 13 debtors, the Bankruptcy Code specifically provides for "*reasonable compensation to the debtor's attorney for representing the interests of the debtor in connection with the bankruptcy case . . . .*" § 330(a)(4)(B) (emphasis added). It does not, however, make the same allowance for attorneys in an individual chapter 11 case.

(2) Attorney's fees for individual chapter 11 debtors are likely governed by the U.S. Supreme Court ruling in *Lamie v. U.S. Trustee*, 540 U.S. 526 (2004). Thus, estate property may not be used to pay for legal services related to the chapter 11 debtor's personal interests.

> "The zone of non-compensation could cover advice and representation regarding discharge or nondischargeability, exemptions, or plan structuring and preparation if the plan allocates some of the estate to the revested debtor postconfirmation."[4]

Even the unearned portion of a pre-petition retainer is likely to be property of the estate and may not be available to pay for post-petition services.[5] *Id.*

B. The Individual Chapter 11 Plan

1. **Funding the Plan** - BAPCPA added subsection § 1123(a)(8), which provides that

[I]n a case in which the debtor is an individual, [a plan shall] provide for the payment to creditors under the plan of all or such portion of earnings from personal services performed by the debtor after the commencement of the case or other future income of the debtor as is necessary for the execution of the plan. (Emphasis added.)

This provides the debtor with some significant flexibility.

(1) Not all post-petition earnings are required to fund the plan, only enough "as is necessary for execution of the plan."

(2) Monthly payments are not required. Moreover, the plan can be funded out of "other future income" (a term not defined).

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[3] NCBJ panelist materials, *supra* note 1 at 4.

[4] *Id.* at 5 (emphasis added).

[5] *See id.* n.8.

2. **Required Plan Payments**

   a) **Domestic Support Obligations ("DSOs")** –

      (1) POST-Petition DSOs - BAPCPA added subsection § 1129(a)(14), which provides that

      If the debtor is required by a judicial or administrative order, or by statute, to pay a domestic support obligation, [a court can confirm a plan only if, in addition to other requirements,] the debtor has paid all amounts payable under such order or such statute for such obligation that first become payable after the date of the filing of the petition.

      (i) This provision clearly targets individual chapter 11 cases because non-individual entities rarely (if ever) would be required to pay a DSO.

      (ii) Under § 1129(a)(14), a plan may not be confirmed until the debtor is current with all DSOs that first became payable post petition.

      (2) PRE-Petition DSOs

      (i) BAPCPA also changed the priority status for unsecured pre-petition DSOs. Under § 507(a)(1), DSOs now have first-position priority status. (Before BAPCPA, they had seventh-position priority status.)

      - Note that pre-petition DSOs are subject to a carve-out for the related trustee fees. § 507(a)(1)(C).

      (ii) Despite the clear first-position priority status of pre-petition DSOs under § 507(a)(1), they are not administrative expenses. Administrative expenses allowable under § 507(a)(2)—e.g., attorneys fees—must be paid in full on the effective date of the plan. Pursuant to § 1129(a)(9)(B), however, pre-petition DSO claims "may be paid over time after administrative expenses." *In re Sanders*, 341 B.R. 47, 50 (N.D. Ala. 2006) (emphasis added).

      (iii) Moreover, in a chapter 11 case, priority claimants vote as a class. Thus, if the pre-petition DSO class "votes to accept full payment in deferred cash payments, the vote is binding on dissenting claimants." *Id.*

      (iv) Bonus Question: How to treat an 8-year monthly alimony obligation, which existed pre-petition? Is it accelerated to a lump-sum amount under § 507(a)(1)?

      (3) Noticing Duties for DSOs - § 1106 imposes new duties upon a chapter 11 trustee and, via § 1107(a), upon an individual chapter 11 debtor in possession. The trustee or debtor in possession must:

      (i) Provide to the DSO claim holder written notice of the claim and the holder's right to use child support enforcement agencies for assistance.

The notice must include the address and phone numbers of the State child support enforcement agency. § 1106(c)(1)(A).

(ii) Provide to the State child support enforcement agency written notice of the claim and the claim holder's name, address, and telephone number. § 1106(c)(1)(B).

(iii) At the time of discharge, provide to both the DSO claim holder and the State child support enforcement agency written notice of (i) the discharge, (ii) the debtor's last known address, (iii) the last known name and address of the debtor's employer, and (iv) the name of each creditor holding a claim either reaffirmed or not dischargeable under § 523(a)(2),(4), or (14A). § 1106(c)(1)(C).

(iv) The debtor's failure to meet the above noticing requirements may constitute cause for conversion or dismissal under § 1112(b)(4)(F) or (P).

b) **Tax Claim Provisions** –

(1) Unsecured Claims - § 1129(a)(9)(C), which applies to all chapter 11 cases, has clarified that governmental units holding unsecured claims "*will receive on account of such claim regular installment payments in cash--*

(i) *of a total value, as of the effective date of the plan, equal to the allowed amount of such claim;*

(ii) *over a period ending not later than 5 years after the date of the order for relief . . . ;*

(iii) *in a manner not less favorable than the most favored nonpriority unsecured claim provided for by the plan (other than cash payments made to a class of creditors under section 1122(b)) . . . .*" (Emphasis added).

(2) Secured Claims - § 1129(a)(9)(D) provides that governmental units holding secured claims "will receive on account of that claim, cash payments, in the same manner and over the same period, as prescribed in [§ 1129(a)(9)(C)]."

