Individual Chapter 11s: Comparative Proof that They Are Not Simply Chapter 13's Older Sibling

C.R. Bowles
Bingham Greenebaum Doll LLP; Louisville, Ky.

Jonathan T. Brand
Transworld Systems Inc.; Chicago

Robert E. Eggmann
Desai Eggmann Mason LLC; St. Louis

Mary R. Jensen
Office of the U.S. Trustee; Madison, Wis.

2015

Individuals in Chapter 11 of the Bankruptcy Code

Pilot Study Final Report

Professor Margaret Howard, Reporter
Law Alumni Association Professor of Law
Washington and Lee University School of Law

and

Professor Richard Hynes, Principal Investigator
Nicholas E. Chimicles Research Professor of Business Law and Regulation
Director, John M. Olin Program in Law and Economics
University of Virginia School of Law

Introduction

Prior empirical research has taught us a great deal about individuals who file under Chapters 7 and 13 of the Bankruptcy Code[1] and corporations that file under Chapter 11,[2] but we know relatively little about individuals who file under Chapter 11[3]—beginning with the rather startling fact that one-third of all Chapter 11 cases

[1] *See, e.g.,* D. STANLEY & M. GIRTH, BANKRUPTCY: PROBLEM, PROCESS, REFORM 94 (1971); TERESA SULLIVAN, ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, AS WE FORGIVE OUR DEBTORS (1989) [hereinafter "As We Forgive"]; TERESA SULLIVAN, ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, THE FRAGILE MIDDLE CLASS: AMERICANS IN DEBT (2000) [hereinafter "Fragile Middle Class"]; Robert Lawless, et al, *Did Bankruptcy Reform Fail? An Empirical Study of Consumer Debtors*, 82 AM. BANKR. L.J. 349 (2008); Scott F. Norberg & Andrew J. Velkey, *Debtor Discharge and Creditor Repayment in Chapter 13,* 39 Creighton L. Rev. 473 (2006); Scott F. Norberg, *Consumer Bankruptcy's New Clothes: An Empirical Study of Discharge and Debt Collection in Chapter 13,* 7 AM. BANKR. INST. L. REV. 415. *See* Robert M. Lawless & Elizabeth Warren, *The Myth of the Disappearing Business Bankruptcy*, 93 CAL. L. REV. 743 (2005).

[2] Arturo Bris, et al., *The Costs of Bankruptcy: Chapter 7 Liquidation versus Chapter 11 Reorganization*, 61 J. FIN. 1253 (2006)); LYNN LOPUCKI, COURTING FAILURE (2006). [haven't figured out where else to put these cites] *See, e.g.,* Edward R. Morrison, *Bankruptcy Decision Making: An Empirical Study of Continuation Bias in Small-Business Bankruptcies*, 50 J.L & ECON. 381 (2007) [hereinafter, "*Bankruptcy Decision-Making*"]; Edward R. Morrison, *Bargaining Around Bankruptcy: Small Business Workouts and State Law*, 38 J. LEGAL STUD. 255 (2009) [hereinafter, "*Small Business Workouts*"]; *See* Elizabeth Warren & Jay Lawrence Westbrook, *The Success of Chapter 11: A Challenge to the Critics*, 107 MICH. L. REV. 603 (2009) [hereinafter "Success of Chapter 11"].

[3] Professors Warren & Westbrook report some facts about individuals in Chapter 11 in two of their prior studies, but their focus was on business bankruptcy more generally. *See* Elizabeth Warren &

are filed by individuals.[4] This study is intended to fill the gap in our knowledge about individual Chapter 11 cases.

Individual Chapter 11 cases inhabit a borderland between corporate bankruptcies and standard consumer bankruptcies. The debtors are individuals, but they are much more likely to operate a business than are individuals in Chapters 7 and 13,[5] and they have substantially greater assets and debts.[6] Even the rules governing an individual Chapter 11 are a blend of those applicable to more standard consumer and business bankruptcy cases. For example, there is no absolute priority rule in the more common form of individual reorganization—Chapter 13—but most courts have held the absolute priority rule applicable in Chapter 11 whether the debtor is a corporation or an individual.[7] On the other hand, corporations in Chapter 11 receive a discharge upon confirmation of their plan of reorganization,[8] but individuals in Chapters 11 and 13 do not receive a discharge until they have made the payments required by their plans.[9] Because individual Chapter 11 cases inhabit this borderland, we look to the corporate and personal bankruptcy literature for informative comparison.

Jay Lawrence Westbrook, *Success of Chapter 11*, supra note 2; Elizabeth Warren & Jay Lawrence Westbrook, *Financial Characteristics of Businesses in Bankruptcy,* 73 AM. BANKR. L. J. 499 (1999).

[4] *See infra* Table 1, and accompanying text.

[5] *See infra* Section III.B.1.

[6] *See infra* Tables 19-21, and accompanying text.

