

# Individual Chapter 11 Confirmation Mock Hearing

## Litigants:

### **Henry Carl Kevane**

*Pachulski Stang Ziehl & Jones LLP; San Francisco*

### **Patricia A. Redmond**

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

## Bench:

### **Hon. Laurel Meyerson Isicoff**

*U.S. Bankruptcy Court (S.D. Fla.); Miami*

### **Hon. Maureen A. Tighe**

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



# DISCOVER



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**UNITED STATES BANKRUPTCY COURT**

**DISTRICT OF HOPLANDIA**

<p>In re:  JOHN SUDS,  Debtor.</p>	<p>Case No.: 14-97513  Chapter 11</p>
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**MEMORANDUM OF LAW IN SUPPORT OF CONFIRMATION OF  
PLAN OF REORGANIZATION PROPOSED BY DEBTOR**

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This memorandum of law (the “Memorandum of Law”) is submitted pursuant to section 1129 of Title 11 of the United States Code (the “Bankruptcy Code”) on behalf of John Suds (“Suds” or “Debtor”), as debtor and debtor in possession in the above-captioned chapter 11 case, in support of confirmation of the Plan of Reorganization Proposed by the Debtor, dated October 1, 2014 (as it may be amended from time to time, the “Plan”).<sup>1</sup>

The Plan has the support of the Debtor and GE Capital. Only two objections to confirmation of the Plan were received. Both objections deal with discrete legal issues and for the reasons set forth below, neither forms a legitimate basis for the Court to deny confirmation. Specifically, Wells Fargo (Class 2) rejected the Plan and objects to confirmation of the Plan on the basis that it violates the anti-modification provisions of section 1123(b)(5). Trade creditor Seedy (Class 4) also voted against the Plan and objects to confirmation of the Plan on the basis that it violates the absolute priority rule.<sup>2</sup> Moreover, Seedy objects to the Plan on the basis it was proposed in bad faith, as evidenced by Mr. Suds use of estate resources to maintain his customary lifestyle, including compensation to his criminal defense attorney in an effort to maintain Stache Brewery as a going concern (among other goals). For the reasons discussed below, these objections should be overruled and the Plan confirmed.<sup>3</sup>

### **FACTS**

1. The pertinent facts are set forth in the Disclosure Statement approved on July 1, 2014, the Plan, the Declaration of John Suds in Support of Confirmation, the Declaration of Jason H. Rosell Regarding Voting With Respect to the Plan of Reorganization Proposed by the Debtor, and any testimony that may be adduced at the Confirmation Hearing.

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1 Capitalized terms used but not defined herein shall have the meanings ascribed to them in the Plan.

2 After tallying the votes in Class 4, Class 4 has also rejected the Plan.

3 For purposes of this chapter 11 case, the Debtor is not a “small business debtor” as defined by section 101(51D) because the United States trustee has appointed a committee of unsecured creditors pursuant to section 1102(a)(1). The Debtor did not seek an order that a committee not be appointed pursuant to section 1102(a)(3).

ARGUMENT

**I. THE PLAN PROPONENTS WILL SATISFY THE BURDEN OF PROOF UNDER SECTION 1129 OF THE BANKRUPTCY CODE**

2. To obtain confirmation of the Plan, the Debtor must demonstrate that the Plan satisfies the provisions of section 1129(a) of the Bankruptcy Code. The Debtor submits that the objections to the Plan raise issues of law that may be determined without further evidence or the resolution of factual disputes, to the extent there are any.

**II. SECTION 1123(b)(5) PERMITS MODIFICATION OF WELLS FARGO'S CLAIM THAT IS SECURED BY A LIEN IN REAL PROPERTY THAT IS THE DEBTOR'S PRINCIPAL RESIDENCE AND BUSINESS**

3. The issue presented is whether a claim secured by real property that includes the debtor's principal residence *as well as* other income-producing property is "a claim secured only by a security interest in real property that is the debtor's principal residence." 11 U.S.C. § 1123(b)(5). Although this is a matter of first impression in Hoplandia, the Debtor urges this Court to adopt a standard that will allow an individual chapter 11 plan to modify claims secured by mortgages on real property that is the debtor's principal residence when such property is also used for income-producing purposes.

4. The mortgage at issue may be modified because Wells Fargo holds a lien not only on property which serves as the Debtor's principal residence, but also on property which serves as the Debtor's business, Stache Brewery. Permissible modification includes the strip down of the lien to the value of the collateral.

5. Section 506(a) defines whether an allowed claim is secured or unsecured. It provides:

An allowed claim of a creditor secured by a lien on

property in which the estate has an interest . . . is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, . . . and is an unsecured claim to the extent that the value of such creditor's interest . . . is less than the amount of such allowed claim.

11 U.S.C. § 506(a)(1).

6. The normal rule in bankruptcy is that a claim that is secured by a lien on property is treated as a secured claim “only to the extent of the value of the property on which the lien is fixed.” *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235 (1989). To the extent the collateral does not support the claim, the claimant is unsecured. 11 U.S.C. § 506(a)(1); *In re Johns*, 37 F.3d 1021, 1023-24 (3rd Cir. 1994). In the instant case, Wells Fargo's \$250,00 claim is being treated as a secured claim in the amount of \$200,000, which is the current fair market value of the real property securing the claim.

7. Pursuant to section 506(d), the creditor's lien is void to the extent it is unsecured. The debtor is required by section 1129(b)(2)(A) to pay 100% of only the allowed secured portion of the claim. Use of section 506 in conjunction with sections 1123(b) and 1129(b)(2)(A) to reduce the secured claim to the value of the collateral has generally been called “strip down” and the process of modifying the rights of the secured creditor over its objection is referred to as “cram down.” *See In re Ferandos*, 402 F.3d 147, 151 (3rd Cir. 2005).

8. Section 1123(b)(5) governs the contents of a chapter 11 plan and provides:

(b) Subject to subsection (a) of this section, the plan may - (5) modify the rights of holders of secured claims, other than a claim secured only by a security interest in real property that is the debtor's principal residence. . . .

11 U.S.C. § 1123(b)(5).

9. Under section 1123(b), debtors generally have the ability to modify secured claims in a chapter 11 plan. However, one exception is specified under section 1123(b)(5), which limits a debtor’s ability to modify, through the provisions of a chapter 11 plan, the rights of the holder of a claim secured only by a security interest in real property that is a debtor’s principal residence. This exception is known as the “anti-modification provision.” See *In re Wages*, 508 B.R. 161 (9th Cir. B.A.P. 2014); *Scarborough v. Chase Manhattan Mortg. Corp. (In re Scarborough)*, 461 F.3d 406 (3d Cir. 2006).

10. Based on the plain language of section 1123(b)(5), a creditor does not receive anti-modification protection for a claim secured by real property that includes both the debtor’s principal residence and other income-producing property that is not the debtor’s principal residence. By using the word “is” in the phrase “real property that *is* the debtor’s principal residence,” Congress equated the terms “real property” and “principal residence.” Put differently, this use of “is” means that the real property that secures the mortgage must be only the debtor’s principal residence in order for the anti-modification provision to apply. This interpretation is in line with the reasoning of the Bankruptcy Court for the District of Connecticut when it noted that section 1322(b)(2) – the chapter 13 parallel to section 1123(b)(5)<sup>4</sup> – “protects claims secured only by a security interest in real property that is the debtor’s principal residence, not real property that includes or contains the debtor’s principal residence, and not real property on which the debtor resides.” *In re Adebajo*, 165 B.R. 98, 104 (Bankr. D. Conn. 1994). A claim secured by real property that is, even in part, not the debtor’s principal residence does not fall under the terms of section 1123(b)(5). Consequently, “real property which is designed to serve as the principal residence not only for the debtor’s family but for other [income-producing purposes] is not encompassed by the clause.” *Id.*; see also *In re Maddaloni*, 225 B.R. 277, 280 (D. Conn. 1998) (“[T]he use of ‘is’ without any modifier (e.g., ‘in whole’ or ‘in part’)

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4 The wording of each provision is identical.

does not evince an intent by Congress to apply the antimodification provision to real property that includes, but is more than, a debtor's residence.”); *In re McGregor*, 172 B.R. 718, 720 (Bankr. D. Mass. 1994) (relying on plain language of section 1322(b)(2) to permit modification of claim secured by “the debtor's residence and property which has ‘inherently income producing’ power”); *In re Legowski*, 167 B.R. 711, 714 (Bankr. D. Mass. 1994) (same).

