Introduction to Individual Chapter 11 Cases

Mark H. Shapiro
Steinberg Shapiro & Clark; Southfield, Mich.

Michael T. Tabor
Attorney at Law; Jackson, Tenn.

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Consumer Ch. 11

1. Identifying appropriate circumstances to consider a consumer Chapter 11
    a. Filing for individual and business, and consolidating cases
2. Pre-filing preparation – do we have an impaired class likely to vote in favor of a plan?
    a. Right professionals?
    b. Prepetition financial projections prepared?
3. What will (and won't) Chapter 11 do for your client
    a. Lien stripping, bifurcation of secured and unsecured claims
4. The "honeymoon" phase (post-filing and pre-plan).
    a. Some clients happy to stay in Chapter 11 as long as possible. Some want/need to get out. How to manage your client's objectives.
5. Now that we're in Chapter 11, how do we get out? The confirmation process
    a. <u>707(b) Means Test applies or not?</u>

       Section 1129(a)(15) requires the debtor either (i) pay unsecured creditors in full or (ii) to devote an amount equal to five-years' worth of projected disposable income to the plan, with the five years measured by the date the plan is confirmed or plan payments start, whichever is later. Standing to raise this objection is not class-based. Even if the class of unsecured creditors has accepted the plan, an individual unsecured creditor may invoke the disposable income test.

       Much like the debate in Chapter 13, a key question is what is the definition of projected disposable income. Section 1129(a)(15) specifically refers to Section 1325(b)(2). Even if the definition was settled for Chapter 13, this does not necessarily resolve the issue for Chapter 11. At issue is whether Section 1325(b)(3) and its incorporation of the means test of 707(b)(2) is also applicable to determine the "amounts reasonably necessary" under Section 1325(b)(2).

i. 1325(b)(3) and 707(b)(2) Do Not Apply.

At least one court and the Advisory Committee on Bankruptcy Rules have determined that 1325(b)(3) does not apply to Chapter 11. *In re Roedemeier*, 374 B.R. 264(Bankr. D. Kan. 2007).

The *Roedemeier* court and commentators have reasoned that Section 1129(a)(15)only references Section 1325(b)(2) and does not reference Section 1325(b)(3). Therefore Section 1325(b)(3) and its incorporation of Section 707(b)(2) does not apply. As such, ". . . in calculating an individual Chapter 11 debtor's projected disposable income, § 1129(a)(15)(B) must be read to allow a judicial determination of the expenses that are reasonably necessary for the support of the debtor and his or her dependents." *Roedemeier* at 273.[1]

ii. 1325(b)(3) and 707(b)(2) Applies.

The basic argument is Section 1325(b)(2) defines disposable income as current monthly income less **"amounts reasonably necessary"** to be expended for the maintenance and support of the debtor and debtor's dependents. Section 1325(b)(3) specifically states that it is to be used to calculate the "[a]mounts reasonably necessary to be expended under [Section 1325(b)] (2). Thus, Section 707(b)(2)'s expenses are incorporated into Chapter 11 by Section 1325(b)(3).

No court has specifically ruled that Section 1325(b)(3) and 707(b)(2) apply in the context of an objection based on Section 1129(a)(15). A few courts, however, have stated that 707(b)(2) applies in a Chapter 11. See e.g., *In re Dumas*, 419 B.R. 704, 710-711 (Bankr. E.D. Tex. 2009)(§ 707(b)(2) applies in both Chapter 13 and Chapter 11); *In re Johnson*, 399 B.R. 72, 77 (Bankr. S.D. Cal. 2008)

iii. Practice Implications

Even in cases (e.g. primarily non-consumer debt) where the means test is inapplicable, if Section 707(b)(2) is used to determine the allowable expense it can have massive implications and make it difficult to confirm a plan. All expenses, except secured obligations, in excess of the National and Local Standards will not be considered. A high earning debtor with expenses in

[1] One other court, *In re Bacardi*, 2010 Bankr. LEXIS 3 (Bankr. N.D. Ill. Jan. 6, 2010), has matter of factly stated " . . . the means test does not in fact apply in chapter 11. Section 1129(a)(15) mentions section 1325(b)(2) but not section 1325(b)(3)." This statement, however, is unsupported *dicta* in a footnote.

excess of the IRS guidelines will have to significantly reduce those expenses to meet the disposable income requirement of 1129(a)(15).

One simple example is the impact on debtors paying college and/or private school tuition. Section 707(b)(2) limits the amount to be included as an actual expense to $1,775 per each child under the age of 18 per year. First, this means any tuition payments for college cannot be included. Second, private schools typically charge tuition in excess of $1,775 per year. For example, Harding Academy in Memphis charges $11,595 per year for grade 9 through 12. The $9,820 difference between the actual tuition and 707(b)(2) allowance would have to be included in the disposable income and be paid to creditors. This may mean debtor can no longer send her children to her preferred school.

