

Consumer:
**Confirming an Individual
Chapter 11 Plan for the
High-Net-Worth Individual**

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Edge of the Black Chest: An Individual Chapter 11 Fact Pattern

Hector B. Rossa (“HB”) is a financial consultant and artist (d/b/a Black Chest Creations and Dead Women’s Pearls) who has who you know from several restructuring deals. HB is the 100% owner of Calipso Enterprises PSC (“PSC”), a financial advising service that employs five people. HB is married to Mary Clung and has two sons, Jocard and James. Mary makes \$200,000 a year as a fashion consultant.

Unfortunately, an investment by HB in Isle De Mortra Spa Inc. (“Isle”) went bad due to the apparent fraud by the island’s owner, Charlie “Lord” Beckett (“Beckett”). HB financed his investment with a personal guarantee of Isle’s \$6,000,000 mortgage and the pledge of a \$2,000,000 CD, owned by PSC, to Isle’s secured lender, Aztec Ltd. Bank (“Aztec”). PSC also guaranteed the Aztec Debt. Isle is totally under water and it has no assets to satisfy the Guaranteed Debt.

HB works for PSC as a financial advisor full time. Due to a mix up by PSC’s non-bankruptcy counsel, Rageatti and Pintel (“R&P”), HB does not have any form of employment contract with PSC, although he thought he had a contract and has been paid \$75,000 per month for his services.

At the present time, both HB and PSC are insolvent by about \$4,000,000 due primarily to the Aztec Debt when using a fair market value of their assets. However HB and PSC’s future prospects are good due to new business which HB is confident he can bring in to PSC. There is also a reasonable chance that a lawsuit against Beckett could bring in significant money.

As you note, \$1.1 million of the ABC Bank debt and all of the guaranteed Isle debt are owed both by HB and PSC. PSC also has a 10-year lease on its offices with Norington Properties.

HB and PSC have the following monthly income and expenses (averaged for past 12 months).

	HB Monthly Income	PSC Monthly Income
("Base Salary")	\$75,000	
Bonus	\$10,000	
Business Income		\$225,000
Other Income	\$10,000 (art sales)	\$200,000 ("Success fees")
Total Income	\$95,000	\$425,000

	HB Expenses Family Living Expense all paid by HB
Food	\$8,000
Auto	\$3,000
Country Club Dues	\$2,000
Mortgages	\$12,000
Credit Cards	\$18,000
Misc. Household Expenses	\$5,000
Private Schools	\$8,000
Insurance	\$8,000
Taxes	\$27,000
Total	\$91,000

	PSC Expenses Business Expenses
Office Rent	\$80,000
Furniture and Equipment Rent	\$60,000
Salaries Bonus Benefits & Withholding	
HB	\$85,000
Other Employees	\$110,000
Interest Expense	\$25,000
Other Business Expenses	\$60,000
Total	\$420,000

HB and PSC just lost the Aztec lawsuit two days ago and were denied a stay of execution pending appeal. Both HB and PSC need to file bankruptcy to protect against aggressive garnishments by Aztec's law firm Turner & Swan (T&S).

HB's business is highly variable with earnings dependent on the market and HB's referral network. HB's art business, gold jewelry, is very stable and could expand if HB did more work on it.

QUESTIONS

1. The PSC's business is almost exclusively due to HB's reputation. HB wants your firm to represent both himself individually and PSC in their prospective Chapter 11s. While HB believes there is an identity of interests between him and PSC, there is the contract issue between PSC and HB concerning HB's services. Can you represent both HB and PSC in their Chapter 11s? Can you represent both prior to Bankruptcy and then get separate counsel for one of them when they file?

2. HB asks you if there is any exemption planning you can do for him. He notes that he lives in Florida and he knows there are several exemptions available. Specifically he would like to sell his vacation home and use the \$500,000 in equity to pay down the debt on his residence. Can you advise him on these issues and still be his counsel in an individual Chapter 11 case?

3. HB does not want to reduce any of his living expenses. On the second day of his bankruptcy, Aztec files a motion to limit HB's living expenses to the \$12,000 in mortgage payments, his taxes of \$27,000 and \$10,000 for all other expenses. Concerning this motion:

(a) Can you represent HB in opposing this motion assuming you are bankruptcy counsel in HB's individual Chapter 11?

(b) Assuming you can represent HB concerning this motion, what should you advise HB to do in his Chapter 11 concerning his expense situation? What about his wife's income?

4. Swallow Enterprises ("Swallow") approaches HB and PSC and offers to purchase all of PSC assets through a plan, which will pay all of HBs and PSC's unsecured debts under two conditions:

- HB agrees to work for \$500,000 per year (plus some bonuses, for five years for Swallow under a detailed employment contract with Swallow Enterprises;
- HB agrees to a 5-year non-compete as part of his employment contract; and

- At least three of the four PSC contracts agree to continue their contracts with Swallow.

(a) Assuming the best plan HB and PSC can propose in their Chapter 11s is a 75% payment over 5 years to unsecured creditors, can you recommend that HB oppose the offer? Assuming HB is against the offer, can you oppose the offer in his bankruptcy case?

(b) HB tells you that all four PSC contracts have agreed to hire HB individually and purchase his secured debt if he agrees to convert his Chapter 11 case and the PSC Chapter 11 case to Chapter 7s and discharge their unsecured debts. HB thinks this will save him a lot of money. What can you do as individual Chapter 11 Counsel on this matter?

(c) Assume that HB in fact has a valid employment with a non-compete with his PSC and Swallow offers to purchase the PSC and pay off all of HB's and the PSC's unsecured creditors if HB agrees to an assumption of his contract with the PSC. Does HB have to agree to that transaction to meet his fiduciary duty to his creditors? If he refuses to agree to the assumption of his contract, would that be grounds for conversion or dismissal of the Bankruptcy cases? Ground for the appointment of a Bankruptcy Trustee?

5. HB wants to sue Beckett for fraud, seeking \$10,000,000 in damages. After six months of discovery, Beckett offers \$2,000,000 to settle the law suit, payable to Aztec. Aztec has agreed to forgive the rest of its debt with HB and PSC for the \$2,000,000 payment from Beckett.

(a) Assuming the offer is reasonable from a litigation stand point, what do you have to advise HB concerning this offer?

(b) Assuming the offer is properly rejected, what are HB's obligations to Aztec as a fiduciary during the appeal of their judgment?

6. HB takes eight weeks of vacation each year. If he worked on his jewelry business four more weeks per year instead of traveling, his monthly expenses would go down \$5,000 per month on average and his monthly income would go up \$10,000 on average. What advice should you give HB concerning this duties to maximize earnings for the estate?

Absolute Bankruptcy:¹ Ethical Issue Arising From the Application of the Absolute Priority Rule in Individual Chapter 11 Cases

As the readers of this column know, the challenges of representing an individual Chapter 11 debtor are many, especially after the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”).² Recently, split of authority on the issue of what impact the changes made by BAPCPA concerning the definition of what constitutes property of an individual Chapter 11 debtor’s bankruptcy estate and the requirements for confirmation of an individual’s Chapter 11 plan in a “cram-down,”³ has raised new questions in this area.