11. The Debtor concedes that there is a split of authority and other courts interpreting the “plain language” of section 1123(b)(5) have held that the anti-modification exception applies to any loan secured by real property that the debtor *uses* as a principal residence. *Wages*, 508 B.R. 161 (B.A.P. 9th Cir. 2014). The *Wages* court disagreed with the Third Circuit's parsing of the words of the statute in *Scarborough* because it disregarded the Bankruptcy Code's definition of “debtor's principal residence” in section 101(13A). That term “means a residential structure, including incidental property, without regard to whether that structure if used as the principal residence by the debtor, is attached to real property.” 11 U.S.C. § 101(13A). Accordingly, the *Wages* court concluded that the definition does not equate the term “real property” with “debtor's principal residence” and, therefore, an analysis which equates the two is misplaced. *Wages* at 166.

12. The *Wages* panel adopted the bright line approach taken by the bankruptcy court in *In re Macaluso*, 254 B.R. 799, 800 (Bankr. W.D.N.Y. 2000). The *Macaluso* court held that the anti-modification exception in section 1322(b)(2) applies to any property that is used as the debtor's principal residence, notwithstanding the fact that the debtor's property in that case included a second residential unit and a store. In doing so, the *Wages* court adopted an objective rule – either a property is a debtor's principal residence or it is not. *Wages* at 167.

13. Although *Wages*' “objective” interpretation of section 1123(b)(5) is tempting for its simplicity, it incorrectly interprets the plain meaning of section

1123(b)(5). As the dissent in *Wages* observed, the *Wages* majority takes the statutory phrase “claim secured only by a security interest in real property that **is** the debtor’s principal residence” and recasts it as if the phrase actually read “claim secured only by a security interest in real property that **includes** the debtor’s principal residence.” *Id.* at 168.

14. The Third Circuit’s approach in *Scarborough* is the better reasoned holding. In *Scarborough*, the Third Circuit held that the anti-modification provisions in section 1322(b)(2) and 1123(b)(5) do not apply to mortgaged real property on which the debtor principally resides if the debtor uses another part of the mortgaged real property to generate income. Accordingly, *Scarborough* effectively construed the anti-modification provisions to apply only to mortgaged real property the debtor uses exclusively as his or her principal residence.

15. The fact that two appellate courts could, after careful analysis, come to such divergent conclusions on the plain meaning of the statute indicates the statute actually is ambiguous. In such a case, it is appropriate to look at the legislative history. In its analysis, the *Scarborough* court points out that the House Judiciary Committee’s Report on the Bankruptcy Reform Act of 1994 stated that section 1123(b)(5) “does not apply to a commercial property, or to any transaction in which the creditor acquired a lien on property other than real property used as the debtor’s residence.” *Scarborough* at 413 (citing H.R. Rep. No. 835, at 46 (1994)). The majority in *Wages* made no claim that the legislative history supports its broad interpretation.

16. Accordingly, the legislative history supports *Scarborough*’s conclusion that where a creditor’s lien extends to income-producing property, the creditor’s claim is not secured only by property that is the debtor’s principal residence. The plain meaning and the legislative history of section 1123(b)(5) both support the conclusion that the anti-modification provision is inapplicable where,

as here, a creditor's claim is secured by a brewery, which also happens to be the debtor's principal place of business.

**III. SECTION 1115(a) PERMITS THE DEBTOR TO RETAIN HIS PREPETITION AND POSTPETITION PROPERTY DESPITE THE TREATMENT OF CLASS 4 CREDITORS**

17. Pursuant to the Plan, Mr. Suds will retain all property of the estate, including his prepetition interest in brewery equipment, recipes and other trade secrets, inventory, and other non-exempt personal property. In addition, the Plan allows Mr. Suds to retain his exempt property. Seedy objects to these Plan provisions on the basis that they violate the absolute priority rule because the Debtor is retaining a junior "interest" in property over the rejection of the Plan by Class 4 creditors holding senior unsecured claims.

18. Section 1129(b)(1) of the Bankruptcy Code states what has come to be known as the "absolute priority rule." The absolute priority rule requires that creditors be paid in full before holders of subordinate claims or equity receive or retain any property in the context of a plan. In individual chapter 11 cases, Courts have struggled to determine whether the absolute priority rule should apply to individual debtors though individuals are permitted to be debtors in chapter 11. *See, e.g., Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988) (holding that the absolute priority rule barred chapter 11 debtors' retention of ownership interest in a farm over the objections of creditors holding senior unsecured claims); *see also In re Friedman*, 466 B.R. 471, 479 n.16 (9th Cir. B.A.P. 2012) ("Courts almost universally found that individuals could reorganize and that the absolute priority rule applied to their plan prior to the enactment of BAPCPA.")

19. In 2005, Congress enacted the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"). BAPCPA amended chapter 11

by expanding the bankruptcy estate in individual chapter 11 cases to include post-petition property and earnings. Previously, earnings from services performed by an individual debtor after the commencement of the case were excluded from the property of the estate. *See* 11 U.S.C. § 541(a)(6). However, as written, the language in section 1129(b)(2)(B)(ii), as it relates to the absolute priority rule as applied to individuals, can and has been be interpreted two ways.<sup>5</sup> The first way, often referred to as the “broad view,” reads the language of the statute to abrogate the absolute priority rule in individual chapter 11 cases.<sup>6</sup> The second way, the “narrow view,” applies the absolute priority rule only to an individual debtor’s prepetition property (in other words, the debtor may retain the “additional” portion added to the estate by section 1115).<sup>7</sup> The Debtor submits that, for the reasons discussed below, this Court should adopt the “broad view” and find that the absolute priority rule does not apply in individual chapter 11 cases.<sup>8</sup> However, in the alternative, the Debtor asks that the Court

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5 *See In re Brown*, 505 B.R. 638, 643-645, n. 12, 13 (E.D. Pa. 2014), for an extensive listing of the jurisdictions and courts adhering to each interpretation under this nationwide split of authority.

6 For a survey of “broad view” cases, *see In re Shat*, 424 B.R. 854 (Bankr. D. Nev. 2010); *In re Tegeder*, 369 B.R. 477 (Bankr. D. Neb. 2007); *In re Rodemeier*, 374 B.R. 264 (Bankr. D. Kan. 2007); *In re Johnson*, 402 B.R. 851 (Bankr. N.D. Ind. 2009); *In re Friedman*, 466 B.R. 471 (B.A.P. 9th Cir. 2012).

7 For a survey of “narrow view” cases, *see In re Arnold*, 471 B.R. 578 (Bankr. C.D. Cal. 2012); *In re Lee Min Ho Chen*, 482 B.R. 473 (Bankr. D.P.R. 2012); *In re Martin*, 497 B.R. 349 (Bankr. M.D. Fla. 2013); *Ice House Am., LLC v. Cardin*, 751 F.3d 734 (6th Cir. 2014); *In re Maharaj*, 681 F.3d 558 (4th Cir. 2012); *In re Kamell*, 451 B.R. 505 (Bankr. C.D. Cal. 2011); *In re Gbadebo*, 431 B.R. 222 (Bankr. N.D. Cal. 2010); *In re Lucarelli*, 2014 WL 4388250 (Bankr. D. Ct. Sept. 4, 2014).

8 *Friedman*, 466 B.R. at 481-82 (“[W]e observe that there are no conflicting provisions within Chapter 11 relative to our view that the absolute priority rule does not apply in individual chapter 11 cases. We find no anomalies, inconsistencies or conflicts created by this interpretation. More importantly, we find significant contextual concordance with the other requirements for plan confirmation, including those previously described, including but not limited to (1) the new requirement for dedication of all of debtor’s disposable income for five years, (2) the straight-forward best interest of creditors test, and (3) the delay of issuance of discharge until the plan has been fully consummated. Including the § 541 property within the universe of property contained in § 1115, as we believe a plain-meaning interpretation requires, does no violence to the logical impact of the reorganization process or scheme established in chapter 11. Indeed, especially combined with the new additional requirement of five years of debtor’s disposable income, it is illogical to thereafter remove the debtor’s means of production of debtor’s disposable income by maintaining the absolute priority rule in an individual’s case.”).

find that the Plan requires the Debtor to provide “new value” for his retention of his interests in the prepetition property in the form of “sweat equity” and trade secrets.<sup>9</sup>

20. Chapter 11 of the Bankruptcy Code enables an insolvent debtor to reorganize its financial affairs in order to pay back its creditors over a period of time. Most chapter 11 cases are filed by business entities; however, a smaller percentage of cases are filed by individuals who have assets that they wish to save, but debts exceeding the limit imposed on chapter 13 debtors in section 109(e) – as is the case here.<sup>10</sup>

21. For individual debtors in chapter 11 cases, sections 541 and 1115 establish the parameters for what property is to be included in the bankruptcy estate. Property in section 541 includes “all legal or equitable interests of the debtor in property as of the commencement of the case.” In individual chapter 11 cases, section 1115 redefines the property of the estate to also include in the bankruptcy estate a debtor’s postpetition earnings and property.