[7] *See* note 77, *infra*, and accompanying text.

[8] 11 U.S.C. § 1143(d)(1).

[9] *Id*. at §§ 1143(d)(5), 1328. Both Chapter 11 and Chapter 13 grant the court the power to order a hardship discharge, *id.* but this power is almost never exercised. *See infra* notes Tables 7-9, and accompanying text.

The rich literature on personal bankruptcy provides many details about bankrupt debtors, and we summarize some of the main empirical findings. First, many bankrupt debtors are repeat filers, and this is especially true of those who filed under Chapter 13.[10] Second, bankruptcy can cost several thousand dollars to file; nationally, the average attorneys' fees in Chapter 13 exceed $2,500, and in some jurisdictions they approach $5,000.[11] Third, most consumers have debts that are more than three times their yearly income.[12] Fourth, most bankrupt debtors are drawn from what a sociologist would characterize as the middle-class, though their incomes are much lower than those of most middle-class Americans.[13] Fifth, about as many women as men file for bankruptcy, and some studies find that more women than men file under Chapter 13.[14] Sixth although the official statistics substantially understate the importance of business debt in personal bankruptcy,[15] most of the debt in personal bankruptcy was incurred for personal or household purposes.

---

[10] *See, e.g.,* Norberg & Velkey, *supra* note 1, at 500 ("[T]he available data indicate that, of the debtors who had filed a single previous petition, over 80% of those for whom the chapter of the previous filing is known filed the previous case under Chapter 13. Likewise, . . . of the debtors who have filed a single subsequent petition, over 75% filed the later case under Chapter 13.").

[11] *See* Lois R. Lupica, *The Consumer Bankruptcy Fee Study: Final Report*, 20 AM. BANKR. INST. L. REV. 17 (2012).

[12] *See, e.g.,* AS WE FORGIVE, *supra* note 1; FRAGILE MIDDLE CLASS, *supra* note 1; Lawless, et al, *supra* note 1. The self-employed have debts that are more than five times their yearly income. *See* ROBERT M. LAWLESS, *Striking Out on Their Own: The Self-Employed in Bankruptcy*, *in* KATHERINE PORTER, BROKE: HOW DEBT BANKRUPTS THE MIDDLE CLASS (2012).

[13] *Id*.

[14] *See, e.g.,* Norberg & Velkey, *supra* note 1; Hulya Eraslan, et al, The Anatomy of U.S. Personal Bankruptcy Under Chapter 13, Working Paper 07-31 (September 2007).

[15] *See* Lawless & Warren, *supra* note 1.

Many researchers believe that medical and credit card debt play an especially significant role in consumer bankruptcy.[16]

We do not try to replicate the surveys and massive case searches conducted in some prior projects, but our results do allow, or will allow, some comparisons. Although we need to check the filing histories of our debtors much more thoroughly, initial indications suggest that many individuals in Chapter 11 are, like other bankrupt debtors, frequent users of the bankruptcy courts. As we expected, individual Chapter 11 cases appear to be much more expensive than other individual bankruptcies. The median bill for the attorney's costs and fees in the cases we examined was over $17,000—many times higher than the roughly $2,500 national average for Chapter 13.[17] Individuals in Chapter 11 also have dramatically higher debt to income ratios than other consumer debtors; in our sample the median ratio was nearly thirteen.[18] As one would expect, individuals in Chapter 11 have much higher household incomes than individuals in Chapters 7 or 13,[19] but their debt burdens are much larger, and more of their debt derives from some form of business or investment. Real estate debt plays a particularly prominent role, though this is perhaps due to the fact that we examined bankruptcies filed in 2010. Finally, we find that women account for a much smaller proportion of Chapter 11

[16] *See, e.g.*, RONALD MANN, CHARGING AHEAD (2007); Melissa Jacoby, et al, *Rethinking the Debates Over Health Care Financing: Evidence from the Bankruptcy Courts*, 76 N.Y.U. L. REV. 375 (2001).

[17] *See* Lupica, *supra* note 11.

[18] *See infra* Table 19, and accompanying text.

[19] *See infra* Table 17, and accompanying text.

filings—six percent, rather than the one-third other studies have found in Chapter 13 filings.[20]

Most or all of these differences are likely due to the higher cost of filing under Chapter 11, but they are still relevant for policy. If individuals in Chapter 11 looked just like those in Chapter 13 but with slightly larger debts, it would be very hard to justify the application of different legal rules. And the rules are very different. Chapter 13 provides more rigid rules (e.g. the debtor must propose a plan within fifteen days of filing,[21] and the plan's payments cannot extend past five years),[22] active oversight by a bankruptcy trustee and (relatively) low cost. Chapter 11, on the other hand, provides much greater flexibility, relies on the initiative of the debtor-in-possession and the participation of creditors, and costs substantially more. Of course, some may believe that Chapter 13 (or a version thereof) is more appropriate for nearly all debtors who want to reorganize, and others will favor something more like Chapter 11. Still others may prefer a very different resolution mechanism.