A. Distilling the Bourbon: The Absolute Priority Rule in General

The absolute priority rule of the Bankruptcy Code is codified in 11 U.S.C. § 1129(b)(2)(B) and as noted by the Supreme Court, “The absolute priority rule provides that a dissenting class of unsecured creditors must be provided for in full before any junior class can receive or retain any property [under a Chapter 11] plan.”⁴ This rule applied in individual⁵ Chapter 11 cases prior to BAPCPA.⁶

B. Bottling the Product: The Changes Made By BAPCPA

As discussed in Ghost I, and Ghost II,⁷ two of the most important changes made to BAPCPA were the addition of 11 U.S.C. § 1115 and the modifications made to 11 U.S.C. §§ 1123 and 1129. 11 U.S.C. § 1115 provides:

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

(1) 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, 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. [emphasis added]

¹ No, this is not an ad for a famous beverage, just another failed attempt at humor.

² See Bowles, Ghosts of Individual Chapter 11 debtors (Part 1), 25 ABIJ 46 (Dec/Jan 2007) and Schaaf, Stosberg and Bowles, Ghosts of Individual Chapter 11 debtors (Part 2); 26 ABIJ 36 (February 2007) (“Ghosts Part II”).

³ Cram-down is used to refer to non-consensual confirmations of Chapter 11 Plan. See In re Shat, 424 B.R. 854 (Bankr. S.D. Ohio 2010).

⁴ Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 202 (1988).

⁵ See Section E of this article for a discussion whether the absolute priority rule prevented an individual Chapter 11 debtor to retain exempt property.

⁶ See In re Walsh, 447 B.R. 45, 47 n. 9 (Bkrcty. D. Mass. 2011); In re Shat, 424 B.R. 854, 858 (Bankr. S.D. Ohio 2010).

⁷ See Ghost I at 98-99 for a discussion of 11 U.S.C. § 1115 issues and Ghost II at 36-37, and 74 for discussions of 11 U.S.C. § 1129 changes.

This provision makes all of the debtor's income earned from a job or "services performed" after a Chapter 11 is commenced to be property of the estate.⁸

11 U.S.C. § 1123(a)(8) which sets forth mandating Chapter 11 plan provisions was modified to read:

in a case in which the debtor is an individual, provide for the payment to creditors under the plan of all or such portions 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.

11 U.S.C. § 1129 was modified in Section (b)(2)(B)(ii) to read:

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 section 1115*, subject to the requirements of subsection (a)(14) of this subsection 6.⁹

Finally, 11 U.S.C. § 1129(a)(15) reads:

In a case in which the debtor is an individual and in which the holder of an allowed unsecured claim objects to the confirmation of the plan—

(A) the value, as of the effective date of the plan, of the property to be distributed under the plan on account of such claim is not less than the amount of such claim; or

(B) the value of the property to be distributed under the plan is not less than the projected disposable income of the debtor (as defined in section 1325() (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.

The critical question raised by these modifications to the Bankruptcy Code was whether they eliminated the absolute priority rule for property in individual Chapter 11 cases.

⁸ See Ghost I at 98-99 addressing issues arising from this broad definition.

⁹ 11 U.S.C. § 1129(a)(14) relates to a Chapter 11 debtor's requirement to keep all DSO obligations current is not directly relevant to the absolute priority issues which arise in most cases.

C. Smashing the Costs: The Broad View of 11 U.S.C. § 541

Perhaps the earliest reported decision to address the issue of whether the BAPCPA changes abrogated the absolute priority rule was In re Ballard, 358 B.R. 541 (Bkrtcy. D.Com. 2007). In this case, the Court reviewed the new language of 11 U.S.C. § 1129(b)(2)(B)(ii) which allowed the debtor to retain property post-confirmation in violation of the traditional absolute priority rule, as well as the language of 11 U.S.C. § 1115 and concluded that the property covered by Section 1115 included the post-petition earning from services performed by the debtor, as well as all of the property covered by 11 U.S.C. § 541.

The Court made this decision based primarily on what it found to be the natured meaning and language of these provisions.¹⁰

Perhaps the most detailed opinion adopting the broad view of 11 U.S.C. § 1115 in In re Shat, where the Court went through a detailed review of the legislative history of the BAPCPA provisions of an individual Chapter 11 found that the abrogation of the absolute priority rule in, although done in a “convoluted manner,” was the most rational reading of the statute and was consistent with a perceived move to make individual Chapter 11s more like Chapter 13s and had to be applied in a broad plain reading manner.

D. Carefully Removing the Cork and Pouring. The Narrow View of the Scope of 11 U.S.C. § 1115

Recently, however, the “broad view” of 11 U.S.C. § 1115 has been rejected by an increasing number of courts for a variety of reasons.

First, Courts have said that reading 11 U.S.C. § 1115 as covering all of a debtor’s assets, is unnecessarily broad as 11 U.S.C. § 1115 only adds a debtor’s post-petition earnings to the debtor’s estate and incorporates the property covered by 11 U.S.C. § 541 for completeness.¹¹

They hold, unlike the broad reading cases, that reading 11 U.S.C. § 1115 narrowly to include only post-confirmation earnings from personal services of an individual Chapter 11 debtor does not make the reference to 1115 in 11 U.S.C. § 1129 meaningless. As the Court, in In re Gelin¹² noted, this provision allows an individual to use post-confirmation earnings (subject to plan and confirmation requests) to pay living expenses post-confirmation.

Second, many courts, including the broad view Shat court, have noted that if Congress wanted to eliminate the absolute priority rule in individual by this legislation, the structure of 11 U.S.C. §§ 1115 and 1129 was an awkward and strange way to do so.¹³ These courts note that the

¹⁰ 358 B.R. at 545.

¹¹ See e.g., In re Kamell, ___ B.R. ___ 2011 WL 1760282 (Bkrtcy. C.D. Cal. 2011); In re Stephens, 445 B.R. 816, 820-21 (Bkrtcy. S.D. Tx. 2011) (finding a broad reading of 11 U.S.C. § 1115 would make 11 U.S.C. § 541 mere surplusage).

¹² 437 B.R. 435, 442 (Bkrtcy. M.D. Fla. 2010).

¹³ See In re Maharaj, 2011 W. 1753795 (Bkrtcy. E.D. Va. 2011).

Supreme Court has frequently and consistently held that Congress does not make major changes to existing bankruptcy practice without a clearly manifested intent or clear statutory language.¹⁴

Finally, and most honestly, as noted by the Court in *In re Gbadebo*,¹⁵ almost all the amendments made by BAPCPA were designed to place greater restrictions on individual Chapter 11 debtors, stating: “Each one of these new provisions appears designed to impact greater burdens on individual Chapter 11 debtors’ rights so as to ensure a greater payout to creditors.” The Court concluded that, “No one who reads BAPCPA as a whole can reasonably conclude that it was designed to enhance the individual debtor’s ‘fresh start’.”

For these reasons, the narrow view line of cases has slowly become a slight majority position on the issues of the absolute priority rule in individual Chapter 11 cases.¹⁶ We now address the ethical issues related to the absolute priority rule in individual Chapter 11 cases. Unlike the movie referenced to above, you have not missed anything.