22. What property creditors receive in an individual chapter 11 case is determined by the confirmed plan. A plan must meet the requirements laid out in section 1129 before it can be confirmed by the court. One such requirement is that each creditor in an impaired class of claims either accept the plan or receive under the plan as much as it would under a chapter 7 liquidation. 11 U.S.C. § 1129(a)(7). Another requirement is that, with respect to each class of claims, such class has either accepted the plan (by two-thirds in amount and one-half in number) or such

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<sup>9</sup> The Debtor reserves the right to supplement this Memorandum of Law by further argument at the Confirmation Hearing that the absolute priority rule has no application to an individual debtor in a case under chapter 11 because (a) an individual’s ownership of property does not constitute a “claim or interest” against or in a debtor, and (b) an individual debtor does not retain his ownership of property under a plan “*on account*” of any such junior claim or interest, as such italicized terms are used in section 1129(b)(2)(B)(ii). In addition, the Debtor reserves the right to argue that the BAPCPA amendments applicable to individual debtors violate the Thirteenth Amendment’s prohibition against involuntary servitude. U.S. Const. amend. XIII.

<sup>10</sup> Section 109(e) limits the eligibility of an individual to file chapter 13 to an individual with unsecured debts of less than \$383,175 and secured debts of less than \$1,149,525.

class is not impaired under the plan. 11 U.S.C. § 1129(a)(8). If all requirements of section 1129(a) are met except section 1129(a)(8), a court may still confirm a plan over the rejection of a dissenting class of creditors. 11 U.S.C. § 1129(b)(1).

23. Confirming a plan over the rejection of a dissenting class of claimholders is referred to as a “cram down.” Before a cram down is permitted, the plan (1) must not discriminate unfairly against the objecting classes and (2) must be fair and equitable. A plan may cram down a class of unsecured claims provided that the plan meets the criteria set out in section 1129(b)(2)(B), which states:

For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements:

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

24. A class of unsecured claims can be crammed down in two different ways. In the first method, claimholders are paid an amount equal to the present value of the full amount of their claim, either on the effective date or over time. The second method allows unsecured creditors to be paid in part or not at all, so long as the plan does not violate the absolute priority rule.

25. Courts have wrestled with how to apply the absolute priority rule to individual debtors in chapter 11 cases. *Compare Matter of Yasparro*, 100 B.R. 91 (Bankr. M.D. Fla. 1989) (debtor’s plan, which did not propose to pay unsecured creditors the full amount of their allowed claims and which proposed that the debtor retain both exempt and non-exempt assets, did not satisfy the absolute priority rule),

with *In re Henderson*, 321 B.R. 550, 561 (Bankr. M.D. Fla. 2005) (debtor's plan did not violate the absolute priority rule because a total liquidation of all of the debtor's assets was not required in order for a plan to be fair and equitable to dissenting creditors who were subject to cram down), *aff'd* 341 B.R. 783 (M.D. Fla. 2006).

26. The absolute priority rule was not originally conceived to apply to individuals<sup>11</sup> and it appears that chapter 11 wasn't either. See *Toibb v. Radloff*, 501 U.S. 157, 167 (1991) (Stevens, J. dissenting) ("The repeated references to the debtor's 'business,' the operation of the debtor's business, and the 'current or former management of the debtor' make it abundantly clear that the principal focus of the chapter is upon business reorganizations."). Nevertheless, the Bankruptcy Code permits an individual debtor in a chapter 11 case to use the cram down provisions in section 1129(b). *In re Shat*, 424 B.R. 854, 862 (Bankr. D. Nev. 2010) ("[B]efore 2005, the authorities were pretty much in agreement that the absolute priority rule applied to individuals in chapter 11.").

27. In 2005, Congress adopted BAPCPA. BAPCPA made numerous changes to the Bankruptcy Code, some of which impacted individual chapter 11 debtors. For example, Section 1129(b)(2) was amended by adding the following language to the end of section 1129(b)(2)(B)(ii): *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 section.*

28. BAPCPA also added section 1115 which reads:

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

- (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

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11 *Friedman*, 466 B.R. at 478-80 (discussing application of absolute priority rule to individuals).

- (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 section 1104 or a confirmed plan or order confirming a plan, the debtor shall remain in possession of all property of the estate.

29. The new exception language in section 1129(b)(2)(B)(ii) allows an individual debtor to retain property included in the estate under section 1115. Section 1115(a) enlarges the bankruptcy estate by including into the estate two kinds of postpetition property. These two types of property are described as being “in addition to” the kinds of property specified in section 541.

30. Admittedly, courts are split as to whether the absolute priority rule applies to individual debtors due to the awkward language used in sections 1115 and 1129(b)(2)(B)(ii). *In re Maharaj*, 2012 WL 2153066 (4th Cir. June 14, 2012) (“A significant split of authorities has developed nationally among the bankruptcy courts regarding the effect of the BAPCPA amendments on the absolute priority rule when the Chapter 11 debtor is an individual.”). Two interpretations exist. The broad, and better reasoned, view adopts an expansive reading of section 1115 in which section 1115 subsumes and supersedes section 541 in defining property of the estate. *See Friedman*, 466 B.R. 471; *SPCP Group, LLC v. Biggins*, 465 B.R. 316 (M.D. Fla. 2011); *In re Shat*, 424 B.R. 854 (Bankr. D. Nev. 2010); *In re Johnson*, 402 B.R. 851 (Bankr. N.D. Ind. 2009); *In re Tegeder*, 369 B.R. 477 (Bankr. D. Neb. 2007); *In re Roedemeier*, 374 B.R. 264 (Bankr. D. Kan. 2007); *In re Bullard*, 358 B.R. 541 (Bankr. D. Conn. 2007).

31. Under the broad view, property included in the estate under section 1115 includes: (1) prepetition property; (2) property acquired by the debtor postpetition; and (3) postpetition earnings of the debtor. The broad view abrogates the absolute priority rule for individual debtors because the exception in section

1129(b)(2)(B)(ii) applies to all property in the bankruptcy estate.<sup>12</sup>

32. The second interpretation, the narrow view, favors a limited interpretation of section 1115's effect on section 541 in which the phrase "in addition to the property specified in section 541" is a cross-reference, where "property included in the estate under section 1115" includes only: (1) property acquired by the debtor postpetition and (2) postpetition earnings of the debtor. *See In re Maharaj*, WL 2153066; *In re Arnold*, 2012 WL 1820877 (Bankr. C.D. Cal. May 17, 2012); *In re Kamell*, 451 B.R. 505 (Bankr. C.D. Cal. 2011); *In re Gbadebo*, 431 B.R. 222 (Bankr. N.D. Cal. 2010). Therefore, the narrow view only applies the absolute priority rule to prepetition property because section 1115 includes only two kinds of postpetition property.