Much of the prior empirical bankruptcy literature tries to determine whether bankruptcy's reorganization chapters are successfully serving the interests of debtors and creditors. The most common definition of success focuses on the goals of the debtor and asks whether individuals receive a discharge in Chapter 13 or whether corporations confirm a plan of reorganization in Chapter 11.[23] Neither

[20] *See infra* Table 12, and accompanying text.

[21] Bankruptcy Rule 3015.

[22] 11 U.S.C. § 1322(d).

[23] *See, e.g.,* Norberg & Velkey, *supra* note 1; Warren & Westbrook, *supra* note 2.

definition is appropriate for our undertaking because, unlike corporations, individuals do not receive their discharge until their plan is completed,[24] and few debtors will complete their plans within the four-year window in which we observed the cases.[25] We instead adopt a broader definition of success to include any case in which the debtor receives a discharge or avoids conversion and dismissal for four years. Based on this definition, we find a success rate of roughly one-third or about the same success rate found in the Chapter 13 literature.[26] Once again, however, we are using a much broader definition of success.

While discharge or confirmation may be the best definition of success that can be implemented, the literature recites a host of problems. Chief among these is the fact that many debtors do not belong in a reorganization chapter; an efficient bankruptcy system would quickly dismiss these cases or convert them so that the estates can be liquidated.[27] If we follow prior studies by measuring how long it takes bankruptcy courts to dispose of the "failed" reorganizations,[28] the individual Chapter 11s fare less well. More concretely, we find that it takes courts significantly longer to dismiss or convert failed individual Chapter 11 cases than prior scholars

[24] *See* 11 U.S.C. § 1143

[25] Many of the plans that our sample debtors proposed are scheduled to last thirty years. *See infra* Section III.C.

[26] *See, e.g.,* As WE FORGIVE, *supra* note 1, at 339; Michael Bork & Susan D. Tuck, *Bankruptcy Statistical Trends: Chapter 13 Dispositions4* graph 1 (Admin. Office of the U.S. Courts, Working Paper No. 2, 1994); Gordon Bermant & Ed Flynn, *Measuring Projected Performance in Chapter13: Comparisons Across the States,* AM. BANKR. INST. J., July-Aug. 2000, at 22, 22; Henry E. Hildebrand III, *Administering Chapter13-At What Price?,* AM. BANKR. INST. J., July-Aug. 1994, at 16, 16 Norberg & Velkey, *supra* note 1, at 505; Eraslan, et al, *supra* note 14.

[27] *See, e.g., Bankruptcy Decision Making, supra* note 2; *Small Business Workouts, supra* note 2; Warren & Westbrook, *supra* note 2.

[28] *Id*.

have found when studying Chapter 13 cases or corporate Chapter 11 cases. We suspect that the reason for this is the combination of a lack of rigid timing rules, the lack of a bankruptcy trustee, and fairly low stakes that limit creditor participation. The longer delay may also be a function of the major role played by real estate debt in our sample, given our focus on bankruptcies filed in 2010.

Section I summarizes the law that governs individual Chapter 11 filings and compares it to the law governing the far more commonly used individual reorganization chapter, Chapter 13.[29] Sections II and III present our empirical results. We divide our results into two sections because the data comes from two different sources.

Section II analyzes data drawn from spreadsheets created by the courts themselves. These spreadsheets allowed us to gather and analyze information on a massive number of cases in this pilot study. The disadvantages of this data set are that we were limited to the variables that the courts chose to code and that we did not have data from every jurisdiction. We did have data from thirty-four jurisdictions, however, accounting for about seventy percent of all Chapter 11 filings.

Section III analyzes a much smaller data set that we created by drawing a nearly random sample of all individual Chapter 11 cases filed in the United States. Due to the limited size of this data set (this is a pilot study), our conclusions remain

[29] *See, e.g.,* Bruce A. Markell, *The Sub Rosa Subchapter: Individual Debtors in Chapter 11 After BAPCPA,* 2007 U. ILL. L. REV. 27.

very tentative. Section IV focuses on the critical questions we face in designing the larger study.

I. The Law of the Individual Chapter 11

a. Eligibility and Initial Filing

Although amendments to the Bankruptcy Code in 2005 inserted several provisions from Chapter 13 into Chapter 11, often with no modification in wording,[30] the two chapters remain quite different. Not all of those differences are significant to our study, and we do not propose to offer a complete survey. Nevertheless, a laundry list of substantive differences is pertinent and will be the focus of this discussion.

Section 109, which sets out the requirements for who may be a debtor in bankruptcy, provides that "a person that may be a debtor under chapter 7 . . . may be a debtor under chapter 11."[31] Since "person is broadly defined to include "individual, partnership, and corporation,"[32] it would seem self-evident that individuals are eligible for Chapter 11. Nevertheless, it required a decision from the United States Supreme Court, *Toibb v. Radloff*,[33] to make that proposition clear.