(1) Good Faith

The initial and overriding issue is whether an attorney¹⁷ can, in good faith, propose a plan for an individual Chapter 11 which does not propose to pay all creditors 100% on their claims and still have the debtor retain ownership interests in their property. In at least the Ninth Circuit, the answer may be, no.

In the pre BAPCPA case of *In re Perez*,¹⁸ the Ninth Circuit refused to affirm the confirmation of an individual debtor’s Chapter 11 case which proposed to pay all creditors in full over a 67-month period, but without interest. They did so even though the sole creditor which voted against the plan (and caused a class to vote against the plan), but who never filed an objection before the Bankruptcy Court to confirmation based on the absolute priority rule.¹⁹

The *Perez* court went further, stating, *in dicta*

[W]e are most disappointed in the estate’s counsel, who is responsible for proposing and seeking confirmation of these failed plans. . .

¹⁴ See *In re Kamell*, 2011 WL 176282 at *3 and cases discussed therein; see also *Norwest Bank Worthington v. Ahlers*, 485 U.S. at 211 (noting that when Congress enacts a new law, it can normally be presumed to know the interpretations of law made under the prior statutes.)

¹⁵ 431 B.R. at 229.

¹⁶ This trend will likely continue in light of a recent, Court of Appeals decision, *In re Lett*, 632 F.3d 1216 (11th Cir. 2011) concerning a pre BAPCPA individual Chapter 11 case, where the Court of Appeals ruled that the absolute priority rule applied in individual Chapter 11 cases, even though this issue was not preserved on appeal.

¹⁷ The author understands there is a great deal of controversy regarding the debtor’s duty and the duty of counsel for the debtor, but thankfully, that issue is beyond the scope of this article. We will therefore assume for purposes of this article that the debtor has a fiduciary duty to the debtor’s bankruptcy estate.

¹⁸ 30 F.3d 1209 (9th Cir. 1994).

¹⁹ *Id.* at 1214. See also *In re Lett*, 632 F.3d at 1216 (allowing absolute priority objection to first be raised on appeal).

He has defended Plan 111 on appeal before the BAP and before us despite what appears to have been his clear understanding that the [absolute priority rule] was not satisfied.²⁰

Therefore, if the narrow view of 11 U.S.C. § 1115 prevails and there is no exception to the absolute priority rule,²¹ counsel will have to carefully consider the impact of these decisions.²²

(2) Is there a future income problem under Ahlers?

Although not an issue which has been addressed by a court, an interesting question arises as to whether Ahlers prohibition against “sweat equity plans” has (or could) be overruled by 11 U.S.C. §§ 1123(a)(8) and 1129(a)(15), which requires debtors, at least over a 5-year income, to distribute their projected disposable income for that period under a plan.

Ahlers, in part, found that new value, in the form of future services, could not be new value on constitutional grounds as well as an interpretation of the absolute priority rules of the Bankruptcy Code. As Congress now requires future income be paid, could a debtor propose a confirmable plan under the new value exception to the absolute priority rule? This is an issue attorneys will have to consider.

(3) Is a debtor’s exempt property subject to the Absolute Priority Rule?

An interesting issue, which presents numerous problems to debtor’s counsel is whether a debtor can keep exempt property under a “cram-down” Chapter 11 plan. The case of In re Gosman²³ held that even though exempted from the claims of creditors, exempt property was estate property and covered by the absolute priority rule. This meant, among other things that a debtor could not attempt to use a contribution of exempt property as new value.

However, a majority line of case law seems to be developing that exempt property is not subject to the absolute priority rule requirement that the individual debtor cannot keep any interest in property unless all senior creditors are paid in full. This position is best set forth by the narrow view court of In re Steedly,²⁴ where the court held:

An individual debtor’s ability to claim exemptions under § 522 exists for individual chapter 11 debtors. *In re Henderson*, 321 B.R. [550, 558 (Bkrcty. M.D. Fla. 2005)] (citing 11 U.S.C. § 1123(c)). “Once [a debtor’s] exemptions are allowed the [property is] no longer part of the [d]ebtor’s estate, and the [d]ebtor does not retain property on account of such interest because he retains it as a matter of right by virtue of recognition of his right to exemptions.”

²⁰ Id at 1219 n. 14. (However, please review this footnote as the assertion of the estate counsel’s knowledge is somewhat weak).

²¹ Indeed, the Shat court discusses whether it is possible to propose or confirm a non-consensual plan that pays creditors less than the present value of their allowed claims. In re Shat, 424 B.R. at 858.

²² In light of the problems creditors faced in Perez and Lett, it is better practice for creditors to both vote against and objects to plans to have absolute priority issue considered.

²³ 282 B.R. 45 (Bkrcty. S.D. Fla. 2002).

²⁴ 2010 WL 3528599 (S.D. Ga. 2011).

Id. at 559. A debtor's interest in exempt property can therefore never be junior to the interest of an unsecured creditor because unsecured creditors cannot reach exempt property. *Id.* at 560. A debtor may thus retain exempt property without violating § 1129(b)(2)(B)(ii). *Id.* at 561; *In re Ballard*, 358 B.R. 541, 544-45 (Bankr.D.Com. 2007).

E. Conclusion

Representing an individual Chapter 11 debtor has always been a daunting task. The recent decisions construing the absolute priority rule plus the dicta of Perez may, however, move these challenges to the realm of near impossibility as always only time will tell.

Ghosts of Individual Chapter 11 Debtors: Ethical Issues in Representing Debtors in Individual Chapter 11s under BAPCPA: Part I

Citation:

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Journal Article:

This article honors (or dishonors) one of bankruptcy's greatest pieces of literature, *A Christmas Carol*, by Charles Dickens.¹ Early in the story, one of the most famous individual debtors in history, Jacob Marley, the former partner of Ebenezer Scrooge, is featured as a chained ghost, forever paying for the "debts" he incurred in life. This month's article addresses the ethical and practical pitfalls in representing individual debtors in chapter 11 cases under Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA).²

Ghosts of Debtors Past: Credit Counseling for Individual Chapter 11 Debtors

Section 109 of the Code establishes the criteria for becoming a debtor in a bankruptcy proceeding. Each chapter (*i.e.*, 7, 11, 12 or 13) has different standards for eligibility. "One of the primary amendments enacted by BAPCPA was a new eligibility requirement for individual debtors." *In re Dixon*, 338 B.R. 383, 386 (8th Cir. BAP Mo. 2006); *see* 11 U.S.C. §109(h).

Section 109(h)(1) of the Code provides:

Subject to paragraphs (2) and (3), and notwithstanding any other provision of this section, an individual may not be a debtor under this title unless such individual has, during the 180-day period preceding the date of filing of the petition by such individual, received from an approved nonprofit budget and credit counseling agency described in §111(a) an individual or group briefing (including a briefing conducted by telephone or on the Internet) that outlined the opportunities for available credit counseling and assisted such individual in performing a related budget analysis.