(3) Significantly, subsection (C)'s use of the phrase "regular installment payments" differs from other Bankruptcy Code provisions that require "equal monthly amounts." *See, e.g.*, § 1325(a)(5)(B).

(4) At least one court has evaluated the legislative history of § 1129(a)(9)(C) and concluded that its plain language does not prohibit balloon payments on priority tax claims:

> "The section does not provide that the payments shall be in equal amounts throughout the life of the plan. Had Congress intended to impose such a requirement, it certainly knew how to do so, as evidenced by its addition in the same legislation of the requirement in § 1325(a)(5)(B) that certain

distributions under chapter 13 plans be in 'equal monthly amounts.' " *In re F.G. Metals, Inc.*, 390 B.R. 467, 475 (Bankr. M.D. Fla. 2008) (J. Glenn).

c) **Anti-Modification Provision for Claims Secured by Principal Residence** –

(1) § 1123(b)(5) provides that when a creditor's claim is "secured only by a security interest in real property that is the debtor's principal residence[,]" a plan may not modify the secured creditor's claim. This provision essentially mirrors the non-modification provision of § 1322(b)(2).

(2) When the creditor's claim is entirely unsecured, however, residential loans may be stripped off under § 1123(b)(5) just as they are for chapter 13 debtors under § 1322(b)(2). *See In re Tanner*, 217 F.3d 1357, 1360 11th Cir. 2000) (referencing the door left open in *Nobelman v. American Savings Bank*, 508 U.S. 324 (1993) when the U.S. Supreme Court deemed the creditor to be a holder of a secured claim based on the secured portion of its bifurcated or stripped-down claim).

(3) Thus, the net rule in the Second, Third, Sixth, Ninth, and Eleventh Circuits is "strip down – no, strip off – yes."[6]

(4) Also note that when a loan is entirely unsecured, a creditor is not able to make the § 1111(b)(2) election because the creditor's interest is of "inconsequential value." § 1111(b)(1)(B)(i).

d) **Minimum Plan Payments/Disposable Income Test** – § 1129(a)(15) specifically provides that in an individual chapter 11 case, **when an unsecured creditor objects to the confirmation of the plan**, the plan must either (A) pay the unsecured claim in full or

> *(B) . . . [distribute] not less than the projected disposable income of the debtor (as defined in section 1325(b)(2)) to be received during the 5-year period beginning on the date that the first payment is due under the plan, or during the period for which the plan provides payments, whichever is longer.* (Emphasis added.)

(1) Adoption of § 1325(b)(2) Definition does not Implicate the § 707(b) Means Test

(i) § 1325(b)(2), however, defines "disposable income" (and not "projected disposable income"[7]) as *"current monthly income . . . less amounts*

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[6] *See* NCBJ panelist materials, *supra* note 1 at 20 n 53.

[7] Interestingly, § 1325(b)(1)(B) utilizes the term "projected disposable income" ("PDI"), but then directs that PDI is to "be applied to make payments to unsecured creditors under the plan." (Emphasis added). Thus, PDI does not necessarily equate to the entire amount required to be paid in a chapter 13 plan. *See* NCBJ panelist materials, *supra* note 1 at 8-14.

reasonably necessary to be expended . . . for the maintenance or support of the debtor or a dependent of the debtor . . . ."

(ii) § 1325(b)(3) goes on to require that if the debtor's income exceeds the applicable state median income for the debtor's family size, then the mechanical means test of § 707(b)(2)(A) and (B) shall be used to determine the debtor's expenses.

(iii)Because § 1129(a)(15)(B) specifically incorporates § 1325(b)(2) but not (b)(3), at least two courts have held that judicially determined standards and not the mechanical means test should be used to determine an individual chapter 11 debtor's expenses.

- *In re Roedemeier*, 374 B.R. 264, 272-73 (Bankr. D. Kan. 2007)
- *In re Gray*, 2009 WL 2475017 (Bankr. N.D. W.Va. 2009) (not reported).

Note: Some individual chapter 11 debtors might actually fair better under the mechanical means test. In a judicial determination, courts typically find secured debts for luxury homes and vehicles to be excessive and require debtors to dispose of these assets. In contrast, under § 707(b)(2)(A)(iii), all secured debt payments are deductible when computing projected disposable income. This lowers disposable income, which in turn lowers plan payments. In effect, utilizing the mechanical means test could reward debtors who have luxury (and heavily encumbered property) by allowing them to retain more and pay their creditors less.

(2) The Forward Looking Approach – the *Hamilton v. Lanning* Ruling

(i) In June 2010, the U.S. Supreme Court resolved a split among the circuits and mandated the use of a "forward looking approach" instead of a "mechanical approach" to determine *projected* disposable income for chapter 13 debtors. *Hamilton v. Lanning*, 130 S.Ct. 2464, 2478 (U.S. 2010) ("[W]e hold that when a bankruptcy court calculates a debtor's projected disposable income, the court may account for changes in the debtor's income or expenses that are known or virtually certain at the time of confirmation.").

(ii) When this forward looking approach is applied to individual chapter 11 debtors, it should result in substantially more latitude and flexibility.

(3) Miscellaneous Considerations

(i) What if the individual chapter 11 debtor's income is so irregular—i.e., non-monthly, that as defined under § 1325(b), the debtor has little or no monthly disposable income?

(ii) If an unsecured creditor objects, can the debtor simply pay the objecting creditor's claim in full, or would this violate the same class/same treatment provisions of §§ 1122 and 1123(a)(4)?

(iii)Only an unsecured creditor (and not a creditors' committee or the U.S. Trustee) may object to confirmation on the basis of § 1129(a)(15).