## A. Section 1115 Abrogates the Absolute

### Priority Rule in Individual Chapter 11 Cases

33. Numerous courts to address the issue have adopted the broad view and abrogated the absolute priority rule as it applies to individual chapter 11 cases. *See In re Friedman*, 466 B.R. 471 (9th Cir. B.A.P. 2012); *In re Shat*, 424 B.R. 854 (Bankr. D. Nev. 2010); *In re Johnson*, 402 B.R. 851 (Bankr. N.D. Ind. 2009); *In re Tegeder*, 369 B.R. 477 (Bankr. D. Neb. 2007); *In re Roedemeier*, 374 B.R. 264 (Bankr. D. Kan. 2007); *In re Bullard*, 358 B.R. 541 (Bankr. D. Conn. 2007); *SPCP*

<sup>12</sup> The Debtor also notes that "[a]s pointed out by the bankruptcy court in *In re Lively*, 467 B.R. 884, 890 n. 3 (Bankr.S.D.Tex.2012) (citing by way of example to *In re Shat*, 424 B.R. 854 (Bankr.D.Nev.2010)), some courts have suggested that 11 U.S.C. § 1129(b)(2)(B)(ii)'s express reference to 11 U.S.C. § 1129(a)(14) is a scrivener's error and that Congress actually intended the reference to instead be to (a)(15), thus making (b)(2)(B)(ii)'s exemption for individual debtors from the absolute priority rule (whatever its extent) subject to (a)(15)'s requirements and not those of (a)(14)." *Lucarelli*, 2014 WL 4388250, \*3 n. 2. This interpretation is in contrast to Collier's understanding that section 1129(b)(2)(B)(ii) "may not be used to undermine the confirmation requirement that the debtor be current on all postpetition domestic support obligations as required for confirmation by section 1129(a)(14)." 7-1129 Collier on Bankruptcy ¶ 1129.04[d] (16th ed. 2014).

*Group, LLC v. Biggins*, 465 B.R. 316 (M.D. Fla. 2011).

34. First, the unambiguous language of section 1115 requires abrogation. The courts in *Tegeder*, *Biggins*, and *Friedman* found the language of section 1115 to be clear and unambiguous. *Biggins*, 465 B.R. at 322 (“The Court reaches this conclusion not by analyzing the legislative history of the relevant statutes, as the *Shat* and *Gelin* courts did, but by focusing on the statutes’ plain language.”); *Tegeder*, 369 B.R. at 480 (“Thus, § 1115 is clear that property of the estate in a case in which the debtor is an individual includes the property described in § 541 . . . as well as postpetition property and earnings.”). The Ninth Circuit BAP in *In re Friedman* gave a thoughtful analysis as to why the language at issue is unambiguous. The *Friedman* majority found that the plain language, when read in context with the rest of the Bankruptcy Code, does not require the application of an absolute priority rule to an individual. *Id.* at 483 (“Finally, a plain reading of §§ 1129 and 1115 demonstrates that, just as in chapter 13, to confirm a plan does not require the application of an absolute priority rule.”).

35. Second, Congress, in adopting BAPCPA’s individual debtor chapter 11 provisions, borrowed language from chapter 13. Chapter 13 has no absolute priority rule equivalent. Therefore, Congress likely intended to abrogate the absolute priority rule. *Id.* Moreover, since the new disposable income requirement of section 1129(a)(15) – which closely resembles the disposable income requirement of section 1325(b)(1) – requires the contribution of post-confirmation disposable income (presumably generated from the property retained by the debtor), this negates the need for the absolute priority rule. *Id.* (“As in Chapter 13, the disposable income requirement insures that the individual debtor is required to dedicate all of his or her disposable income over a designated time period (three or five years in Chapter 13, at least five years in chapter 11) to plan payments directed to unsecured creditors.”). Why would Congress require an individual debtor to actively dedicate future post-

petition earnings or income in one place yet place at risk the debtor's very earning ability (from his continued use and exploitation of prepetition property)?

36. The similarities between the BAPCPA amendments and certain other chapter 13 provisions demonstrate that Congress intended to bring individual chapter 11 cases more in line with chapter 13. *Friedman*, 466 B.R. at 484 (“However, clearly, the drafters of § 1129(a)(15) tried to create symmetry between chapters 11 and 13 for individual debtors.”); *Shat*, 424 B.R. at 868 (“Here, given the host of change [sic] to chapter 11 with respect to individuals, all made with the goal of shaping an individual's chapter 11 case to look like a chapter 13 case . . . this court concludes that the broader interpretation is the proper one.”); *Roedemeier*, 374 B.R. at 275-76 (Bankr. D. Kan. 2007) (“Many of the BAPCPA's changes to Chapter 11 apply only to individual debtors and are clearly drawn from the Chapter 13 model. . . . Taken together, these changes indicate Congress intended to extend the exemption from the absolute priority rule to individual Chapter 11 debtors as well.”). Compare § 1123(a)(8) with § 1322(a)(1); § 1129(a)(15) with § 1325(b)(1); § 1141(d)(5)(A) with § 1328(a); § 1141(d)(5)(B) with § 1328(b); § 1127(e) with § 1329(a).

37. In many cases, the BAPCPA amendments match the chapter 13 provision word for word. BAPCPA imported chapter 13 concepts into individual chapter 11 cases; by extension, individuals should be exempt from the absolute priority rule because chapter 13 has no such requirement.

## **B. Equity Requires the Abrogation of the Absolute**

### **Priority Rule in Individual Chapter 11 Cases**

38. If the absolute priority rule was not abrogated in Hoplandia by section 1115, equity and common sense require the abrogation of the absolute priority rule in individual chapter 11 cases. Absent such abrogation, vindictive unse-

cured creditors could, regardless of the fairness of the proposed dividend, maintain a stranglehold on a plan and require a debtor to either pay them in full or relinquish virtually all of his assets – as Seedy is doing in the instant case.<sup>13</sup> Mr. Suds’ equipment is highly customized and would not fetch as much following a liquidation of the assets as they would in Mr. Suds’ unique control.

39. First, section 1129(a)(7)(A)(ii) requires that the holder of an impaired claim that rejects a plan receive an amount under the plan that is not less than the creditor would have received if the debtor were liquidated under chapter 7. Seedy rejected the Plan and is thus entitled to receive an amount not less than Seedy would receive if the Debtor were liquidated under chapter 7. In the instant case, Seedy’s projected recovery on its Class 4 claim far exceeds what it would receive in a chapter 7 case, so this requirement is satisfied.

40. Second, if the holder of an unsecured claim objects to confirmation, section 1129(a)(15) requires that an individual chapter 11 plan either pay such claim in full or provide that “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(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.” 11 U.S.C. § 1129(a)(15)(B). Accordingly,

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13 *Lucarelli*, 2014 WL 4388250, \*8 (“The court notes that when the real-world implications of each view are compared, the broad view leads to a more practical and functional result in individual Chapter 11 cases. The narrow view will have the practical effect of making confirmation of a nonconsensual plan in an individual Chapter 11 case highly unlikely, if not virtually impossible. . . . Indeed, the narrow view effectively requires an individual debtor whose liabilities exceed the Chapter 13 debt limits, and whose creditors will not consent to less than full payment of their claims, to undergo the functional equivalent of a liquidation. Additionally, as is true in this case, debtors in many individual Chapter 11 cases have a pre-petition ownership interest in a business that is their primary source of income. How can liquidating a debtor’s primary source of post-petition disposable income—his business—be reconciled with maximizing the amount returned to creditors under Section 1129(a)(15)? It appears that the two cannot be reconciled in a way that maximizes the return to creditors and allows an individual debtor to successfully reorganize under Chapter 11 in the absence of a consensual plan.”)

section 1129(a)(15) requires that the holder of a claim receive at least what the creditor would have received in a chapter 13 case. Seedy objects to confirmation of the Plan. As such, Seedy is entitled to receive an amount not less than Seedy would receive if the Debtor were in chapter 13. In the instant case, Seedy's projected recovery on its Class 4 claim exceeds what it would receive in a chapter 13 case. Moreover, Seedy stands to recover substantially more – a 15% bonus distribution – if the Debtor is able to use his market know-how in creating a year round *Plato the Blind*. Accordingly, this requirement is satisfied.

41. Not content with receiving a higher recovery than it would in a chapter 7 or chapter 13 case, Seedy voted to reject the Plan. Because of the size of Seedy's claim (more than two-thirds in dollar amount of Class 4), Seedy has a blocking position in Class 4. As such, Seedy's rejection of the Plan caused Class 4 to reject the Plan. When an impaired class rejects a plan, section 1129(b)(2)(B) requires that the plan conform to the absolute priority rule.

42. If this Court were to adopt the "narrow view" discussed above, the Debtor would be required to amend the Plan so that the only interest retained by the Debtor would be his postpetition property; despite that he would also, pursuant to section 1129(a)(15), be required to commit his disposable income to plan distributions for at least the next 5 years. However, the Debtor would be without the means to implement the Plan. For example, the Debtor's projected disposable income is premised on his income as a brewmaster and, specifically, his ability to bring *Plato the Blind* to market year round utilizing his customized equipment and trade secrets. However, without his equipment and access to Stache Brewery, the Debtor will not be able to implement his Plan. Mr. Suds' livelihood is in Stache Brewery and the customized equipment. Depriving Mr. Suds of these prepetition assets is to deprive him of his livelihood.