During the one year period since BAPCPA became effective, many courts have addressed §109(h). *See Dixon*, 338 B.R. at 386 (specifically, §109(h) states that, as a general rule, all individual debtors must receive an appropriate briefing during the 180 days preceding the date of filing).³

While most of the cases address the credit counseling requirement in the context of chapter 7 and 13 cases, §109(h) does not except chapter 11 debtors from its requirements.⁴ Chapter 11 and 12 cases have also been dismissed due to a debtor's failure to comply with §109(h).⁵ The courts deciding these cases followed the same line of reasoning in the consumer cases cited *supra*, and dismissed them because the individual debtors did not obtain proper credit counseling.⁶

The failure to obtain credit counseling is a fatal flaw unless the debtor can satisfy one of two exceptions or an exemption in §109(h)(2), (3) and (4), respectively. *See In re Hedquist*, 342 B.R. 295 (8th Cir BAP 2006) ("[T]he requirements of §109(h) are mandatory; failure to meet them is a 'fatal flaw' rendering an individual debtor ineligible for bankruptcy relief" (footnote omitted)).

These exceptions or the exemption exist if the debtor cannot complete the credit counseling requirement because: (1) the U.S. Trustee has determined that the credit counseling agencies for an entire district "are not reasonably able to provide adequate services" for the district (11 U.S.C. §109(h)(2)(A)); (2) the debtor is granted a temporary deferral by the court due to exigent circumstances (11 U.S.C. §109(h)(3)); or (3) the debtor is incapacitated, disabled or in active military duty in a defined combat zone (11 U.S.C. §109(h)(4)).⁷ Subsections (h)(2) and (h)(4) are objective, so courts should have little difficulty determining whether a debtor satisfies their criteria. Subsection (h)(2) requires that the Office of the U.S. Trustee formally determine that credit counseling is not sufficiently available throughout the district. This occurred in areas ravaged by Hurricane Katrina.⁸ Under subsection (h)(4), the requirements for incapacity and disability are set out in the statute, and military duty in a war zone seems relatively easy to prove.

Therefore, the cases that address §109(h) discuss the exception for exigent circumstances in §109(h)(3). Section 109(h)(3) has two subjective prongs and one objective prong. *See Talib*, 335 B.R. at 421. "The subjective tests require that the court find that

there are exigent circumstances that 'merit a waiver'...and that the certification is 'satisfactory to the court.'" *Id.*; *see also* 11 U.S.C. §109(h)(3)(A). "The objective requirement is that the certification allege that the debtor requested credit counseling prior to the filing of the petition from an approved agency but was told that the services would not be available for more than five days subsequent to the date of the request."⁹

Most cases addressing §109(h)(3) were filed to prevent some imminent harm, such as a foreclosure sale. This argument is persuasive in some jurisdictions, but not others. *See, e.g., In re Hedquist*, 342 B.R. 295 (8th Cir. (BAP) (insufficient); *In re Burrell*, 339 B.R. 664 (Bankr. W.D. Mich. 2006) (sufficient); *In re Dixon*, 338 B.R. 383 (8th Circuit BAP) (insufficient); *In re DiPinto*, 336 B.R. 693 (Bankr. E.D. Pa. 2006) (insufficient).

A further requirement is that the court must accept the arguments in the certification. 11 U.S.C. §109(h)(3)(C). Although this section seems to mimic the requirement that the exigent circumstances "merit waiver" in subsection (h)(3)(A), one court recognized that under general rules of statutory construction, the court must give it meaning if possible.¹⁰ The court, therefore, concluded that this subsection indicated Congress intended for the bankruptcy court to use its discretion when deciding issues under §109(h)(3).

It is also important to recognize that the exigency exception is only a temporary solution for the debtor. Unlike the subsection (h)(4) permanent exemption, a subsection (h)(3) exception requires credit counseling within 30 days, with one 15-day extension if allowed by the court. In *Burrell*, the debtor's failure to "cure" his or her lack of credit counseling within this period appeared to have some relevance in the court's refusal to recognize the exception. *Burrell*, 339 B.R. 666-67.

Recognizing that the statute makes pre-bankruptcy counseling mandatory except in the very restrictive circumstances discussed previously, the individual chapter 11 debtors in *Hedquist* and *Watson* argued that the statute violated their constitutional right to equal protection and due process.¹¹ These arguments were rejected because the credit counseling obligation did not violate any fundamental right and was not devoid of a rational justification. *Id.* In fact, the court found the requirement "was well within the policy judgment of the legislature." *Hedquist*, 342 B.R. 300; *Watson*, 332 B.R. at 747.

Another failed attempt to avoid dismissal for lack of credit counseling involved an argument of excusable neglect.¹² The bankruptcy court discussed the requirements for excusable neglect, but would not grant relief from the dismissal order because the debtors could not prove they could satisfy the criteria of §109(h)(3). *Id.* at 880.

The conclusion of the court in *In re Cleaver*¹³ accurately describes the conclusions of the courts addressing §109(h): "Pursuant to the newly enacted changes to the Bankruptcy Code, an individual must receive credit briefing prior to filing for bankruptcy protection, or he must submit a certification to the court describing exigent circumstances and detailing the unavailability of the credit briefing during the five days after requesting it."¹⁴ Therefore, chapter 11 attorneys must ensure compliance with these provisions to ensure that a chapter 11 case will not "die" shortly after its inception.

Ghosts of Debtors Present: Ethical Issues for Lawyers

As debtors' attorneys know, or should know, the vast majority of courts have held that counsel for chapter 11 debtors represent the bankruptcy estate¹⁵ and not the principals of the debtor.¹⁶ While representing your actual client in a corporate chapter 11 case is difficult, representing a debtor's bankruptcy estate in an individual chapter 11 is almost an out-of-body experience. As noted by one of the leading scholars in bankruptcy ethics, Nancy Rapoport:

Representing a corporation can present numerous problems for estate counsel, but representing individual debtors in chapter 11 is even trickier: "The complex fiduciary duties of a chapter 11 debtor-in-possession and its counsel can become even more confused when the debtor(s)-in-possession are individuals." Obviously, there is the metaphysical challenge of realizing that the human who hired you to file his chapter 11 petition is not your client in the bankruptcy case. Even though it's fairly easy, at least in theory, to understand that the president of a corporation or the managing partner of a partnership is not your client when you are representing the business entity itself, it stretches the bounds of legal fiction to comprehend the difference between the bankruptcy estate of an individual (your client) and the individual himself (not your client).

Rapoport and Bowles at 70-71. Two key issues—(1) the individual debtor's fiduciary duty to creditors and (2) new 11 U.S.C. §1115—make the challenges facing debtors' counsel and the individual chapter 11 debtors themselves especially challenging.¹⁷

What Am I To Do, Spirit?: An Individual Debtor's Duties

One of the most difficult concepts chapter 11 debtors have to grasp when they file their bankruptcy is that they owe a fiduciary duty to their creditors¹⁸ to act in the best interests of their bankruptcy estate.¹⁹ Courts have universally held that individual chapter 11 debtors owe these duties just like other debtors-in-possession (DIPs).²⁰ This means the individual chapter 11 debtor must generally put the interests of his creditors ahead of his or her own interests and must actively work to benefit a bankruptcy estate even when that would disadvantage the individual himself. Two cases demonstrate the issues that may arise when this standard is applied.