C. **Confirmation Issues**

1. **Post-Petition Disclosure and Solicitation** – §§ 1125 and 1126 requires that, unlike chapter 13, chapter 11 debtors must solicit creditors, and creditors can vote to accept or reject the chapter 11 plan.

   a) As described above, unsecured creditors have the right to effectively veto an individual chapter 11 plan by objecting to it and thus invoking § 1129(a)(15).[8]

   b) Filing a negative ballot, however, is not enough. *In re Shat*, 424 B.R. 854, 857 n 4 (Bankr. D. Nev. 2010) (Simply casting a negative ballot is insufficient to invoke § 1129(a)(15) because "the objector must affirmatively take a position the plan proposed is objectionable on some legal ground.")

2. **Cramdown and the Absolute Priority Rule**

   a) "Prior to the BAPCPA, . . . higher, priority-impaired claims generally had to be paid in full before lower priority claims could be paid at all, unless those classes of claims consented to such a treatment."[9] Because virtually all individual chapter 11 debtors intend to retain at least some property, only a plan that paid all classes in full or had no objectors could be confirmed under the pre-BAPCPA § 1129(b) rule.

   b) Under the amended § 1129(b)(2)(B) absolute priority rule, for an individual chapter 11 plan to be fair and equitable

      (B) *With respect to a class of unsecured claims--*

      (i) *the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or*

      (ii) *the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property, except that in a case in which the debtor is an individual, the debtor may retain property included in the estate under*

[8] Robert J. Landry, III, *Individual Chapter 11 Reorganizations: Big Problems with the New "Big" Chapter 13*, 29 U. Ark. Little Rock L. Rev. 251, 268-69 (2007) ("The creditor democracy model of Chapter 11 is now replaced with the 'single creditor modification rule' of § 1129(a)(15).").

[9] *See* Landry, *supra* note 8 at 270.

<u>*section 1115, subject to the requirements of subsection (a)(14) of this section*</u>. (Emphasis added).

c) **<u>Broad View</u>** - Some courts have interpreted this exception broadly. They find that because § 1115 includes the phrase "in addition to property specified in § 541[,]" Congress clearly intended to exempt from the absolute priority rule all pre- and post-petition property as well as post-petition earnings during the life of the plan. In other words, the individual chapter 11 debtor is completely exempt from the absolute priority rule and may cram down a plan over the objection of an unsecured creditor. (Note that the plan must still meet the disposable income test under § 1129(a)(15).)

   (1) *In re Johnson*, 402 B.R. 851, 852-53 (Bankr. N.D. Ind. 2009)

   (2) *In re Roedemeier*, 374 B.R. 264, 276 (Bankr. D. Kan. 2007)

   (3) *In re Tegeder*, 369 B.R. 477, 480 (Bankr. D. Neb. 2007)

d) **<u>Narrow View</u>** - A recent trend has emerged, however, and some courts have taken a contrary view that the exception for individuals in § 1129(b)(2)(B)(ii) exempts from the absolute priority rule only <u>post</u>-petition property under § 1115 and not pre-petition property under § 541.

   (1) *In re Gbadebo*, 431 B.R. 222, 229 (Bankr. N.D. Cal. April 16, 2010) (finding the new phrase added to § 1129(b)(2)(B)(ii)—i.e., property "included in the estate under section 1115"—to mean the property "<u>added</u> to the estate by § 1115.") (emphasis added)).

   (2) *In re Mullins*, 2010 WL 3359668 *5 (Bankr. W.D. Va. June 22, 2010) (not reported) (concluding that the result reached in *Gbadebo* is "more consistent with the language of the statute" than the broader interpretations).

   (3) *In re Steedley*, 2010 WL 3528599 *2-3 (Bankr. S.D. Ga. Aug. 27, 2010) (slip copy) ("because § 1115 adds postpetition property to the individual [chapter 11] debtor's estate . . . , it is that postpetition property that may be retained . . . without violating the absolute priority rule.")

   (4) *In re Gelin*, 2010 WL 3789100 *3-5 (Bankr. M.D. Fla. Sept. 29, 2010) (J. Jennemann) (slip copy) ("If Congress meant to eliminate the absolute priority rule . . . for individual debtors, it could have simply stated that § 1129(b)(2)(B)(ii) is inapplicable in a case in which the debtor is an individual.")

Under this narrow interpretation, individual chapter 11 debtors can retain post-petition assets and earnings. "But they cannot cram down a plan that contemplates retention of pre-petition assets unless they get acceptances from unsecured creditors or pay them in full." *Gelin* at *6.

c) **Exempt Property** – Whether the individual chapter 11 debtor can retain exempt property also remains an issue. § 1129(b)(2)(B)(ii) states that the junior claim holder shall not retain "any property" instead of limiting the violation of the absolute priority rule to occasions when a junior claim holder retains estate property.

(1) *See, e.g., In re Bullard*, 358 B.R. 541, 544 (Bankr. D. Conn. 2007) (finding that the debtor's retention of exempt property does not offend the absolute priority rule because it is not "on account of . . . [the debtor's] junior interest . . . in property." (emphasis added.)); *In re Henderson*, 321 B.R. 550, 559-60 (Bankr. M.D. Fla. 2005) (J. Paskay) (Exempt property, once allowed, is not estate property, and a debtor's interest in exempt property "can never be junior to the interest of [an unsecured creditor] . . . because unsecured creditors could never reach exempt property outside of bankruptcy . . . .").