43. This form of indentured servitude could not possibly be

what Congress had in mind when it adopted the BAPCPA provisions. Accordingly, Seedy's objections must be overruled and this Court must adopt the "broad view" such where a creditor receives more than it would in a chapter 7 or chapter 13 case, the absolute priority rule is abrogated. To hold otherwise would effectually eliminate nonconsensual individual chapter 11 cases. *Friedman*, 466 B.R. at 478 (The absolute priority was not intended for individual chapter 11 cases, but "was a judicially created concept, arising from a series of early twentieth-century railroad cases. . . . The U.S. Supreme Court adopted the absolute priority rule to prevent deals between senior creditors and equity holders that would impose unfair terms on secured creditors."). As the *Friedman* court recognized, "Congress affirmatively amended the law so that § 1129(a)(15)(B) would trump § 1129(b)(2)(B)(ii) in individual debtor cases." *Id.* at 484.

**C. New Value Exception Also Permits Debtor to Retain Interests**

44. If the Court were to adopt the "narrow view" and conclude that the absolute priority rule applies in individual chapter 11 cases, the Debtor submits that the Debtor's post-confirmation efforts in connection with bringing *Plato the Blind* to market year round constitute "new value" and any interest retained in prepetition property is on account of this "new value."

45. The absolute priority rule is not absolute. "[C]ourts have always reviewed §1129(b)(2)(B)(ii) through the lens of common sense and have approached legislative interpretation in a way to facilitate the goals of the statute." *Friedman*, 466 B.R. at 478 ("An interesting feature of the absolute priority rule, even before enactment of the BAPCPA amendment to § 1129(b)(2)(B)(ii), is that the rule has never been absolute."); *Kansas City Terminal Ry. Co. v. Cent. Union Trust Co.*, 271 U.S. 445, 455 (1926) (recognizing, in dicta, that a new, substantial, and necessary contribution could allow an old equity holder to retain an interest in the

reorganized debtor).

46. Historically, the Supreme Court has recognized that a debtor's promise of future services, in the context of "new value," is intangible, inalienable, and unenforceable. *Ahlers*, 485 U.S. at 204 (quoting *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106, 122-23 (1939)). However, *Ahlers* was decided pre-BAPCPA. Specifically, it was decided prior to the adoption of sections 1123(a)(8) and 1129(a)(15) that *requires* a debtor to distribute its disposable income for at least 5 years. Accordingly, future labor and management skills are no longer "merely vague hopes or possibilities" – they are required. Accordingly, the Debtor submits that Congress implicitly overruled the holding in *Ahlers* when it enacted sections 1123(a)(8) and 1129(a)(15).

#### **IV. RACING EXPENSES ARE ORDINARY COURSE EXPENSES**

47. Seedy objects to the Plan on the basis that the Plan was not proposed in good faith as required by section 1129(a)(3). Specifically, Seedy contends that the Debtor's payment of monthly racing expenses during the pendency of this chapter 11 were unauthorized payments outside the ordinary course of business in contravention of section 363(c)(1). However, the Debtor submits that such expenses were incurred on a regular basis prepetition and constitute the Debtor's ordinary course living expenses. Moreover, such expenses were disclosed in monthly operating reports and incurred in furtherance of the business as a marketing tool. Accordingly, pursuant to section 363(c)(1), court authority was not required.

48. Section 363(c)(1) provides:

If the business of the debtor is authorized to be operated under section 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.

11 U.S.C. § 363(c)(1). Prior to the enactment of section 1115, few cases addressed the issue of whether a debtor was required to obtain court approval for the payment of living expenses from estate property. Of those courts that considered the issue, some held that normal living expenses of an individual chapter 11 debtor did not need court approval, while others indicated that some form of court approval would be necessary, at least in cases of significant expenses. *Compare In re Murray*, 216 B.R. 712, 713 (Bankr. W.D.N.Y. 1998); *In re Keenan*, 195 B.R. 236, 243 (Bankr. W.D. N.Y. 1996); *In re Bradley*, 185 B.R. 7, 8 (Bankr. W.D.N.Y. 1995) (“[W]hen a Chapter 11 Debtor-in-Possession is a natural person, his personal expenses and his obligations for incidents of his personal life are every bit as much a part of the ordinary course of his business and financial affairs as are expenses incident to the operation of the various shopping malls, nursing homes, and office buildings that he owned.”) with *In re Harp*, 166 B.R. 740, 741-46, 755-56 (discussing that the chapter 11 debtor violated his fiduciary duties by paying for rental of vacation homes, sponsoring a football game brunch and taking a vacation to an exclusive resort in the Netherland Antilles). However, other pre-BAPCPA courts held that no authority permitted the payment of an individual chapter 11 debtor’s living expenses from estate property. *In re Vincent*, 4 B.R. 21, 23 (Bankr. M.D. Tenn. 1979); see also *In re Walter*, 83 B.R. 14, 19-20 (B.A.P. 9th Cir. 1988) (“The bankruptcy court properly relied on case law whereby courts had held that personal living expenses for debtors and their families, as well as attorney’s fees which benefitted the debtor as an individual, but not the bankruptcy estate, could not be paid out of monies or assets of the estate. The bankruptcy court has authority to deny the debtor use of estate property for living expenses for himself or his family.”).

49. However, it is worthwhile to emphasize that the above decisions interpreting section 363(c)(1) in the context of ordinary living expenses arose prior to the adoption of section 1115, which brings into the estate postpetition earnings. Accordingly, prior to the enactment of section 1115, debtors could indisputably spend their postpetition earnings freely. They could not, however, spend their prepetition savings (which became part of the estate) on lavish ordinary course liv-

ing expenses.

50. Post-BAPCPA courts have been more lenient and have held that section 363(c)(1) authorizes individual chapter 11 debtors to use estate property to pay ordinary living expenses, without obtaining court approval. *In re Seely*, 492 B.R. 284, 289-91 (Bankr. C.D. Cal. 2013); *see also In re Goldstein*, 383 B.R. 496, 499 (Bankr. C.D. Cal. 2007); *In re Villalobos*, 2011 WL 4485793, at \*8-9 (B.A.P. 9th Cir. Aug. 19, 2011).

51. The *Seely* court reasoned:

Notwithstanding section 363(c)(1)'s reference to the ordinary course of a debtor's *business*, because the debtor cannot continue to generate post-petition wages without being able to pay for the personal expenses necessary to permit him to live his life and remain gainfully employed, section 363(c)(1) has generally been understood to authorize chapter 13 debtors to pay post-petition living expenses without notice and an opportunity for hearing or a prior court order, so long as such expenses are "ordinary course" rather than unusual or extraordinary. If a chapter 13 debtor's post-petition living expenses prove unreasonable or excessive, his chapter 13 case will be converted or dismissed, either because his plan was not proposed in good faith or because he is unwilling to devote all of his disposable income to the payment of creditors under his plan, and not because the debtor failed to obtain prior court approval for the payment of his ordinary course living expenses during the pendency of the case.

Rather than struggle to invent out of whole cloth a procedure and standard for approving requests by chapter 11 debtors for authority to spend property of the estate for the payment of post-petition living expenses, the court should give section 363(c)(1) the same interpretation in chapter 11 cases as it has always been understood to have in chapter 13 cases. That is, the court should recognize that section 363(c)(1) authorizes a debtor in possession to use property of the estate to pay post-petition living expenses without prior court approval, so long as the amounts to be disbursed qualify as "ordinary course" expenses. An individual chapter 11 debtor needs to pay his living expenses in order to continue generating revenues for the estate. Thus, the payment of ordinary course living expenses should be treated as being within the

debtor's ordinary course of business for the purpose of interpreting section 363(c)(1).