In the case of *In re Bowman*,²¹ a chapter 7 debtor objected to the trustee's settlement of a lawsuit for an amount which would pay the debtor's creditors in full but not produce any distribution to the debtor.²² The debtor exercised her right²³ to convert her case to a chapter 11 proceeding. The court granted the debtors' motion but immediately re-converted the case to a chapter 7 proceeding, finding the debtor's insistence on further litigation of her claim was a violation of her fiduciary duty as a chapter 11 DIP. The *Bowman* court held:

Likewise, in this case when debtor must weigh whether to accept a prompt settlement that would substantially pay her creditors or to wait and gamble on a potential to receive a greater recovery, her creditors' interests have a higher priority than the debtor's own; and they must take precedence. Debtor's own statement that she "intends to proceed with litigation, through trial," indicates her unwillingness to examine other interests above hers. But there is more to the conflict than mere unwillingness, it is an inherent conflict of interest between her duty as a fiduciary to the estate and her desire to maximize the amount of money she may recover for herself.²⁴

In a similar fashion, the court in *In re Tel-Net Hawaii Inc.*²⁵ removed the DIP who was the corporation's controlling shareholder due to its failure to pursue preference actions that would have increased its exposure on guaranteed debts.²⁶ The court found that in light of the conflicting interests of its controlling shareholder, an independent trustee had to be appointed.

Therefore, attorneys must be careful to advise potential chapter 11 debtors of the full ramifications of a chapter 11 filing. Further, they must do this while being unable to give the individual (not in his role as DIP) advice as to how he or she could improve their financial condition at the expense of the estate.²⁷

If You're Quick, I Will Give You Half a Crown (with Court Approval): 11 U.S.C. §1115

Section 1115²⁸ of the Code, added by BAPCPA, radically changes the definition of what constitutes property of the estate. Its most important provision is that an individual's "earnings from services preferred" after the commencement of the case, but before the case is closed, constitute property of the estate.

Prior to the enactment of 11 U.S.C. §1115, courts were bitterly divided as to what portion, if any, of an individual debtor's post-petition earnings were property of the estate under 11 U.S.C. §541. A majority of courts held that under the earnings exception of 11 U.S.C. §541(c), post-petition earnings of a debtor were not property of the estate.²⁹ However, a sizeable minority of courts found that at least a portion of post-petition profits generated by professionals and sole proprietors were not earnings subject to the §541(a)(6) exception³⁰ and therefore were property of the individual chapter 11's bankruptcy estate.

While 11 U.S.C. §1115 resolves this split of authority, it leaves unanswered several practical questions of how an individual chapter 11 debtor obtains final authority to pay his or her personal living expenses and the expenses of his or her family during the bankruptcy.

The initial question confronting individual chapter 11 debtors and their counsel is whether an individual debtor's "living expenses" can be paid as ordinary-course-of-business expenses under 11 U.S.C. §363(c)(1)³¹ and 11 U.S.C. §1108³² or notice and a hearing under 11 U.S.C. §363(b)(1).³³ Prior to the enactment of 11 U.S.C. §1115, few cases addressed the issue of whether a debtor had to get court approval for the payment of living expenses. Some courts that considered the question held that normal living expenses of an individual chapter 11 debtor did not need court approval,³⁴ while others indicated that some form of court approval would be necessary at least in cases of significant expenses.³⁵ Indeed one early decision, *In re Vincent*,³⁶ held that there was no authority for the payment of living expenses for a chapter 11 individual debtor under the Code. Given 11 U.S.C. §1115 and chapter 11 debtors' fiduciary duty to creditors, individual debtors should give serious thought to having a budget for living expenses approved by their court in order to avoid challenges to the spending later in the case.³⁷

A second problem concerns what constitutes "reasonable" living expenses for purposes of 11 U.S.C. §363. For example, will judges take into account the debtor's standard of living in determining what constitutes reasonable living expenses?³⁸ Should courts adopt a disposable-income test similar to 11 U.S.C. §1325(b) or 1129(a)(15),³⁹ or will they impose the "minimal" standard of living tests imposed on parties seeking to discharge student loans?⁴⁰

While none of these questions have clear answers, it seems apparent that individual chapter 11 debtors who are accustomed to leading affluent lifestyles will no longer be able to maintain such standards of living during the pendency of their chapter 11s.⁴¹

A third area of possible confusion is whether an individual chapter 11 debtor can exempt a portion of his post-petition earnings from services performed under applicable state exemption law. For example, under Kentucky law⁴² a significant portion of "disposable earnings" (which include earnings from services) are exempt from garnishment by creditors. While Kentucky law provides that this exemption does not apply to "[a]ny order of any court of bankruptcy under chapter 13 of the Bankruptcy Code," it apparently still applies in chapter 11 cases. The question that may shortly confront courts and debtors is whether an individual chapter 11 debtor can use state law to exempt post-petition wages. In addition, since most such laws are time-period based, can those exemptions be asserted for each applicable post petition time period? Finally, there is the question of whether individual chapter 11 debtors can pay reasonable living expenses for their family. While this question almost seems to be that of a paranoid fear of a madman,⁴³ consider whether a bankruptcy court would permit a corporate chapter 11 debtor to pay the living expenses of a president's son, brother-in-law or other relative, if they provided *no value* to the debtor's estate.

Further, while spouses, former spouses, children of the debtor and other designated parties are entitled to first-priority payments for their domestic support obligations⁴⁴ and chapter 13 debtors are expressly authorized to pay for the support of their dependents⁴⁵ in their cases, there appears to be no similar direct and expenses authorization in chapter 11 permitting an individual chapter 11 debtor to pay for his or her family's support from estate funds.⁴⁶ Indeed, in a pre-11 U.S.C. §1115 individual chapter 11 case, *U.S. v. Sutton*, the Fifth Circuit overruled a lower court decision that allowed living expenses of the individual chapter 11 debtor's spouse and minor children to be paid from estate funds. While courts should be able to distinguish *Sutton* on its unique facts, it does illustrate the problems with new 11 U.S.C. §1115.

Intermission

And with the conclusion of the discussion of the ethical duties of chapter 11 debtors, we must briefly interrupt this issue of Straight & Narrow until after the New Year. Join us next year, when this article concludes with a discussion of attorney-client privilege in individual chapter 11 cases and how debtors can propose confirmable plans. Until then, have a joyous holiday season and a Happy New Year!

Footnotes

1 Before his reformation, Ebenezer Scrooge was one of the most effective collection managers imaginable.

2 New issues arising from the changes made to individual chapter 11 practice by BAPCPA have been the subject of several scholarly articles and presentations, including: Keach, "Deadman Filing Redux: Is the New Individual Chapter Eleven Unconstitutional?," 13 Am. Bkr. Inst. L.R. 483 (Winter 2005); Warner, "Garnishment Restrictions in a Means Test World," 13 Am. Bkr. Inst. L.R. 733 (Winter 2005); Williams and Todres, "Tax Consequences of Post-Petition Income as Property of the Estate in an Individual Debtor Chapter 11 Case and Tax Disclosure in Chapter 11," 13 Am. Bkr. Inst. L.R. 701 (Winter 2005).

3 For example, *see In re Rodriguez*, 336 B.R. 462, 477 (Bankr. D. Idaho 2005) (eligibility requirements of §109(h)(1) were not met); *In re Talib*, 335 B.R. 417 (Bankr. W.D. Mo. 2005) (same); *In re Sukmungs*, 333 B.R. 875 (Bankr. D. Utah 2005) (same). *See also In re Burrell*, 339 B.R. 664, 666 (Bankr. W.D. Mich. 2006) ("To be a debtor under Title 11, an individual must have received credit counseling within 180 days preceding the date of filing the bankruptcy petition").