(2) *But see*, *In re Gosman*, 282 B.R. 45, 49-53 (Bankr. S.D. Fla. 2002) (J. Hyman) (debtor cannot retain exempt property because the plain language of § 1129(b)(2)(B)(ii) utilizes the word "property" and not "non-exempt property" or "property of the estate").

D. **Discharge for an Individual Chapter 11 Debtor**

1. **Standard Discharge: AFTER Completion of Plan Payments** – Prior to BAPCPA, all chapter 11 debtors received a discharge upon confirmation under § 1141(d)(1)(A). BAPCPA, however, added subsection (d)(5), which provides that:

> ***(5)*** *In a case in which the debtor is an individual--*
>
> ***(A)*** *unless after notice and a hearing the court orders otherwise for cause, confirmation of the plan does not discharge any debt provided for in the plan until the court grants a discharge on completion of all payments under the plan;* . . . . § 1141(d)(5)(A) (emphasis added).

a) There is no minimum time period for a plan. Section 1129(a)(15)(B) requires distribution of not less than the debtor's PDI to be received during the five years beginning with the first plan payment "*or during the period for which the plan provides payments, whichever is longer.*" Thus, an individual chapter 11 debtor will typically receive a discharge after five years, after all plan payments are made.

b) The Code does not provide a maximum time limit for an individual chapter 11 plan:

(1) "Perhaps because of the lack of any time limit, there is nothing in Chapter 11 that is similar to the provisions of Chapter 13, which permit payments to be made to some creditors after the date of the final plan payment or an exception to the debtor's discharge to accommodate such ongoing payments. *See* 11 U.S.C. §§ 1322(b)(5),

1328, 1141(d)(5)." *In re Johnson*, 402 B.R. 851, 853 (Bankr. N.D. Ind. 2009).

(2) The *Johnson* court found the time limit to be "potentially unlimited":

"Although this debtor's plan will only last for five years, and some plans may be completed in a matter of months, . . . it is easy to imagine a Chapter 11 plan that could last for decades. All it would take for that to happen is for a debtor to have a 20 to 30 year home mortgage (something that is not at all unusual) and for the confirmed plan to provide that the mortgage debt will be paid according to its terms. . . . In Chapter 11 the payments under such a plan would not be completed, and the debtor would not be entitled to a discharge, until the mortgage debt was fully satisfied-20 to 30 years hence." *Id.* at 855.

2. **Early Discharge** – subsection (5)(A) contemplates an early discharge in its use of the qualifying phrase "unless . . . the court orders otherwise for cause".

a) The Code does not specify what might constitute cause.

b) Instead, a flexible, case-by-case evaluation is required.

c) One court found *Johnson's* above-described "potentially unlimited" time limit to be a "patently unreasonable result." *In re Belcher*, 410 B.R. 206, 218 (Bankr. W.D. Va. 2009). *Belcher* found that it would be more reasonable to find that cause existed for granting a discharge after completion of the five years of payments to general unsecured creditors but before completing payments on long-term educational loans and mortgage obligations.

"[This would] protect[ ] those creditors whose interests are impaired by the confirmed plan without endangering the interests of those creditors not needing such protection." *Id.*

3. **Hardship Discharge** – subsection (5)(B) provides that

(B) *at any time after the confirmation of the plan, and after notice and a hearing, the court may grant a discharge to the debtor who has not completed payments under the plan if—*

(i) *the value, as of the effective date of the plan, of property actually distributed under the plan on account of each allowed unsecured claim is not less than the amount that would have been paid on such claim if the estate of the debtor had been liquidated under chapter 7 on such date; and*

(ii) *modification of the plan under section 1127 is not practicable; . . . .*

§ 1141(d)(5)(B) (emphasis added).

Note that this "not practicable" standard may be significantly less burdensome than the "hardship" discharge provisions of § 1328(b)(1), which requires a "failure to complete [plan] payments . . . due to circumstances for which the debtor should not justly be held accountable"—i.e., beyond the debtor's control.

4. **Scope of Discharge – Narrower than Chapter 13 Discharge** - § 1141(d)(2) provides that

> *(2) A discharge under this chapter does not discharge a debtor who is an individual from any debt excepted from discharge under section 523 of this title.*

Because this provision exempts the entirety of § 523 from discharge, a discharge under chapter 11 is narrower than the discharge a chapter 13 debtor receives under § 1328(a). *See, e.g.*, *In re Schultz*, 2010 WL 3290492 *8 (Bankr. M.D. Fla. 2010) (J. Glenn) (not reported) (noting that a debt payable to a former spouse—ie., a debt which is not a DSO but otherwise falls within the meaning of § 523(a)(15)—is not dischargeable under § 1141(d)(2) but would be dischargeable under § 1328(a)).

5. **§ 1141(d)(5)(C) – Required Pre-Discharge Finding Regarding § 522(q)**

a) The three subsections for § 1141(d)(5) are written in the conjunctive. Thus, subsection (C) applies to all discharges of individual chapter 11 debtors.

b) Under this subsection (C), the court is required to find that (1) there is "*no reasonable cause to believe*" that § 522(q)(1) is applicable to the Debtor and (2) there is no pending proceeding "*in which the Debtor may be found guilty of a felony of the kind described in § 522(q)(1)(A) or liable for a debt of the kind described in § 522(q)(1)(B).*"

(1) Note that this does not require a felony conviction but merely a pending proceeding in which the debtor may be found guilty or liable.

(2) This finding should be made not more than ten days before the date of the discharge order. § 1141(d)(5)(C).

c) This chapter 11 provision mirrors the chapter 13 provision of § 1328(h).