Chapter 13 carries much more restrictive eligibility requirements. It may be filed only by an individual, who in addition has regular income, and who meets fairly

[30] *See, e.g.*, Charles Jordan Tabb, THE LAW OF BANKRUPTCY 1037 (3d. ed. 2014) ("in 2005, Congress changed several of the foregoing rules [regarding chapter 11] for *individual debtors* to bring chapter 11 more into line with chapter 13.").

[31] 11 U.S.C. § 109(d). Other entities are specifically excluded from eligibility to file Chapter 7 or Chapter 11, but those details are irrelevant to our study.

[32] § 101(41).

[33] 501 U.S. 157 (1991).

modest debt limitations.[34] One of the primary reasons a particular debtor may choose Chapter 11 is that he or she wishes to reorganize but cannot meet Chapter 13's debt limits; the only other bankruptcy choice would be liquidation under Chapter 7.[35]

Every individual who files bankruptcy, regardless of chapter, must obtain the pre-filing "briefing" mandated by § 109(f). The same is not true for the financial management course required as condition of discharge for many individuals in bankruptcy. It applies only to individual debtors in Chapters 7 and 13, but not to most individuals in Chapter 11.[36] The only individual Chapter 11 debtors who must complete the course, as a condition of discharge, are (perhaps) those who propose a liquidating plan.[37]

---

[34] These debt limits are adjusted every three years, under the mandate of § 104(a). As of April 1, 2013, the debt limits under § 109(e) are $383,175 for unsecured debts are $1,149,525 for secured debts. Between April 1, 2010 and March 31, 2013, the debt limits were $360,475 and $1,081,400, respectively. Thus, the debt limits changed during the year on which this Pilot Study focused.

In addition, the categories of unsecured and secured debts may include only obligations that are noncontingent and liquidated. The debt limits remain the same if an individual files jointly with his or her spouse.

[35] Chapter 12 may be available if a debtor is a "family farmer or family fisherman." § 109(f). We have not tracked Chapter 12 cases.

Because individuals meeting the Chapter 13 debt limits would be expected to choose that chapter (if, for no other reason, because it is substantially less costly), we have been particularly interested in debtors meeting those limits who nonetheless elect Chapter 11.

[36] Completion of the financial management course is required as a condition of discharge for debtors in Chapter 7 by § 727(a)(11), and, for debtors in Chapter 13, by § 1328(g).

[37] Under § 1141(d)(3), confirmation of the plan does not constitute discharge if three conditions are met: the debtor's plan provides for liquidation of all or substantially all of the property of the estate; the debtor does not engage in business after plan consummation; and the debtor would have been denied a discharge under § 727(a) if the case had been filed under Chapter 7. Usually, this subsection applies to corporations, liquidating under Chapter 11, who would be denied a discharge under § 727(a)(1).

The "perhaps" in the text accounts for the possibility that § 1141(d)(3) is inapplicable to individuals in Chapter 11. The text of the section sets out an exception to discharge upon confirmation, but confirmation of an individual debtor's Chapter 11 plan does not give rise to discharge in any event. § 1141(d)(5).

Chapter 13 cases are substantially less expensive than are Chapter 11s, beginning with the filing fees. Currently, the fee for Chapter 13 is $310, compared with $1717 for Chapter 11 cases.[38] Fees are also paid to the Chapter 13 standing trustee, generally calculated as a percentage of the amount of payments under the plan.[39] Quarterly fees, payable to the United States Trustee in a Chapter 11 case, are based on the amount disbursed during the relevant quarter. The fees range from $325 for disbursements up to $14,999.99, to $30,000 for disbursements exceeding $30,000,000.[40] Individual Chapter 11 debtors are highly unlikely to deal with such staggering sums, of course.

Spouses may file joint bankruptcy cases.[41] Official Form 1, used for the filing of a voluntary petition, provides two boxes—one for the name of the debtor and the other for the debtor's spouse. More often than not, apparently, the husband's name is listed first, as "debtor," when a case is jointly filed.

In the recent past, courts often held that same-sex couples were not eligible to file jointly,[42] even when the parties were legally married in another jurisdiction.[43]

---

[38] The statutory filing fees for Chapters 7 and 11 are $235 and $1167, respectively. 28 U.S.C. § 1930(a). Administrative fees, authorized by § 1930(b) and prescribed by the Judicial Conference of the United States, add an additional $75 and $550 for Chapters 7 and 11, respectively. That brings the total to $310 for Chapter 7 and $1717 for Chapter 11.

[39] *Id*., § 1930(e). The statute prescribes a cap; the actual percentage varies from jurisdiction to jurisdiction.

[40] *Id*., § 1930(a)(6).