Even if 707(b)(2) does not apply, if may be difficult to convince the judge that school tuition is "reasonably necessary", but at least you will have the opportunity to plead your client's case. Application of 707(b)(2) will cut off all argument.

b. Absolute Priority Rule

In a non-individual case, unless unsecured creditors are paid in full, lower classes of claims or interest (typically equity) cannot retain their interest – the Absolute Priority Rule. In an individual debtor case, however, Section 1129(b)(2)(B)(ii) allows the debtor to "retain property included in the estate under Section 1115" subject to the required payment of postpetition domestic support obligations. There is currently a split among the courts whether this allows the debtor to retain pre-petition property without paying unsecured creditors in full.

i. Some courts hold that Congress intended to exempt individual Chapter 11 debtors from the absolute priority rule altogether. See e.g, *In re O'Neal*, 2013 Bankr. LEXIS 1531, 36-37 (Bankr. W.D. Ark. 2013); *In re Tegeder*, 369 B.R. 477, 479-481 (Bankr.D.Neb.2007); *In re Roedemeier*, 374 B.R. 264, 273-276 & nn. 15-19 (Bankr.D.Kan.2007); *In re Shat*, 424 B.R. 854, 862-868 (Bankr.D.Nev.2010); *SPCP Group, LLC v. Biggins*, 465 B.R. 316, 320-324 (M.D.Fla.2011); *In re Friedman*, 466 B.R. 471 (9th Cir. BAP 2012); According to these courts, a Chapter 11 debtor may retain prepetition and postpetition property and still cramdown a plan of reorganization over the objection of a creditor.

ii. The emerging trend reaches the contrary conclusion, holding that the absolute priority rule prohibits the debtor from retaining pre-petition property without paying unsecured creditors in full. *In re Maharaj*, 449 B.R.

484, 491-94 (Bankr. E.D. Va. 2011); *In re Kamell*, 451 B.R. 505, 507-12 (Bankr. C.D. Cal. 2011); *In re Draiman*, 450 B.R. 777, 820-22 (Bankr. N.D. Ill. 2011); *In re Walsh*, 447 B.R. 45, 47-49 (Bankr. D. Mass. 2011); *In re Stephens*, 445 B.R. 816, 820-21 (Bankr. S.D. Tex. 2011); *In re Gelin*, 437 B.R. 435, 440-43 (Bankr. M.D. Fla. 2010); *In re Mullins*, 435 B.R. 352, 359-61 (Bankr. W.D. Va. 2010); and *In re Gbadebo*, 431 B.R. 222, 227-30 (Bankr. N.D. Cal. 2010).

In addition to the decision above, the Court of Appeals in the 10th Circuit, *In re Stephens*, 704 F.3d 1279, 1286-1287 (10th Cir. 2013), and 4th Circuit, *In re Maharaj*, 681 F.3d 558 (4th Cir. Va. 2012), have held the absolute priority rule applies. The District Court for the Eastern District of Tennessee recently affirmed the bankruptcy court's ruling that the absolute priority rule applies in an individual Chapter 11. *In re Lindsey*, 2012 U.S. Dist. LEXIS 146802, 3-4 (E.D. Tenn. 2012).

iii. Practice implications

Application of the absolute priority rule can make confirmation of a plan difficult or very unpalatable for the debtor. Even in those cases where the plan is otherwise confirmable, debtor will be required to pay unsecured creditors in full in order to retain non-exempt property. Depending on the amount of the unsecured debt and the debtor's projected disposable income this may simply be impossible. In that situation the debtor will be faced with either not confirming the plan or surrendering the assets to the unsecured creditors for liquidation.

c. A little bit of law, a lot of horse-trading

d. Financial projections post-Ch. 11 – CRUCIAL.

If you or the debtor cannot prepare detailed income and expense projections, an accountant or similar professional needs to be retained to prepare them. Not providing financials as an exhibit to the plan of reorganization is not acceptable, and may result in denial of confirmation for failing to prove the plan is feasible. Under Section 1129 of the Bankruptcy Code, a plan of reorganization cannot be confirmed if it is "likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor. . . ." 11 U.S.C. § 1129(a)(11) – the feasibility test. To establish feasibility, the debtor must present "proof through reasonable projections that there will be sufficient cash flow to fund the plan and maintain operations according to the plan. Such projections cannot be speculative, conjectural or unrealistic." *See e.g., In re Nelson*, 84 Bankr. 90, 93 (Bankr. W.D. Tex. 1988)); 160 Bankr. 202, 234-37 (Bankr. S.D. Fla. 1993); *Pan Am Corp. v. Delta Air Lines*, 175 B.R. 438, 508 (S.D.N.Y. 1994).

As Section 1129(a)(14) requires the debtor to pay at least 5 years worth of disposable income to unsecured creditors, unless the debtor can pay this in a lump sum early, projections should be for at least five years.

e. The Ultimate Goal – Getting the Discharge

In the case of an individual debtor, confirmation of a plan of reorganization does not discharge and release the claims of creditors. In the case of the individual debtor, 11 U.S.C. § 1141(d)(5)(A) states that ". . . 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."

i. Option No. 1 – Wait

As the discharge cannot be entered until unsecured creditors are paid, the case can simply be left open until such time as the creditors are paid. The principle downside to this option is the United States Trustee's fees will continue to accrue and have to be paid while the case remains opens. In a five year plan period this could end up to be a significant amount.

ii. Option No. 2—Administratively close the case

Rather than keep the case open, an alternative option is requesting the case be administratively closed and then filing a motion to reopen the case and enter the discharge once all the plan payments have been made.

One issue that needs to be addressed when requesting the order to administratively close the case is the fee that is required when a motion to reopen a case is later filed. The fee for a motion to reopen a Chapter 11 proceeding is $1,167.00. Some districts have waived this fee in the context of reopening for the purpose of entering the discharge. In those districts that do not waive the fee, an attempt should be made to get a waiver of the fee in the order administratively closing the case.