E. **Other Post-Confirmation Issues**

1. **Administrative Closure – Avoiding Quarterly UST Fees**

a) For individual chapter 11 debtors, the monthly reporting requirements and especially the quarterly U.S. Trustee fees can be burdensome. *See e.g.*, *In re Johnson*, 402 B.R. 851, 854-57 (Bankr. N.D. Ind. 2009) (UST fees estimated to be paid over the 5-year life of the plan totaled $13,000 out of approx. $51,250—i.e., 25.4%—of the funds available for unsecured creditors and the UST).

b) One way around the 28 U.S.C. § 1930 requirements for quarterly fees is to (1) administratively close the case shortly after confirmation and then (2) reopen it after completing all plan payments but before requesting a discharge and entry of the final decree.

c) The most persuasive rationale for using this work-around solution is when minimizing the debtor's expenses—i.e., eliminating the ongoing quarterly UST fees—will result in a corresponding increase in payments to unsecured creditors.

(1) Originally the UST argued against this practice, claiming that

> "avoiding the U.S. Trustee's quarterly fees is not a sufficient reason to close the case prior to the debtor completing the plan payments, and that doing so will make it more difficult for creditors to monitor the debtor's activities and to take advantage of their opportunity to seek post confirmation modification of the plan, 11 U.S.C. § 1127(e), or, should the debtor fail to perform the plan, conversion or dismissal. 11 U.S.C. § 1112(b)(4)(N)." *Johnson*, 402 B.R. at 854.

(2) Recently, however, the UST has reversed its position and now will not object to an individual chapter 11 debtor's request to temporarily close a case.[10]

d) Statutory and Caselaw Authority

(1) Federal Rule of Bankruptcy Procedure 3022 provides that a court may close a case after a chapter 11 estate is "fully administered."

(i) While the Bankruptcy Code does not specifically define the term "fully administered," caselaw provides that a case must at the very least be "substantially consummated" in accordance with § 1101(2). That is, to say (1) all, or substantially all, of the property proposed to be transferred under a plan must have been transferred; (2) the debtor or the successor to the debtor must have assumed the debtor's business or management of all or substantially all of the property dealt with in the plan; and (3) distributions under the plan must have begun. *In re IDC Services, Inc.*, 1998 WL 547085 *3 (S.D.N.Y. 1998) (not reported) (citing 11 U.S.C. § 1101(2)).

(ii) Beyond substantial confirmation, "an estate cannot be fully administered while there are outstanding motions, contested matters, or adversary proceedings pending." *In re Kliegl Bros. Universal Elect. Stage Lighting Co., Inc.*, 238 B.R. 531, 546 (Bankr. E.D.N.Y. 1999).

(iii)In deciding whether to close a chapter 11 case, other factors frequently cited for a court to consider include "1) whether the order confirming the

[10] *See* Walter W. Theus, *Individual Chapter 11s: Case Closing Reconsidered*, Am. Bankr. Inst. J., Feb. 2010, at 1.

plan has become final and 2) whether deposits required by the plan have been distributed." *IDC Services*, WL 547085 at *3.

(2) <u>§ 350(b)</u> provides that "a case may be reopened in the court in which such case was closed to administer assets, to accord relief to the debtor, or for other cause."

(3) <u>Bankruptcy Rule 5010</u> provides that "[a] case may be reopened on motion of the debtor or other party in interest pursuant to § 350(b) of the Code."

e) <u>Procedures</u>

(1) <u>Closing the case</u>:

(i) When the confirmation order has become final and a confirmed plan has been both substantially consummated and fully administered (with the exception of the completion of all plan payments), a chapter 11 individual debtor may move to administratively close the case as long as

- All required filings and payments due to the UST are current, and all litigation has concluded except to the extent that the Court has retained jurisdiction over certain pending matters (e.g., an outstanding appeal); and
- Debtor's counsel verifies that to the best of counsel's knowledge, there are no outstanding issues that would preclude the administrative closure of the case.

(ii) Bankruptcy Rule 4006 requires the bankruptcy clerk of court to give notice to all parties in interest that an individual's bankruptcy case is closed without the entry of an order of discharge. This notice should "accurately reflect[ ] the status of the case and . . . not mislead creditors into believing they may pursue immediate collection of the full amount of their allowed claims."[11]

(iii) While administrative closure **will terminate the automatic stay pursuant to § 362(c)(2)(A)**, the provisions of the confirmed plan and confirmation order continue to bind the debtor, the creditors, and other parties in interest as set forth in § 1141(a).

(iv) Note that closing the case may adversely impact future modifications to a plan because § 1115(a)(1) and (2) define property of the estate to include post-petition property and earnings acquired "*after the commencement of the case but <u>before the case is closed</u>, dismissed, or converted, . . . whichever occurs first.*" (Emphasis added).

(2) <u>Reopening the case</u>:

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[11] Theus, *supra* note 10 at 63.

(i) Pursuant to § 350(b) and in accordance with Bankruptcy Rule 5010, the debtor, a creditor, or any other party in interest may bring a motion to reopen the case for cause.

(ii) Courts should require a debtor to attach a detailed accounting demonstrating completion of all payments called for under the plan and eligibility for discharge under § 1141(d)(5).

(iii) Parties in interest should be given sufficient time to object to a motion to reopen. Any objection should be treated as a contested matter under Bankruptcy Rule 9014.

(iv) The debtor retains the burden to demonstrate an entitlement to discharge.

f) Caselaw:

(1) *In re Ball*, 2008 WL 2223865 (Bankr. N.D. W.Va. 2008).