[41] Under § 302(a), "[a] joint case under a chapter of this title is commenced by the filing . . . of a single petition . . . by an individual that may be a debtor under such chapter and such individual's spouse." Other cases, if sufficiently related, may be administratively consolidated. [Cite?]

[42] *See, e.g*., Bone v. Allen (*In re* Allen), 186 B.R. 769 (Bankr. N.D. Ga. 1995)) (holding that term "spouse" as used in Bankruptcy Code does not apply to homosexual couple, but only to those legally married—a status determined under state law; allowing 20 days to dismiss one co-debtor or suffer dismissal of entire case).

That stance has changed since the United States Supreme Court invalidated § 1 of the Defense of Marriage Act (DOMA), which defined marriage as a union of a man and a woman for purposes of federal law.[44] Although little case authority has developed since the Court's decision, bankruptcy courts are now likely to permit joint bankruptcy filings by same-sex couples.[45] The state of this issue as of 2010—the time frame upon which this Pilot Study focused—is less certain.

b. Involuntary Cases and Constitutional Issues

Involuntary cases, although quite rare, are permitted in Chapter 11 but not Chapter 13.[46] Congress considered the possibility of permitting involuntary Chapter 13 cases while the current statute was under consideration, but the Report of the

---

[43] *See, e.g.*, *In re* Kandu, 315 B.R. 123 (Bankr. W.D. Wash. 2004) (holding debtors, legally married in Canada, ineligible for joint bankruptcy petition). *But see* Rabin v. Schoenmann (*In re* Rabin), 359 B.R. 242 (B.A.P. 9th Cir. 2007) (holding debtors who were registered domestic partners under California law entitled to exemption rights identical to people who are married); *In re* Balas, 449 B.R. 567 (Bankr. C.D. Cal. 2011) (permitting same-sex couple to file joint bankruptcy petition).

[44] The Court held, in *United States v. Windsor*, 133 S. Ct. 2675 (2013), that application of this provision to deny the benefit of a spousal estate tax deduction under federal law unconstitutionally deprived a surviving spouse of equal protection under the fifth amendment.

[45] The question has been squarely presented in only one case so far—*In re Matson*, 509 B.R. 860 (Bankr. E.D. Wis. 2014). In *Matson*, as in *Windsor*, the couple had been legally married in a jurisdiction recognizing same-sex marriages—Iowa and Canada, respectively. The couple in *Windsor*, however, lived in a jurisdiction that recognized same-sex marriages (New York), while the couple in *Matson* lived in a jurisdiction (Wisconsin) with a constitutional ban on the recognition of same-sex marriages. Furthermore, the *Windsor* decision did not address the constitutionality of § 2 of DOMA, which provides that no *state* is required to give effect to "any public act, record, or judicial proceeding respecting a relationship between persons of the same sex." 28 U.S.C. § 1738C. The court in *Matson* noted, however, that § 2 of DOMA "applies to *states*; it does *not* apply to federal courts and certainly does not apply to this Court." 509 B.R. at 863. Thus, the court approached the issue—the right of same-sex spouses, married in a state recognizing such unions, to file a joint bankruptcy case in a state that does not recognize their marriage—as a matter of choice of law. The court applied the well-settled rule that the validity of a marriage is governed by the law of the place it was celebrated, and held that the parties were "spouses" for purposes of the Bankruptcy Code.

This holding is consistent with the Department of Justice's announcement that, in light of *Windsor*, same-sex couples are to be treated like heterosexual couples for purposes of bankruptcy, even when the couple is now domiciled in a state that does not recognize their marriage. http://www.justice.gov/ust/eo/public_affairs/consumer_info/index.htm (last visited 10/17-14).

[46] Section 303(a) provides that involuntary cases "may be commenced only under chapter 7 or 11."

House Judiciary Committee foresaw constitutional problems under the thirteenth amendment[47]:

> As under current law, chapter 13 is completely voluntary. This Committee firmly rejected the idea of mandatory or involuntary chapter XIII in the 90th Congress. The thirteenth amendment prohibits involuntary servitude. Though it has never been tested in the wage earner plan context, it has been suggested that a mandatory chapter 13, by forcing an individual to work for creditors would violate this prohibition.[48]

Since that time, courts and commentators have voiced similar concerns,[49] albeit not without dissent.[50]

The issue could not be tested, of course, since involuntary Chapter 13 cases were impossible. Now, however, the 2005 Amendments have created the very statutory configuration, in Chapter 11, that was thought, decades ago, to raise thirteenth amendment problems—that is, the possibility of an involuntary case against an individual debtor who would be required to devote future income to

---

[47] Section 1 of that amendment provides that "[n]either slavery nor involuntary servitude, except as a punishment for crime whereof the party shall have been duly convicted, shall exist within the United States."

[48] H.R. REP. No. 95-595, at 120 (1977) (footnotes omitted), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6080-81 (1977).