4 *See Dixon*, 338 B.R. at 386 ("It is the clear expectation of the statute that all individual debtors receive such a briefing prior to filing") (emphasis in original).

5 *See In re Hedquist*, 342 B.R. 295 (8th Cir. BAP 2006); *In re Watson*, 332 B.R. 740 (Bankr. E.D. Va. 2005); *In re Bogedain*, 2006 WL 2471939 (E.D. Mich. Aug. 24, 2006).

6 The problem faced by debtors whose cases are dismissed involves the application of the automatic stay. Section 362(c)(3) and (4) limit application of the automatic stay when a previous bankruptcy case was dismissed within one year of the new filing. 11 U.S.C. §362(c)(3) and (4). To avoid the possible inequitable result the limitation on the automatic stay might impose on an unsuspecting debtor, bankruptcy courts have struck the case, rather than dismissing it. *See In re Elmendorf*, 345 B.R. 486 (Bankr. S.D.N.Y. 2006). In *Elmendorf*, the bankruptcy court struck a chapter 7 case and two chapter 13 cases filed before the debtors

sought credit counseling. The bankruptcy court determined it may decide, on case-by-case basis, whether to strike petitions filed in violation of the credit counseling requirement. *Id.* at p. 499-500. *But see In re Wilson*, 346 B.R. 59 (Bankr. N.D.N.Y. 2006) (the appropriate disposition, upon determination by bankruptcy court that debtors had not satisfied the pre-petition credit counseling requirement, was to dismiss, not strike, the bankruptcy case).

7 *See, generally, In re DiPinto*, 336 B.R. 693 (Bankr. E.D. Pa. 2006).

8 Section 109(h)(2) requires a review of the exception at least once a year. Based on information from the Office of the U.S. Trustee, it is understood that this exception was not extended for areas affected by Hurricane Katrina when it came up for review.

9 *Talib*, 335 B.R. at 421; *see also* 11 U.S.C. §109(h)(3)(B).

10 *Dixon*, 338 B.R. at 387.

11 *Hedquist*, 342 B.R. 299-300; *Watson*, 332 B.R. at 746-47.

12 *See In re Sukmunga*, 333 B.R. 875 (Bankr. D. Utah 2005).

13 333 B.R. 430 (Bankr. S.D. Ohio 2005).

14 *Id.*

15 *See, generally, Everett v. Perez*, 30 F.3d 1209 (9th Cir. 1994); *In re Cenargo International PLC*, 294 B.R. 571 (Bankr. S.D.N.Y. 2003); *In re ICM Notes Ltd.*, 278 B.R. 117 (S.D. Tx. 2002); *In re Harp*, 166 B.R. 740 (Bankr. N.D. Ala. 1993); *In re Rusty Jones Inc.*, 134 B.R. 321 (Bankr. N.D. Ill. 1991); *In re Grabill Corp.*, 113 B.R. 966 (Bankr. N.D. Ill. 1990); *In re Storms*, 101 B.R. 645 (Bankr. S.D. Cal. 1989). *See also* Rapoport & Bowles, "Has the DIP's Attorney Become the Ultimate Creditor's Lawyer in Bankruptcy Reorganization Cases?," 5 Am. Bkr. Inst. L. Rev. 47 (Spring 1997) (hereinafter "Rapoport & Bowles").

16 However, at least two cases, *Hansen Jones & Lela P.C. v. Segal*, 220 B.R. 434 (D. Utah 1998), and *In re Sidco Inc.*, 173 B.R. 194 (E.D. Colo. 1994), have held that counsel owe duties to the debtors-in-possession, not the estate.

17 There are numerous other problems with individual chapter 11 debtors, including attorney-client privilege issues, which are beyond the scope of this article. *See, generally, In re Bame*, 251 B.R. 367 (Bankr. D. Minn. 2000).

18 *Id.* at 53-55. *See also Commodity Futures Trading Commission v. Weintraub*, 471 U.S. 343, 355 (1985).

19 *See* Rapoport & Bowles at 53-58 for a full discussion of the exact nature of these duties.

20 *See, generally, In re Hardy*, 319 B.R. 5 (Bankr. N.D. Fla. 2004) (full disclosure of assets and of business transactions required); *In re Robino*, 243 B.R. 472 (Bankr. N.D. Ala. 1999) (compliance with court orders); *In re Tornheim*, 181 B.R. 161 (Bankr. S.D.N.Y. 1995) (duty to pay fees and file required reports); *In re Bownan*, 181 B.R. 836 (Bankr. D. Md. 1995) (duty to put creditor interests first in settlement of a lawsuit); *In re Harp*, 166 B.R. 740 (Bankr. N.D. Ala. 1993) (duty to properly account for estate property and to properly use estate funds).

21 181 B.R. at 836.

22 *Id.* at 841.

23 *Id.* citing *In re Finney*, 992 F.2d 43, 45 (4th Cir. 1993).

24 *Id.* at 845. However, courts do not automatically require trustees to settle a claim where an offer is made to pay creditors' claims. *See, generally, In re Central Ice Cream Co.*, 836 F.2d 1068 (7th Cir. 1987) (discussing settlement which included payments to equity-owners and insiders).

25 105 B.R. 594 (Bankr. D. Haw. 1989).

26 *Id.* at 595.

27 See *In re Harp*, 166 B.R. at 747-48: It is not easy for a debtor-in-possession, corporate or individual, to serve two masters—juggling the personal needs and desires of the debtor itself, with its clear fiduciary responsibilities to unsecured creditors, other parties in interest and the court. Nor is the role any easier for the attorney who represents the debtor-in-possession.

28 11 U.S.C.A. §1115 provides: (a) In a case in which the debtor is an individual, property of the estate includes, in addition to the 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. (b) Except as provided in §1104 or a confirmed plan or order confirming a plan, the debtor shall remain in possession of all property of the estate.

29 See, e.g., *In re Habe*, 2006 WL262116 (6th Cir. 2006); *Roland v. UNUM Life Ins. Co. of Am.*, 223 B.R. 499 (W.D.N.Y. 1998); *In re Powell*, 187 B.R. 642 (Bankr. D. Minn. 1995).

30 See, e.g., *In re Harp*, 166 B.R. 740 (Bankr. N.D. Ala. 1993) (noting that chapter 11 debtors spent \$206,772.45 on personal expenses in seven months in bankruptcy); *In re Heberman*, 122 B.R. 273 (Bankr. W.D. Tx. 1990); *In re Cooley*, 87 B.R. 432 (Bankr. S.D. Tx. 1984).

31 11 U.S.C. §363(c)(1) provides: If the business of the debtor is authorized to be operated under §721, 1108, 1203, 1204 or 1304 of this title and unless the court orders otherwise, the trustee may enter into transactions, including the sale or lease of property of the estate, in the ordinary course of business, without notice or a hearing, and may use property of the estate in the ordinary course of business without notice or a hearing.