(2) *In re Belcher*, 410 B.R. 206 (Bankr. W.D. Va. 2009).

(3) *In re Sheridan*, 391 B.R. 287 (Bankr. E.D. N.C. 2008).

(4) *In re Johnson*, 402 B.R. 851 (Bankr. N.D. Ind. 2009).

(5) *In re Beyer*, 433 B.R. 884 (Bankr. M.D. Fla. 2009) (J. Jennemann).

(6) *In re Necaise*, 2010 WL 3294692 (Bankr. S.D. Miss. August 20, 2010) (slip copy).

2. **Plan Modification** - § 1127(e) provides that

e) *If the debtor is an individual, the plan may be modified at any time after confirmation of the plan but before the completion of payments under the plan, whether or not the plan has been substantially consummated, upon request of the debtor, the trustee, the United States trustee, or the holder of an allowed unsecured claim, to--*

(1) increase or reduce the amount of payments on claims of a particular class provided for by the plan;

(2) extend or reduce the time period for such payments; or

(3) alter the amount of the distribution to a creditor whose claim is provided for by the plan to the extent necessary to take account of any payment of such claim made other than under the plan.

a) § 1127(c) requires adequate disclosure consistent with § 1125.

b) Bankruptcy Rule 3019(b) governs the notice and hearing procedures required for modification of an individual chapter 11 debtor's plan.

c) Under § 1129(a)(15)(B), a plan's minimum payments are based on the "projected disposable income," which is determined at confirmation. (*See supra* section on "Minimum Plan Payments/Disposable Income Test.")

(1) Can a creditor successfully seek modification of a plan to recover actual income received in excess of projections?

(2) If so, under what circumstances would a court grant such a creditor's request? After all, under both the broad and narrow interpretations of the new exception to the absolute priority rule for individual chapter 11 cases, the debtor is permitted to retain excess post-petition earnings.

d) To date, the only reported cases modifying a confirmed plan under § 1127(e) have arisen in the context of hardship discharge and proposed administrative closure to avoid the quarterly UST fees.

3. Conversion or Dismissal - § 1112(b)(1) provides that

(b)(1) *[With certain exceptions], on request of a party in interest, and after notice and a hearing, absent unusual circumstances specifically identified by the court that establish that the requested conversion or dismissal is not in the best interests of creditors and the estate, the court shall convert a case under this chapter to a case under chapter 7 or dismiss a case under this chapter, whichever is in the best interests of creditors and the estate, if the movant establishes cause.* (Emphasis added.)

a) § 1112(b)(4) identifies a non-exhaustive list of what might constitute cause for conversion or dismissal. This list includes:

- Failure to maintain appropriate insurance. § 1112(b)(4)(C).
- Failure to comply with a court order. § 1112(b)(4)(E).
- Unexcused failure to satisfy timely any filing or reporting requirement. § 1112(b)(4)(F).
- Failure to attend the section 341 meeting or a Rule 2004 examination without good cause shown. § 1112(b)(4)(G).
- Failure to timely pay post-petition taxes owed or to timely file tax returns due post petition. § 1112(b)(4)(I).
- Failure to pay quarterly fees or other charges under chapter 123 of title 28. § 1112(b)(4)(K).
- Failure to pay any post-petition DSO. § 1112(b)(4)(P).

b) Conversion or dismissal is <u>mandatory</u> unless a court specifically finds and articulates the "unusual circumstances" under which the requested conversion or dismissal is "not in the best interests of creditors and the estate".

(1) *In re Blixseth*, 2009 WL 1525994 (Bankr. D. Mont. May 29, 2009) (not reported).

(2) *In re Kholyavka*, 2008 WL 3887653 (Bankr. E.D. Pa. Aug. 20, 2008) (not reported).

(3) *In re Bartle*, 560 F.3d 724 (7th Cir. March 31, 2009).

(4) *In re Tucker*, 411 B.R. 530 (Bankr. S.D. Ga. August 5, 2009).

II) OTHER COMPARISONS TO CHAPTER 13

A. <u>Incremental Fees and Reporting Requirements</u>

1. **Initial Filing Fees:** While the base filing fee for a individual chapter 13 case is currently $235, it increases to $1,000 for an individual chapter 11 case.

2. **Quarterly Fees:** Pursuant to 28 U.S.C. 1930(a)(6), all chapter 11 debtors, individual and non-individual alike, must also pay quarterly fees to the U.S. Trustee for each quarter (or fraction thereof) until the case is converted or dismissed. The fee starts at $325 and is based on the value of disbursements made during the quarter. The fee is due on the last day of the calendar month following the quarter's end.

3. **Monthly Reports:** All chapter 11 debtors, individual and non-individual alike, must file monthly operating reports pursuant to §§ 704(8), 1106(a)(1) and Fed. R. Bankr. P. 2015(a)(3).

> Monthly operating reports are much more than busy work imposed upon a Chapter 11 debtor for no reason other than to require it to do something. <u>They are the means by which creditors can monitor a debtor's post-petition operations</u>. . . . As such, their filing is very high on the list of fiduciary obligations imposed upon a debtor in possession. *In re Berryhill*, 127 B.R. 427, 433 (Bankr. N.D. Ind. 1991) (emphasis added and citation omitted).

4. **WARNING: Reports for Controlled Entities** - An individual chapter 11 debtor may be required to file periodic financial reports "of the value, operations, and profitability of each entity that is not a publicly traded corporation or a debtor in a case under title 11, and <u>in which the estate holds a substantial or controlling interest</u>." Fed. R. Bankr. P. 2015.3 (emphasis added).