[49] *See, e.g.*, *In re* Nahat, 315 B.R. 368 (Bankr. N.D. Tex. 2004); *In re* Graham, 21 B.R. 235 (Bankr. N.D. Iowa 1982); *In re* Noonan, 17 B.R. 793 (Bankr. S.D.N.Y. 1982); G. Eric Brunstad Jr., *The Inapplicability of "Means Testing" to Cases Converted to Chapter 7*, AM. BANKR. INST. J., 1, 60 (Nov. 2005). *See also In re* Powell, 187 B.R. 642, 646 (Bankr. D. Minn. 1995) ("No where is the threat of impinging upon the protection afforded by the Thirteenth Amendment to the United States Constitution more real than in the case such as this where a creditor is attempting to harness the postpetition wages of individual debtors in a Chapter 11 proceeding.").

[50] In *In re* Graham, 21 B.R. 235 (Bankr. N.D. Iowa 1982), debtor's ex-wife moved to convert his chapter 7 case to a chapter 11, thereby enabling unsecured creditors (including herself) to impose a repayment plan that would reach his substantial postpetition income. The court noted that converting the case would divert the fruits of the debtor's labors to his prepetition creditors, much like a mandatory chapter 13, but thought the constitutional concerns clearly overblown: "Such a mandatory repayment scheme is so radically different in character from the slavery that the thirteenth amendment was meant to abolish . . . that the Court questions whether the framers of that amendment had the prohibition of mandatory repayment plans in mind when they drafted it." *Id*. at 238 n.3.

repayment of prepetition debts. Several changes have produced this possibility. First, the amendments added § 1115 to the Code. It includes as property of the estate "earnings from services performed by the debtor after the commencement of the case."[51] Second, the amendments added § 1123(a)(8), requiring that an individual debtor's Chapter 11 plan "provide for the payment to creditors . . . of all or such portion of earnings from personal services performed by the debtor after the commencement of the case . . . as is necessary for the execution of the plan." Finally, the amendments added § 1129(a)(15)(B), which requires, as a condition for confirmation, that the debtor commit his or her "projected disposable income" for the next five years to the plan.[52]

These new provisions operate in conjunction with preexisting Chapter 11 rules: individual Chapter 11 debtors cannot convert an involuntary case to another chapter;[53] Chapter 11 plans have no statutory maximum time limit[54] and can be extended on a creditor's motion;[55] unlike in Chapter 13,[56] creditors can propose a

[51] § 1115(a)(2). Postpetition earnings are part of the Chapter 13 estate under § 1306(a).

[52] § 1123(a)(8). This subsection applies only if an unsecured creditor objects to confirmation of the plan, § 1129(a)(15). In the alternative, a debtor may pay all allowed unsecured claims in full, § 1129(a)(15)(A).

The parallel provision under Chapter 13 is § 1325(b)(1)(B), which requires that a debtor devote all projected disposable income, during the applicable commitment period, to payment of unsecured claims. This provision is triggered when the trustee or an unsecured creditor raises an objection to plan confirmation, and the debtor does not choose to repay unsecured claims in full.

[53] § 1112(a)(2). A Chapter 13 debtor, in contrast, may convert to Chapter 7 "at any time." § 1307(a).

[54] § 1129(a)(15)(B). A Chapter 13 plan may be no longer than five years. § 1322(d)(1).

[55] § 1127(e)(2).

[56] Section 1321 states that "[t]he debtor shall file a plan."

plan in chapter 11 if the debtor has not;[57] and, finally, debtors in involuntary cases do not have an absolute right to dismiss the case.[58]

Taken together, these provisions allow creditors to use an involuntary Chapter 11 bankruptcy to reach a debtor's future income, rendering the constitutional question no longer theoretical.[59]

c. Controlling the Case

Chapter 13 cases are administered by a "standing" trustee,[60] who is responsible for duties such as examining proofs of claim, investigating the debtor's financial affairs, and making payments to creditors in accordance with the plan. This contrasts with the usual practice in Chapter 11 cases, in which the debtor becomes a debtor-in-possession, with the rights and powers of a trustee.[61] Individual Chapter 11 cases are no different, and the oversight role falls to the United States Trustee. The United States Trustee is charged with carrying out administrative responsibilities such as reviewing fee applications and

[57] § 1121(c) (permitting creditors to file a plan if the debtor fails to do so within the first 120 days of the proceeding, or if the debtor's plan fails to garner the requisite support within 180 days).

[58] § 1112(b) (requiring a showing of cause). Under § 1307(b), the bankruptcy court "shall" grant dismissal of a Chapter 13 case upon the debtor's request, unless the case has been previously converted into Chapter 13.