32 11 U.S.C. §1108 provides: Unless the court, on request of a party in interest and after notice and a hearing, orders otherwise, the trustee may operate the debtor's business.

33 11 U.S.C. §363 (b)(1) provides, in pertinent part, that "the trustee, after notice and a hearing, may use, sell or lease, other than in the ordinary course of business, property of the estate."

34 See *In re Murray*, 216 B.R. 712 (Bankr. W.D.N.Y. 1998); *In re Keenan*, 195 B.R. 236 (Bankr. W.D.N.Y. 1996); *In re Bradley*, 185 B.R. 7 (Bankr. W.D.N.Y. 1995).

35 See generally *In re Harp*, 166 B.R. at 755-756 (discussing violation of fiduciary duties by paying for rental of vacation homes, sponsoring a large pre-game Alabama-Auburn brunch and taking a vacation to an exclusive resort in the Netherland Antilles).

36 4 B.R. 21 (Bankr. M.D. Tenn. 1979).

37 See *In re Harp*, 166 B.R. at 755; see also *In re Roland*, 223 B.R. at 506; *In re Weber*, 209 B.R. 793 (Bankr. D. Mass. 1997) (discussing expenditures of nonstate property in connection with determination of debtors' good faith).

38 While isolated cases have approved indirectly expenditures of an affluent nature, see *In re Bradley*, 18 B.R. at 11 (refusing to impose a budget on individual chapter 11 debtor); *In re Rodriguez*, 41 B.R. 774 (Bankr. S.D. Fla. 1984) (approving personal expenses of \$7,000 per month), most courts have refused to consider status or lifestyle in determining what constitutes reasonable living expenses. See, generally, *In re Cardillo*, 170 B.R. 490 (Bankr. 1994); *In re Jones*, 55 B.R. 462 (Bankr. D. Minn. 1985).

39 See, generally, *In re Watson*, 403 F.3d 1 (1st Cir. 2005) (private school tuition not a reasonably necessary expense); *In re Gleason*, 267 B.R. 630 (Bankr. N.D. Iowa 2001) (recreation and gift expenses not reasonably necessary); *In re Dick*, 222 B.R. 189 (Bankr. D. Mass. 1998) (payment on non-income-producing vacation home not a reasonably necessary expense).

40 See, generally, *In re Hornsby*, 144 F.3d 433 (6th Cir. 1998); *In re Clark*, 34 B.R. 238 B.R. 238 (Bankr. N.D. Ill. 2006); *In re Southard*, 337 B.R. 416 (Bankr. M.D. Fla. 2006).

41 See, generally, *In re Wood*, 68 B.R. 613 (Bankr. D. Hawaii 1986) (large expenditures on pet care demonstrated mismanagement of debtor's business affairs).

42 KRS 427.010.

43 Consider the author; this just might be true.

44 *See* 11 U.S.C. §§101(14A), 507(a)(1) and 1112(b)(4)(P).

45 *See* 11 U.S.C. §1325(b)(2).

46 *See U.S. v. Sutton*, 786 F.2d 1305 (5th Cir. 1986) (holding that an incarcerated individual chapter 11 debtor was not permitted to have his estate pay living expenses of his wife and minor children).

Ghosts of Individual Ch. 11 Debtors Yet to Come

Part II: Confirming an Individual Debtor's Chapter 11 Plan under BAPCPA

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BAPCPA also introduced significant changes to the chapter 11 confirmation requirements for individual debtors.

11 U.S.C. § 1129(a)(14)

Section 1129(a)(14) provides:

The courts shall confirm a plan only if all of the following requirements are met:

(14) If the debtor is required by a judicial or administrative order, or by statute, to pay a domestic support obligation, 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.



Gregory R. Schaaf

Based on subsection (a)(14), a chapter 11 individual debtor is not entitled to confirm a plan unless it is current on all post-petition domestic support obligations. This change is consistent with other BAPCPA changes that make it

more difficult to avoid domestic support obligations. For example, §101(14)(A) provides a definition of "domestic support obligations," and domestic support obligations are now a first-priority claim ahead of allowed administrative expenses.¹

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another source of leverage to force a debtor to pay as much as possible in its reorganization. Only one disgruntled creditor need object to the plan and reference subsection (a)(15) to force the debtor to comply.



C.R. "Chip" Bowles Jr.

If a creditor objects, the debtor must prove that the property distributed under the plan is not less than the projected disposable income of the debtor as defined in chapter 13. Oddly, even though unsecured creditors may

11 U.S.C. § 1129(a)(15)

Another creditor-friendly charge made by BAPCPA is the addition of §1129(a)(15), which provides:

The courts shall confirm a plan only if all of the following requirements are met:

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(15) In a case in which the debtor is an individual and in which the holder of an allowed unsecured claim objects to the confirmation of the plan—

(A) the value, as of the effective date of the plan, of the property to be distributed under the plan on account of such claim is not less than the amount of such claim; or
(B) the value of the property to be distributed under the plan is not less than the projected disposable income of the debtor (as defined in §1325(b)(2)) to be received during the five-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.

Section 1129(a)(15) provides creditors

object, subsection (a)(15)(B) requires a review of all property distributed under the plan (*i.e.*, it includes payments on secured debt and possibly property returned to the individual), not just property distributed to holders of allowed unsecured claims. Although §1129(a)(15) seems to be an

effort by Congress to impose chapter 13 obligations on chapter 11 individual debtors, projected disposable income generally goes to pay general unsecured claims under chapter 13.



Andrew D. Stosberg

Of course, if no creditor holding an allowed unsecured claim objects, this section does not apply.² Also, the debtor can avoid an objection under subsection (a)(15) if it is a 100 percent payment plan. 11 U.S.C.

§1129(a)(15)(B).

There is one other criteria in subsection (a)(15) that might raise questions: The objection must come from a holder of an *allowed* general unsecured claim. If a creditor is partially secured, may a debtor argue it is not a general unsecured claim?³ Or may a debtor object to a claim the day before a confirmation hearing so it is not deemed allowed when the objection is considered?⁴

² See, e.g., 11 U.S.C. §1129(a)(6) (if there is no regulatory control, there is no obligation to comply with this subsection).

³ *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988) (Ahlers).

¹ See 11 U.S.C. §§101(14)(A) and 507(a)(1)(A).

One final point on subsection (a)(15): Like chapter 13 debtors under BAPCPA, individual chapter 11 debtors have a five-year standard for plan payments (although the period is extended if the repayment term is longer in the plan).

In the end, the squeaky wheel may get the grease. If a creditor can force a higher recovery simply by objecting, it seems an easy course of action. Could a debtor affirm an unsecured claim in full to avoid an objection by that creditor?

11 U.S.C. §1325(b)(2)

As indicated, §1129(a)(15) calculates disposable income by reference to 11 U.S.C. §1325(b)(2). The §1325(b)(2)⁵ calculation of disposable income starts with the current monthly income of the debtors other than child support, foster care or disability payments for dependent children. From this “net” income, the debtor may deduct the maintenance and support obligations of the debtor or a dependent and domestic-support obligations accruing post-petition. The debtor is also allowed a charitable contribution deduction up to 15 percent of gross income for the year. Further, if the debtor is a business debtor, there is a deduction for expenses necessary to preserve the business.