B. Miscellaneous Differences

1. Pre-Petition Credit Counseling and Post-Petition Debtor Education--§ 109(h)(1)

a) Under both chapters, an individual debtor must receive credit counseling during the 180-day period preceding the petition date.

b) However, the post-petition debtor education course in personal financial management, a requirement before discharge under § 1328(g)(1), does not apply to the individual chapter 11 debtor, except in what appears to be a highly unlikely circumstance described in § 1141(d)(3).[12]

2. Chapter 11 Permits Involuntary Petitions – a Violation of the 13th Amendment?

a) Chapter 13 is exclusively voluntary, whereas chapter 11 permits involuntary petitions to be filed. *See* § 303.

b) Consider that:

(1) § 1115(a) includes post-petition income as estate property.

(2) § 1123(a)(8) requires an individual debtor's post-petition earnings to be used to fund the plan.

(3) An involuntary chapter 11 debtor cannot convert the case to another chapter.

(4) § 1121 provides that a dissatisfied creditor or other party in interest may file a competing plan of reorganization under certain circumstances.

(5) An involuntary chapter 11 debtor does not have an absolute right to dismiss the case.

c) The combination of these factors raises the argument that involuntary individual chapter 11 cases may be unconstitutional because they violate the Thirteenth Amendment's prohibition against involuntary servitude.

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[12] § 1141(d)(3) provides that "*the confirmation of a plan does not discharge a debtor if—*

(A) The plan provides for the liquidation of all or substantially all of the property of the estate;

(B) the debtor does not engage in business after consummation of the plan ; and

(C) the debtor would be denied a discharge under section 727(a) of this title if the case were a case under chapter 7 of this title." (Emphasis added).

§ 727(a)(11) prevents the court from granting the debtor a discharge if "*after filing the petition, the debtor failed to complete an instructional course concerning personal financial management.*" Because § 1141(d)(3) is written in the conjuctive, these two provisions combine to require an individual chapter 11 debtor to complete a postpetition educational course when the plan is a liquidating plan and the individual debtor does not "engage in business" after consummation of the plan—both are unlikely in an individual case. Otherwise, failing to complete the postpetition educational course will not prevent the individual chapter 11 debtor from obtaining a discharge.

3. Filing a Plan and Starting Payments

a) An individual chapter 13 debtor is required to file a chapter 13 plan within 14 days of the petition date. Rule 3015(b). The debtor must begin making payments within 30 days of the petition date. § 1326(a)(1).

b) There is no corresponding requirement that an individual chapter 11 debtor must file a plan at or near the petition date, and plan payments do not typically begin until after confirmation.

4. Supervision

a) The UST provides supervision in an individual chapter 11 case, and a chapter 11 trustee or examiner may be appointed with comprehensive duties. *See* §§ 1104(a) and 1106(a).

b) Compare this to a chapter 13 case in which a chapter 13 trustee is always appointed with limited duties. § 1302(a)-(b).

5. Creditors' Committee - Chapter 13 has none, while § 1102 provides for the appointment of an unsecured creditors' committee in an individual chapter 11.

6. Disclosure Statement - Chapter 13 does not require a disclosure statement.

7. Determination of Secured Status for Claims Secured by Personal Property

a) BAPCPA specifically directed that, for chapter 7 and chapter 13 cases, claims secured by personal property would be valued as secured to the extent of the property's replacement value—i.e. "retail valuation." §506(a)(2).

b) No such provision applies to chapter 11 cases.

8. "Hanging Paragraph" or "Anti-Cramdown" Provision for 910 Automobiles +

a) The "Hanging Paragraph" of § 1325(a) prohibits bifurcation of purchase-money secured claims for

(1) automobiles purchased within 910 days of the petition date and acquired for personal use, or

(2) other collateral of value when the debt was incurred within one year of filing.

b) This provision does not apply to individual debtors in chapter 11.

9. Pre-Petition Domestic Support Obligations ("DSOs")

a) BAPCPA changed the priority status for unsecured pre-petition DSOs. Under § 507(a)(1), DSOs now have first-position priority status. (Before BAPCPA, they had seventh-position priority status.)

b) In a chapter 13 case, within this first-position priority, a pre-petition DSO payable to or recoverable by the debtor's spouse, former spouse, or child (or such child's parent, legal guardian or responsible relative)—i.e., § 507(a)(1)(A) DSO—will have priority over a DSO that is owed to a governmental unit—i.e., a § 507(a)(1)(B) DSO, unless it has been voluntarily assigned to the governmental unit. *See In re Penaran*, 424 B.R. 868, 876 n. 31 (Bankr. D. Kan. 2010) (a chapter 13 case).

(1) In a chapter 13 case, this priority difference is significant because 1322(a)(4) allows modification to § 507(a)(1)(B) claims (as long as all of the debtor's 5-yr PDI is applied to plan payments), while § 507(a)(1)(A) claims cannot be modified. *Penaran* at 876.