[59] Virtually no bankruptcy cases, at present, are filed involuntarily by creditors against debtors. David S. Kennedy, James E. Bailey, & R. Spencer Clift, *The Involuntary Bankruptcy Process: A Study Of The Relevant Statutory And Procedural Provisions And Related Matters*, 31 U. MEM. L. REV. 1, 3 (2000) ("[L]ess than 1/1000 of one percent of all bankruptcy cases filed were commenced involuntarily."). Our own numbers are consistent. *See infra* Section !!.B. The numbers will not necessarily remain so low, however, once creditors become aware of the possibilities presented by the 2005 Amendments. *See* Lisa M. Schiller & Craig A. Pugatch, The Bankruptcy Strategist (May 29, 2007), http://www.lawjournalnewlsetters/issues/in_bankruptcy/24_7/news/148639-1.html (last visited 3/19/08) ("In the wake of BAPCPA's implementation, the expanded remedies available to recover from a debtor's property for the benefit of the estate make involuntary petitions an increasingly attractive tool in creditors' arsenal.") Nor are constitutional violations, if such they be, made more acceptable by infrequency.

[60] § 1302.

[61] § 1107.

reorganization plans.[62] Inevitably, the United States Trustee will be more active in a Chapter 11 case, particularly one filed by an individual, than in a Chapter 13 proceeding.

A debtor-in-possession may be replaced by an appointed trustee, but only under somewhat exceptional circumstances typically involving fraud, dishonesty, incompetence or gross mismanagement by the debtor-in-possession.[63] Such appointments are unusual.

d. Co-debtor Stay

Chapter 13 offers a stay, during pendency of the bankruptcy proceeding, against efforts to collect a consumer debt from an individual liable with the debtor on that obligation.[64] Chapter 11 has no similar provision, leaving co-debtors—such as nonfiling spouses—vulnerable to creditors' collection actions.

Neither chapter offers protection to co-debtors when nonconsumer debts are involved.

e. Amounts Payable to Creditors

Both Chapter 11 and Chapter 13 impose means tests, but those tests operate quite differently in the two chapters. Under Chapter 13, upon an unsecured creditor's objection to the plan, the debtor must either pay that claim in full or devote all of his or her "projected disposable income," for the "applicable commitment period," to payments to unsecured creditors.[65]

---

[62] 28 U.S.C. § 586(a).

[63] § 1107(a).

[64] § 1301(a).

[65] § 1325(b)(1).

The "applicable commitment period" is either three or five years, depending on whether the debtor's income is above or below the state median for a family of that size.[66] Above-median debtors must undertake the longer repayment period.

Determination of "disposable income" requires calculation of income and expenses, and subtraction of the latter from the former. Income is, in fact, "current monthly income" as defined in § 101(10A). It is an average of all[67] income received over the six months preceding the filing of bankruptcy. Expenses will include "amounts reasonably necessary to be expended" for the debtor and his or her dependents.[68] For above-median debtors, post-2005, allowances for expenses are governed by the means test rules applicable in Chapter 7.[69] Reasonably necessary expenses for below-median debtors are determined in accordance with judicial discretion, as was done before the 2005 amendments. In addition, the debtor may deduct domestic support obligations arising postpetition, certain charitable contributions, and expenses necessary for the operation of any business in which the debtor is engaged.[70]

After determining disposable income, the court must then predict the likely state of affairs over the course of the plan. According to the Supreme Court in *Hamilton v. Lanning*, [71] this "forward-looking" approach requires the bankruptcy

---

[66] § 1325(b)(4)(A). A debtor's plan can be shorter than three or five years, whichever is applicable, only if the plan repays all allowed unsecured claims, in full, in the shorter period. § 1325(b)(4)(B).

[67] There are only a handful of exclusions, the most common of which is Social Security benefits. § 101(10A)(B).

[68] § 1325(a)(3).

[69] § 1325(b)93).

[70] § 1325(b)(2).

[71] 130 S. Ct. 2464 92010).

court to take into account "changes in the debtor's income or expenses that are known or virtually certain" to occur during the plan.[72]

The means test applicable to Chapter 11 cases is much simpler although, as under Chapter 13, its application is triggered by an unsecured creditor's objection to plan confirmation. Such an objection gives the debtor two choices. The first, as under Chapter 13, is full payment of the objecting creditor's claim. The second alternative, however, merely requires that the debtor apply all of his or her projected disposable income, "as defined in § 1325(b)(2)," to repayments for five years.[73] The cross-referenced section is the one defining "disposable income" as current monthly income minus support obligations, charitable contributions and business expenses; it does not incorporate the means test of Chapter 7.

Payments to creditors by individual debtors in Chapter 11 are substantially complicated by the absolute priority rule, which is inapplicable in Chapter 13. The rule provides that no junior class of claims or interest may receive any part of the estate, on account if its claim or interest, if a senior objecting class is not paid in full.[74] How the rule applies when the debtor is an individual was made more complicated by two amendments in 2005. First, language was added to the subsection setting out the rule: "except that in a case in which the debtor is an individual, the debtor may retain property included in the estate under § 1115,

[72] *Id*. at 2478.