Section 1325(b)(2) requires that any exclusion from income be “reasonably necessary.” Section 1325(b)(3) provides that amounts reasonably necessary under paragraph (2) are determined in accordance with §§707(b)(2)(A) and (B) of the Code. But §1129(b)(15) did not reference to §1325(b)(3), only §1325(b)(2). Does this omission allow an argument that the bankruptcy court should determine what is “reasonably necessary” under chapter 11 without resorting to the chapter 7 definition, even though what is “reasonably necessary” under chapter 13 is calculated pursuant on subsection 1325(b)(3)?

⁴ See 11 U.S.C. §502(a) (a claim is deemed allowed unless a party in interest objects).

⁵ 11 U.S.C. §1325(2) provides:
(2) For purposes of this subsection, the term ‘disposable income’ means current monthly income received by the debtor (other than child support payments, foster care payments or disability payments for a dependent child made in accordance with applicable nonbankruptcy law to the extent reasonably necessary to be expended for such child) less amounts reasonably necessary to be expended—

(A)(i) for the maintenance or support of the debtor or a dependent of the debtor, or for a domestic-support obligation, that first becomes payable after the date the petition is filed; and
(ii) for the charitable contributions (that meet the definition of “charitable contribution” under §548(d)(3) to a qualified religious or charitable entity or organization (as defined in §548(d)(4)) in an amount not to exceed 15 percent of gross income of the debtor for the year in which the contributions are made; and
(B) if the debtor is engaged in business, for the payment of expenditures necessary for the continuation, preservation, and operation of such business.

Overall, these changes will make it more difficult for an individual chapter 11 debtor to confirm a reorganization plan. Another impediment to confirmation for the individual chapter 11 debtor involves the absolute priority rule.

[I]t seems unreasonable to conclude that Congress would leave an individual debtor without the ability to maintain at least enough of his or her earnings to live on. Therefore, can the courts fashion an equitable solution to allow an individual to confirm a chapter 11 plan?

Absolute Priority and the Individual Debtor

An individual debtor’s chapter 11 filing creates a new taxable entity.⁶

⁶ See, generally, Williams and Todres, “Tax Consequences of Post-petition Income as Property of the Estate in an Individual Debtor Chapter 11 Case and Tax Disclosure in Chapter 11,” 13 Am. Bankr. Inst. L. Rev. at 701, 712-715 (2005).

Notwithstanding this, BAPCPA now provides that an individual debtor’s post-petition salary or other earnings become property of the estate until “the estate is closed, dismissed or converted... whichever occurs first...” 11 U.S.C. §1115(a)(2); see, also, the discussion of §1115, *supra*.

If earnings are property of the estate, an individual debtor may not retain any portion of its salary in a less-than-100 percent payment plan because the plan would violate the absolute priority rule. The absolute priority rule provides that a class of interests cannot receive payment under a plan until higher priority claims are paid in full. See 11 U.S.C. §1129(b).⁷ Any creditor receiving less than 100 percent payment may object even if the plan only leaves a debtor with enough money to survive.

The usual ways around the absolute priority rule do not seem to help an individual chapter 11 debtor. Previously,

⁷ With respect to a class of unsecured claims—
(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 §1115, subject to the requirements of subsection (1)(14) of this section.
11 U.S.C. §1129(b)(2)(B).

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an individual debtor would propose to pay creditors some amount of money saved from post-petition earnings and perhaps from his or her future earnings, which would give creditors more than they could otherwise expect to receive in a liquidation or through a chapter 13 plan. Now that future earnings are estate property under §1115, future income is not something the debtor can “contribute” to a plan.⁸

Although the earnings themselves are property of the estate, the debtor may try to argue that its promise to work to earn the income has value. After all, if the individual debtor does not work hard (or at least work), there is no future income and creditors are worse off. This argument probably will not succeed, however, under the *Ahlers* decision.

In *Ahlers*, the individual chapter 11 debtors filed a plan that proposed that they retain their farm and use the proceeds of operations to make plan payments. Although the appellate court approved the plan, the Supreme Court determined that the debtors’ plan violated the absolute priority rule. *Ahlers*, 485 U.S. at 202. “Viewed from the time of approval of the plan, respondents’ promise of future services is intangible, inalienable and in all likelihood unenforceable.”⁹

Individual debtors also will likely have no success arguing that any money assets retained for necessities in a plan is

de minimis. The debtors in *Ahlers* tried to argue that the property retained, their farm, had had no value. The Supreme Court rejected this argument, holding: “Even where debts far exceed the current value of assets, a debtor who retains his equity interest in the enterprise retains ‘property.’” *Id.* at 207-08.

This complication is probably something that was not contemplated by the drafters of the BAPCPA Code amendments. New §1129(a)(15) seems intended to require that a chapter 11 individual debtor pay at least as much as he or she would pay in a chapter 13 reorganization. Therefore, the protections afforded a creditor by the absolute priority rule in an individual chapter 11 are substantially or totally addressed. Also, it seems unreasonable to conclude that Congress would leave an individual debtor without the ability to maintain at least enough of his or her earnings to live on.

Therefore, can the courts fashion an equitable solution to allow an individual to confirm a chapter 11 plan? The answer may be no. The individual debtors in *Ahlers* were farmers, the most favored and sympathetic of debtors, who did not qualify for chapter 12.¹⁰ Even though the Supreme Court understood that the debtor’s plight under their interpretation of the Bankruptcy Code left consideration of the impact of the absolute priority rule and property of the estate questions to Congress. *Id.* at 209.

These changes leave an individual that exceeds the chapter 13 debtor

criteria and fails the chapter 7 means test without a viable reorganization or liquidation option under the Code. It seems that the best option is to hope there is no objection to a proposed chapter 11 plan. *See id.* (“Consequently, we think that the interest respondents would retain under any reorganization must be considered ‘property’ under §1129(b)(2)(B)(ii), and therefore can only be retained pursuant to a plan accepted by their creditors or formulated in compliance with the absolute priority rule.”).

God Bless Us, Everyone: Conclusion

Unlike the muse for this article, Charles Dickens’ *A Christmas Carol*, there is no happy ending at the present time for individual chapter 11 debtors. While some debtors may have access to sufficient exempt assets to live on while in bankruptcy and to fund a chapter 11, most individual chapter 11 debtors do not have such convenient resources. BAPCPA has made the already-difficult lives of individual chapter 11 debtors and their lawyers much more challenging, without offering many solutions to these difficulties. However, unless the new provisions concerning BAPCPA are either revised by Congress or ruled unconstitutional by the Supreme Court (topics far outside the scope of this article), these “shadows” will remain unchanged. Therefore, like Tiny Tim, we will have to press on and make the best of a bad situation. ■

⁸ See, also, Keach, “Dead Man Filing, Redux: Is the New Individual Chapter 11 Constitutional?,” 13 Am. Bankr. Inst. L. Rev. at 483, 489-498 (2005).

⁹ *Id.* at 204. See, also, *Matter of Stegall*, 865 F.2d 140, 141-142 (7th Cir. 1989) (noting the 13th Amendment prohibition against involuntary servitude prevents enforcement of a plan based on future work).

¹⁰ *Ahlers*, 485 U.S. at 209, fn. 9.