*In re Seely*, 492 B.R. at 290. Seedy is likely to urge this Court to ignore the Debtor's standard of living and the undisputed fact that the Debtor historically paid his monthly racing expenses. *Villalobos*, 2011 WL 4485793, at \*8-9 (bankruptcy court's finding that individual chapter 11 debtor had historically paid certain expenses was insufficient grounds for approving debtor's postpetition payment of luxury vehicles, expensive homes, and college tuition of grandchildren from estate property). However, the Debtor submits that the racing expenses were regular, generally fixed, ordinary monthly expenses. Moreover, the racing expenses were ordinary marketing expenses for Stache Brewery, which indirectly benefited Seedy. Stache Brewery was prominently displayed on the race cars, trailers, and uniforms, increasing brand awareness throughout the country. In addition, the Debtor is convinced that the perception that Stache Brewery was operational during its bankruptcy was essential to keeping the status quo among its customers, distributors, and suppliers. As such, the Debtor submits that such expenses should be allowed as ordinary course expenses under section 363(c)(1).

52. Regardless, such expenses were not incurred in bad faith. Although perhaps lavish, and incurred at a time when the Debtor was living beyond his earned income, such expenditures were not a willful attempt to direct funds away from the Debtor's creditors. *In re Hawkins*, 2014 WL 4494845 (9th Cir. 2014) (debtor's prepetition lavish lifestyle and expenditures beyond his earned income did not qualify as a willful attempt to evade or defeat taxes under section 523(a)(1)(c)).

## V. CRIMINAL LEGAL FEES BENEFIT THE ESTATE AND MAY BE PAID

53. Seedy also objects to the Plan because it contemplates the payment of legal fees from property of the estate to an attorney that was not retained with the approval of the Court. Specifically, Seedy contends that the Plan does not comply with section 1129(a)(4) because Seedy's criminal defense attorney was not

retained under sections 327 and 330 of the Bankruptcy Code. Moreover, Seedy contends that the criminal defense attorney could not have been retained under sections 327 and 330 because he does not provide the requisite benefit to the estate. *In re Miell*, 2009 U.S. Dist. LEXIS 73757 (N.D. Iowa, Aug. 19, 2009) (section 330(a)(4)(B) does not permit payment of a debtor's attorney in a chapter 11 case); *In re Weaver*, 336 B.R. 115 (Bankr. W.D. Tex. 2005) (general counsel was not entitled to be compensated by estate for time spent in dealing with exempt property); *In re Polishuk*, 258 B.R. 238 (Bankr. N.D. Okla. 2001) (attorney representing debtor in state court divorce action was entitled to be compensated from estate for time spent in trial of divorce action and in obtaining equitable distribution of marital property, but not for litigating child support and custody issues, given lack of any real "benefit" from such services to estate); *In re Dixon*, 2010 WL 3767604 (Bankr. N.D. Ca. 2010) (chapter 11 counsel may not defend exemptions because they are against the interests of the estate); *but see In re Warner*, 141 B.R. 762 (M.D. Fla. 1992) (district court found no abuse of discretion in the bankruptcy court's authorization of payment of criminal defense attorneys out of the bankruptcy estate, pursuant to section 327(e)).

54. First, the Debtor submits that Dewey LLP's services were rendered in the ordinary course because such fees were incurred prepetition and postpetition. As such, they may be paid pursuant to section 363(c)(1).

55. Second, the Debtor respectfully submits that Court approval of an individual's criminal defense attorney in a chapter 11 case is not required and any such requirement would infringe on an individual's fundamental freedom to be represented by counsel of his choosing.

56. Third, Congress overlooked the potential need for criminal defense attorneys in individual chapter 11 cases when it adopted section 1115. Section 330(a) generally prescribes the standard for compensation of officers: reasonable compensation for actual, necessary services rendered by the trustee, examiner,

ombudsman, professional person, or attorney. However, section 330(a) was amended by section 224(b) of the Bankruptcy Reform Act of 1994. This amendment deleted the reference to the debtor's attorney, thus eliminating statutory authority for a debtor's attorney to recover fees from a chapter 7 estate. However, such amendment was enacted 11 years before Congress added section 1115 bringing postpetition income into the chapter 11 estate. Accordingly, between 1994 and 2005, an individual chapter 11 debtor could use his postpetition earnings to pay his criminal defense fees.

57. Today, Seedy submits that an individual chapter 11 debtor must first seek to retain his or her criminal defense attorney under sections 327 and 330 of the Bankruptcy Code. By implication, Seedy's proposal leaves the selection of an individual's criminal defense attorney to the Bankruptcy Court's discretion. More troubling, however, is the power of a trustee. Sections 327 and 330 permit a trustee or debtor in possession to retain counsel. If a trustee is appointed in a chapter 11 case and denies a debtor's request to hire a criminal defense attorney, the individual debtor is without recourse. Section 1115 brings postpetition funds into the purview of the chapter 11 trustee. In this scenario, the debtor is effectively denied access to counsel. Congress could not have intended this outcome.

58. Instead, the Debtor submits that Congress mistakenly failed to amend section 330 to permit the payment of a debtor's personal attorney in an individual chapter 11 case when it added section 1115. At times, it is proper for a court to look at the statutes holistically and through the lens of common sense. This is one of those times. A man's liberty hangs in the balance. Without authority to pay his criminal defense attorneys, Mr. Suds will be required to proceed to sentencing without the benefit of counsel. The Debtor respectfully requests that the Court recognize the drafting flaw in the Bankruptcy Code and permit confirmation of the Plan allowing the payment of the Debtor's criminal defense attorney's fees.

**VI. OBJECTIONS TO BANKRUPTCY COUNSEL'S FEES ARE RESERVED FOR THE HEARING ON FINAL FEE APPLICATIONS**

59. Seedy has also raised an objection to the Debtor's bankruptcy counsel's fees on the basis that fees incurred protecting the Debtor's exempt property was materially adverse to the estate. The Debtor submits, however, that the Plan requires professionals retained in the bankruptcy case to submit final fee applications and professionals will only be paid upon entry of an order allowing such fees. Accordingly, this objection should be reserved for the hearing on the final fee application and is not an appropriate objection to confirmation.

60. For the foregoing reasons, the Debtor respectfully requests that the Court enter an order confirming the Plan.

Dated: November 15, 2014 San Francisco, California	PACHULSKI STANG ZIEHL & JONES LLP	
	By:	<i>/s/ Henry C. Kevane</i>
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**AMERICAN BANKRUPTCY INSTITUTE**  
26th Annual Winter Leadership Conference  
La Quinta, California  
December 4 – 6, 2014

**INDIVIDUAL CHAPTER 11  
CONFIRMATION MOCK HEARING**

Saturday, December 6, 2014  
8:00 a.m. to 9:30 a.m.

**Litigants**

Henry C. Kevane, Pachulski Stang Ziehl & Jones LLP; San Francisco

Patricia A. Redmond, Stearns Weaver Miller Weissler Alhadeff & Sitterson, P.A.; Miami