(2) Chapter 11 does NOT, however, have a corresponding provision that treats subsection (B) claims differently from subsection (A) claims. Instead, § 1129(a)(9)(B), provides that all § 507(a)(1) claims can be deferred "*if such class has accepted the plan.*"

10. <u>The Effect of Conversion-- § 348(f)</u>

a) BAPCPA modified this section to clarify the treatment of post-petition income (i.e., whether it becomes property of the estate or reverts to the debtor) in a conversion from chapter 13 to chapter 7.

b) There is no similar clarifying provision for conversion from chapter 11 to chapter 7. Thus, there is some "uncertainty over how exactly to calculate the value of the hypothetical chapter 7 estate" in a chapter 11 case.[13]

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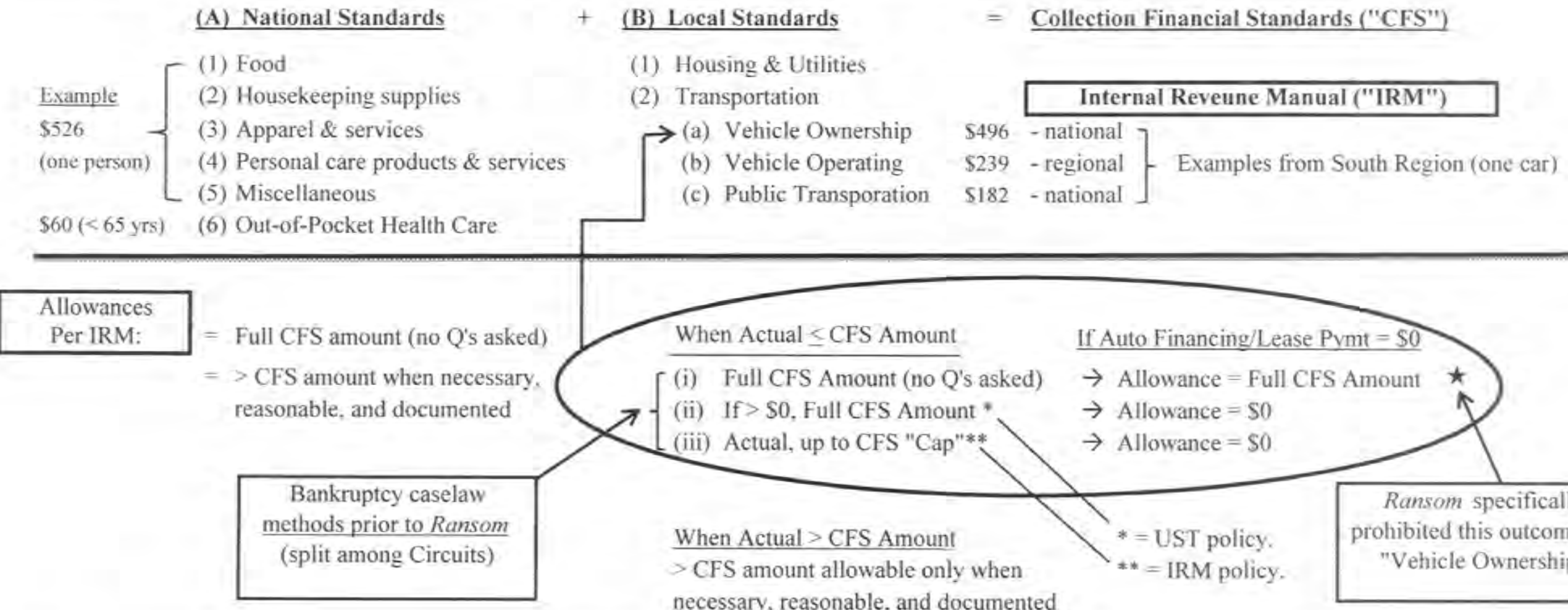
[13] Hon. Bruce A. Markell, *The Sub Rosa SubChapter: Individual Debtors in Chapter 11 after BAPCPA*," I U. Ill. L. Rev. 67, 75-92, 85 (2007).

Recent Developments in Consumer Cases

Honorable Michael G. Williamson
Terry L. Bryson, Esq.

"Applicable" Monthly Expense Allowances under § 707(b)(2)(A)(ii)



***Ransom v. FIA Card Services, N.A.*, 2001 WL 66438 (U.S., Jan. 11, 2011)**

- When debtor's vehicle financing/lease payment = $0, the allowable transportation expense deduction for vehicle *ownership* = $0. In other words, for (B)(2)(a) above, method (i) is disapproved if financing/lease payment = $0. Finance/lease payments are not, however, required for a debtor to deduct vehicle operating expense under (B)(2)(b) above.
- The Court did NOT decide between methods (ii) and (iii) for either *ownership* or *operating* expenses when financing/lease payment > $0. *(See FN 8)*
- "Although [§ 707(b)(2)(A)(ii)(I)] does not *incorporate* the IRS's guidelines, courts may consult this material in interpreting the National and Local Standards[,]" as long as the guidelines are not "at odds with the statutory language." *Id.* at *7 (emphasis added).

***Ransom*'s Effects and Implications**

- Ransom overrules all caselaw that utilized method (i) for vehicle *ownership* costs when financing/lease payment = $0. (*e.g.*, In re *Ross-Tousey*, 549 F.3D 1148 (7th Cir. 2008); *In re Kimbro*, 389 B.R. 518 (B.A.P. 6th Cir. 2008); *In re Bentley*, 400 B.R. 848 (Bankr. M.D. Fla. 2008)).
- Since the IRM specifically states that "taxpayers are allowed the standard amount for housing and utilities or the amount actually spent, whichever is less[,]" under *Ransom*, debtors who have no mortgage, rental, or utility payments at the time of filing bankruptcy may not be able include these costs as allowable Housing and Utilities deductions.
- As Justice Scalia's dissent points out, the majority's claim to "not really incorporate the IRM" is probably making a distinction without a difference. Practitioners may want to maintain a copy of the IRM on their desktop and utilize it whenever it does not explicitly conflict with the Bankruptcy Code.