**Bench**

Honorable Laurel M. Isicoff, U.S. Bankruptcy Court (S.D. Fla.); Miami

Honorable Maureen A. Tighe, U.S. Bankruptcy Court (C.D. Cal.); Woodland Hills

A. Facts

1. In 2010, John Suds opened Stache Brewery, a microbrewery, in Hoplandia. Fresh out of the University of Hoplandia Professional Brewing Program, Mr. Suds obtained (1) a loan from Wells Fargo secured exclusively by the real property of Stache (\$250,000 principal; interest only at 7% APR; maturity in 2020) and (2) a loan from GE Capital secured by Stache's brewing equipment, inventory and accounts (\$100,000 principal; interest only at 15% APR; maturity in 2020).
2. Mr. Suds could not afford "fancy New York corporate lawyers" and opened Stache as a sole proprietorship. To save money, Mr. Suds converted the brewery's attic into a living space and made it his sole residence. The attic accounts for 25% of the brewery's square footage.
3. Stache Brewery became immensely popular in Hoplandia for its West Coast style IPAs renowned for their copious use of fresh Centennial and Cascade hops. Stache also perfected a technically difficult triple IPA beer, called *Plato the Blind*, that was released only once a year and had developed a huge cult following. To accomplish this feat, Mr. Suds meticulously customized his brewery equipment to such an extent even his fellow brewmasters have no idea how it operates.
4. Mr. Suds was able to pay off his student debt. However, rather than pay down his business loans with his new found wealth, Mr. Suds invested in an amateur vintage racecar team to compete for the Brewers Cup – proudly advertising that his team was sponsored by Stache Brewery. During the month, Mr. Suds' race crew would trailer his 1957 Ferrari 250 Testarossa to race tracks throughout the country. Mr. Suds was the driver and would fly to meet his team on race day. Mr. Suds spent approximately \$25,000 per month on racing expenses. Mr. Suds believes that his racing sponsorship has led to numerous new distributorship agreements in each of the cities that hosted the Brewer's Cup.
5. Mr. Suds won his first Brewers Cup. After celebrating with this team, he decided to drive back to Hoplandia rather than fly. Unfortunately, Mr. Suds was pulled over by the HPD and arrested for DUI.
6. Mr. Suds hired Hoplandia's best criminal defense attorney, a partner at Dewey LLP that charges \$1,250 per hour. Mr. Suds' criminal defense legal fees are approximately \$50,000 per month. Mr. Suds pled not guilty and is scheduled to be tried at some point in the future. If Mr. Suds is convicted of the DUI offense, the Stache Brewery liquor license may be revoked by Hoplandia. But Mr. Suds is mainly concerned that a conviction may lead to a severe sentence which he is determined to avoid. If convicted, he faces a sentence of up to 5 years in jail because this would be his second DUI conviction. Mr. Suds is also worried about the possible imposition of significant fines or penalties.
7. After his arrest, Mr. Suds continued to make poor decisions. He limited the production of his wildly popular IPAs and branched out to Oatmeal stouts, other sweeter and maltier ales, and some experimental black lagers. Misinterpreting the market, Stache's financials went into a tailspin. Despite becoming insolvent on a cash flow basis and having to tap into his savings to pay his bills, Mr. Suds continued to fund his racing team's

monthly expenses, flying first class to the races.

8. Eventually, Mr. Suds saw the caution flag and made a pit stop in bankruptcy. Mr. Suds filed an individual chapter 11 case in Hoplandia.
9. In Hoplandia, a chapter 11 individual debtor has the right to claim certain exemptions. The exemption provisions in Hoplandia are liberal and include 100% of the value of the debtor's homestead, provided that *more than half* of the property is allocated to the debtor's personal residence. The exemption provisions also provide an exemption for vehicles valued up to \$250,000.
10. As discussed above, Mr. Suds lives on the property, but also uses his property to operate his brewery, store his inventory, and manage his accounts. Prior to filing bankruptcy, Mr. Suds' attorney counseled him with respect to the exempt status of his homestead. He advised Mr. Suds that he should move his personal effects and living space to occupy more than half of the premises in order to take advantage of Hoplandia's exemptions. Taking his attorney's advice, Mr. Suds moves his personal effects from the attic and spreads them throughout the brewery and tasting room. For example, he installed his personal TV and recliner in the tasting room.
11. Mr. Suds disclosed in his disclosure statement and monthly operating reports that he continued to pay his ordinary racing team's monthly expenses postpetition, which to date, amount to \$200,000. Mr. Suds also disclosed that during a postpetition race, Mr. Suds totaled his race car (valued at \$250,000) and purchased a replacement vehicle (also valued at \$250,000) in cash from Stache Brewery's operating account. Mr. Suds did not seek bankruptcy court approval for these expenses. Unfortunately, Mr. Suds' insurance policy doesn't cover race cars. Mr. Suds timely filed his monthly operating reports, but nobody objected to, or raised a concern with, his monthly expenditures.
12. Mr. Suds filed a chapter 11 plan, the terms of which are set forth below. Each class accepted the plan except class 2 (Wells Fargo) and class 4 (unsecured claims).
13. Class 4 consists of Stache Brewery's trade creditors, most of whom are supportive of Mr. Suds' efforts to keep his business. Seedy, a hop supply company, is owed \$78,000 and is adamantly opposed to the plan. Seedy **objects** to the treatment of its claim, arguing, among other things, that it is unfair that Mr. Suds gets to retain his personal property, including his brewery equipment and race cars, while Seedy only gets 40% of its claim over a number of years. Seedy also **rejects** the plan and his claim is large enough to control the vote of Class 4 creditors.<sup>1</sup> Mr. Suds believes that Seedy has secret plans to enter the brewing business and introduce its own triple hopped IPA.
14. Mr. Suds plans to revive Stache Brewery with some ideas he has been tinkering with since he filed his chapter 11 case, especially a new process for making *Plato the Blind*

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<sup>1</sup> See, e.g., *In re Brown*, 505 B.R. 638, 641 (E.D. Pa. 2014) ("Because [creditor's] claim exceeds the one-third threshold, he holds a 'blocking position' pursuant to § 1126(c), that is, without his consent, the plan cannot be approved.") (citation omitted).

that will make it available year round and could prove enormously lucrative. Without Stache Brewery’s customized kettles and other unique equipment and processes, as well as Mr. Suds’ new ideas and experience, however, Mr. Suds’ dream to improve and expand the *Plato* brand will wither and die. Mr. Suds estimates the cost to develop and produce the next generation *Plato the Blind* at \$100,000 per year. However, the upside potential is unknown.

**B. Plan Terms**

**1. Classification of Claims and Interests:**

<b>Class</b>	<b>Name</b>	<b>Result</b>
Class 1	Administrative Expenses	Unimpaired
Class 2	Wells Fargo	Impaired / Rejecting
Class 3	GE Capital	Impaired / Accepting
Class 4	Unsecured Claims	Impaired / Rejecting

**Class 1 – Administrative Expenses**

Class 1 consists of compensation of professional persons upon approval by the Court pursuant to section 330 and 331. These allowed claims will be paid in full upon entry of an order allowing such claim. However, upon confirmation of the Plan, the debtor is authorized to pay his criminal defense attorney’s fees in full in the amount of \$250,000 without further application to this Court.

**Class 2 – Wells Fargo**

Wells Fargo has a secured claim against the debtor’s residence in the amount of \$250,000. Wells Fargo’s claim is allowed in the amount of \$200,000. This amount, together with interest thereon at the rate of 5% per annum, shall be paid in 180 equal monthly payments of approximately \$1,500.00 each. The first payment shall be made on or before January 1, 2015, with subsequent payments to be made on or before the 1st day of each and every month thereafter until the allowed claim is paid in full.

**Class 3 – GE Capital**

GE Capital has a secured claim against the debtor’s personal property in the amount of \$50,000. This amount, together with interest thereon at the rate of 5% per annum, shall

be paid in 60 equal monthly payments of approximately \$900 each. The first payment shall be made on or before January 1, 2015, with subsequent payments to be made on or before the 1st day of each and every month thereafter, until the allowed claim is paid in full.

#### **Class 4 – Unsecured Claims**

This class includes all unsecured claims, including the Wells Fargo deficiency claim, except those specifically treated elsewhere in this Plan. To be included within this class, unsecured creditors must timely file a proof of claim or be listed in the schedules as undisputed. Any claims that are disputed which are not filed by the claims date shall be barred. All claims uncontested by the debtor as well as contested claims approved by this Court in this class shall be paid from Stache Brewery's post-confirmation net profits. Stache estimates that creditors will receive an approximate 40% recovery over 5 years payable in annual installments.<sup>2</sup> The Plan also provides for a 15% bonus distribution from the proceeds of an exclusive distributorship agreement if Stache Brewery is successful in making a year round *Plato the Blind*. Payments shall be made every year beginning January 1, 2015.

### **2. Retention of Property**

Mr. Suds will retain all property of the estate. Property that is not needed will be abandoned or sold and the proceeds applied to the appropriate secured creditor's claim, whichever is deemed appropriate by Mr. Suds.

## **C. Confirmation Issues**

### **1. § 1123(b)(5) – Anti-Modification Provision**

Wells Fargo objects to the treatment of Class 2. Wells Fargo's claim is secured by the debtor's residence, the brewery, but the debtor proposes to modify Wells Fargo's claim by reducing the principal and interest rate.

*Compare In re Wages*, 508 B.R. 161 (9th Cir. B.A.P. 2014) (adopts bright-line approach that anti-modification exception applies to any loan secured only by real property that the debtor uses as principal residence property, even if that real property also serves additional purposes) with *Scarborough v. Chase Manhattan Mortg. Corp. (In re Scarborough)*, 461 F.3d 406 (3d Cir. 2006) (focusing on Congress' use of the word "is" in the phrase "real property that is the debtor's principal residence," and finding that, by using "is," Congress equated "real property" and "principal residence," meaning that, for the anti-modification provision to apply, the property "must be only the debtor's principal residence" and have no other use).

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<sup>2</sup> The Plan meets the requirements of section 1129(a)(15) because it devotes the projected disposable income of Stache Brewery over the 5-year period beginning January 1, 2015, even though Stache Brewery assumes significant start-up costs to perfect its new *Plato the Blind* release (cost est. \$100,000 per year). The Plan also satisfies the requirements of section 1129(a)(7) because a liquidation of the Stache Brewery kettles and equipment would be less than the 40% dividend from future income.

2. §§ 1115(a) and 1129(b) – Absolute Priority Rule

Plan permits Mr. Suds to retain all property of the estate. This includes his *prepetition* interest in the brewery equipment, recipes and other trade secrets, inventory, and other non-exempt personal property. In addition, the Plan allows Mr. Suds to retain his replacement race car and racing gear and equipment.

Trade creditor Seedy objected to the Plan on the basis that, among other things, the Court in Hoplandia should adopt the majority view that the absolute priority rule applies to chapter 11 individual debtors and that the Plan violates the absolute priority rule because Mr. Suds intends to retain ownership of his personal property while Seedy gets paid 40 cents on the dollar. Seedy asserts that Mr. Suds' improved technique for making *Plato the Blind* could itself fetch over \$100,000 if it were sold to a competing brewery. Without the recipe, however, Stache Brewery would likely not be able to compete against Hoplandia's many local craft brewers and would definitely not generate the profits needed to make a 40% dividend (nor, naturally, the 15% bonus payment from the distributorship agreement).

Does the absolute priority rule apply to individual chapter 11 plans in Hoplandia? If so, does application of the absolute priority rule prohibit Mr. Suds from also retaining his exempt property?

*Compare In re Ice House America, LLC v. Cardin*, 751 F.3d 734 (6th Cir. 2014) (adopting majority narrow view that absolute priority rule applies to chapter 11 individual debtor); *In re Lively*, 717 F.3d 406 (5th Cir. 2013) (same); *In re Stephens*, 704 F.3d 1279 (10th Cir. 2013) (same); *In re Maharaj*, 681 F.3d 558 (4th Cir. 2012) (same) *with In re Friedman*, 466 B.R. 471 (9th Cir. B.A.P. 2012) (adopting minority broad view that BAPCPA amendments abrogated absolute priority rule as applied to chapter 11 individual debtors).

*See also In re Gosman*, 282 B.R. 45 (Bankr. S.D. Fla. 2002) (exempt property must be devoted to debtor's chapter 11 plans); *but see In re Henderson*, 321 B.R. 550, 561 (Bankr. M.D. Fla. 2005); *aff'd, VanBuren Indus. Investors v. Henderson (In re Henderson)*, 341 B.R. 783 (M.D. Fla. 2006) (individual debtor can retain exempt property without violating absolute priority rule because once a debtor's claim of exemptions is allowed, the property is no longer property of the estate).

3. §§ 363(c)(1) and 1129(a)(2)-(4) – Living Expenses & Defense Counsel

Mr. Suds continued to fund his race team postpetition. Trade creditor Seedy objected to the Plan on the basis that the Plan was not proposed in good faith because such expenses were outside the ordinary course of business and Mr. Suds did not seek bankruptcy court approval.

Analyze 363(c)(1) and ability to use estate assets to pay ordinary course living expenses. *See In re Seely*, 492 B.R. 284 (Bankr. C.D. Cal. 2013) (payment of ordinary course living expenses should be treated as being within the debtor's ordinary course of business for the purpose of interpreting section 363(c)(1)); *In re Hawkins*, 2014 WL 4494845

(9th Cir. 2014) (debtor’s prepetition lavish lifestyle and expenditures beyond his earned income did not qualify as a willful attempt to evade or defeat taxes under section 523(a)(1)(c)).

What factors do courts use to evaluate whether an expense is “ordinary” rather than unusual or extraordinary? Is it proper to adopt the horizontal dimension test (industry standard) and vertical dimension test (creditor expectations) articulated by *In re Dant & Russell, Inc.*, 853 F.2d 700 (9th Cir. 1988) (execution of leases was in the ordinary course of business).

The Plan also seeks to pay Mr. Suds’ criminal defense attorney for services rendered postpetition to Mr. Suds in connection with defending his DUI charges. Mr. Suds’ criminal defense attorney was not retained under the Bankruptcy Code. Mr. Suds also periodically paid his criminal defense attorney’s fees during the pendency of the chapter 11 case.

Trade creditor Seedy also objected to the Plan because it does not satisfy section 1129(a)(4) because it contemplates the payment of legal fees from property of the estate to an attorney that was not retained with the approval of the Court.

Does engaging a criminal defense attorney provide the requisite benefit to the estate to be proper under sections 327 and 330? *In re Miell*, 2009 U.S. Dist. LEXIS 73757 (N.D. Iowa, Aug. 19, 2009) (section 330(a)(4)(B) does not permit payment of a debtor’s attorney in a chapter 11 case); *In re Weaver*, 336 B.R. 115 (Bankr. W.D. Tex. 2005) (general counsel was not entitled to be compensated by estate for time spent in dealing with exempt property); *In re Polishuk*, 258 B.R. 238 (Bankr. N.D. Okla. 2001) (attorney representing debtor in state court divorce action was entitled to be compensated from estate for time spent in trial of divorce action and in obtaining equitable distribution of marital property, but not for litigating child support and custody issues, given lack of any real “benefit” from such services to estate); *In re Dixon*, 2010 WL 3767604 (Bankr. N.D. Ca. 2010) (chapter 11 counsel may not defend exemptions because they are against the interests of the estate); *but see In re Warner*, 141 B.R. 762 (M.D. Fla. 1992) (district court found no abuse of discretion in the bankruptcy court’s authorization of payment of criminal defense attorneys out of the bankruptcy estate, pursuant to section 327(e)).

#### 4. §§ 1129(a)(2) and (3) – Defense of Exemption

Sections 1129(a)(2) and (3) provide that:

The court shall confirm a plan only if ... “(2) [t]he proponent of the Plan complies with the applicable provisions of this title” and “(3) [t]he plan has been proposed in good faith and not by any means forbidden by law.”

Section 1129(a)(2) requires the proponent to comply with applicable provisions of title 11. Is counsel’s failure to be disinterested and his representation of an interest materially adverse to the estate an appropriate objection to the confirmation of an individual Chapter 11 plan under subsections (a)(2) or (a)(3)? *See Weaver*, 336 B.R. 115 (dealing with attorney compensation); *Dixon*, 2010 WL 3767604 (same). It is a fundamental

principle of bankruptcy law that a trustee (or a debtor in possession exercising the powers of a trustee) is a fiduciary on behalf of the bankruptcy estate for the benefit of creditors, equity security holders and other interested parties. Counsel hired by the trustee represents the estate and not the principals or management of the debtor or the debtor individually. “While he must always take his directions from his client, where counsel for the estate develops material doubts about whether a proposed course of action in fact serves the estate’s interests, he must seek to persuade his client to take a different course or, failing that, resign.” *In re Perez*, 30 F.3d 1209, 1219 (9th Cir. 1994). The employment of counsel by a trustee (or a committee) is subject to stringent requirements under the Bankruptcy Code. 11 U.S.C. §§ 327, 1103. Only professionals retained under the applicable provisions of the Bankruptcy Code are entitled to compensation from property of the estate, subject to the court’s review for reasonableness. 11 U.S.C. §§ 330, 503.

**5. §§ 1123(a)(8) and 1129(a)(15) – Best Efforts**

Section 1123(a)(8) makes chapter 11 generally consistent with chapter 13, requiring future earnings from post-petition personal services **or** “other future income” to be used to fund payments to creditors. In addition, section 1129(a)(15) requires that an individual chapter 11 debtor pay all unsecured creditors in full or that the debtor’s plan devote an amount equal to five years’ worth of the debtor’s projected disposable income to unsecured creditors.

Section 1129(a)(15) refers to section 1325(b)(2) for a definition of “disposable income.” Section 1325(b)(2)(B) defines expenses for a debtor engaged in business as those “necessary for the continuation, preservation, and operation of such business.” Accordingly, if there was an issue regarding the calculation of Mr. Suds’ disposable income, would his “start-up” costs related to *Plato* be factored into the calculation of “disposable income?”