[73] § 1129(a)(15).

[74] § 1129(b)(2)(B)(2)(ii).

subject to the requirements of subsection (a)(14) of this section."[75] Second, the amendments added § 1115, which defines property of the individual debtor's bankruptcy estate to include postpetition earnings, "in addition to the property specified in § 541." The issue is whether "all property . . . specified in section 541" and retained by the individual Chapter 11 debtor under § 1115(a) refers to all of the property in the estate, or only to a portion of that property.

Difficulties in meshing the language of §§ 1115 and 1129 have produced two lines of authority. Courts following the so-called "broad view" conclude that § 1129(b)(2)(B)(ii) allows an individual chapter 11 debtor to retain all property included in the bankruptcy estate by § 1115—that is, not merely certain postpetition assets, but everything included in the estate under § 541.[76] This approach effectively renders the absolute priority rule inapplicable in individual Chapter 11 cases. The competing view, often labeled the "narrow view," reflects the position of a majority of courts, as well as the view of every circuit court to have examined the question to date.[77] According to these courts, the absolute priority

[75] *Id*. One of the statutory puzzles is whether the drafters meant to cross-reference § 1129(a)(15) rather than subsection (a)(14). The latter mandates payment of postpetition domestic support obligations, as a prerequisite for plan confirmation. Subsection (a)(15), on the other hand, is the disposable income test, discussed above.

[76] *See, e.g*., Friedman v. P+P, LLC (*In re* Friedman), 466 B.R. 471, 482 (B.A.P. 9th Cir. 2012) ("A plain reading of §§ 1129(b)(2)(B)(ii) and 1115 together mandates that the absolute priority rule is not applicable in individual chapter 11 debtor cases."); *In re* O'Neal, 490 B.R. 837 (Bankr. W.D. Ark. 2013) (same); *In re* Tucker, 479 B.R. 873 (Bankr. D. Or. 2012) (vacating prior order denying plan confirmation, in light of *Friedman*); SPCP Group, LLC v. Biggins, 465 B.R. 316, 320-23 (M.D. Fla. 2011) (same); *In re* Shat, 424 B.R. 854 (Bankr. D. Nev. 2010) (reviewing legislative history to 2005 amendments and addition to Chapter 11 of provisions modeled on Chapter 13).

[77] Ice House Am., LLC v. Cardin, 751 F.3d 734 (6th Cir. 2014); *In re* Lively, 717 F.3d 406 (5th Cir. 2013); Dill Oil Co. v. Stephens (*In re* Stephens), 704 F.3d 1279 (10th Cir. 2013); Maharaj v. Stubbs & Perdue, P.A. (*In re* Maharaj), 681 F.3d 558 (4th Cir. 2012).

rule continues to apply in individual Chapter 11 cases,[78] and permits the debtor to retain only property coming into the estate postpetition.

In the absence of circuit-level authority, it is difficult to ascertain the approach followed in a particular jurisdiction. The governing approach may differ from one judge to another, even if intermediate appellate authority is available.[79]

Individual debtors in Chapter 11 cases have more flexibility than debtors in Chapter 13 to modify obligations to secured creditors other than holders of residential mortgages.[80] This flexibility is three-fold. First, because a Chapter 13 plan cannot go beyond five years,[81] a debtor cannot restructure a mortgage on nonresidential property in that chapter. Such a restructuring is possible in Chapter 11. Second, the infamous "hanging paragraph," codified at the end of § 1325(a)(9), applies only in Chapter 13. Thus, individual debtors in Chapter 11 may modify secured claims even though the collateral is an automobile purchased within 910 days before filing, or is another type of collateral securing a debt incurred within a year before the petition. Finally, the strictures of § 506(a)(2), requiring that personal property collateral be valued at replacement value, apply only in Chapters 7 and 13.

---

[78] *See also* Norwest Bank Worthington v. Ahlers, 485 U.S. 197 (1988).

[79] *Compare In re* Arnold, 471 B.R. 578, 590 (Bankr. C.D. Cal. 2012) (holding bankruptcy court not bound by Bankruptcy Appellate Panel's decision in *Friedman*, which took broad view) (certified for direct appeal to Ninth Circuit but settled and appeal withdrawn); *with In re* Sample, No. 2:10-38373-DPC, 2013 WL 3759795, at *2 (Bankr. D. Ariz. July 15, 2013) ("Although this Court tends to favor the dissenting decision of Judge Jury in *Friedman . . .* this Court feels duty bound to follow the majority's holding.").

[80] Both Chapters 11 and 13 prohibit the modification of obligations secured only by the debtor's principal residence. §§ 1123(b)(5) & 1322(b)(2). Because the language of these sections is identical, the Supreme Court's holding in *Nobelman v. American Savings Bank*, 508 U.S. 324 (1993), interpreting § 1322(b)(2), is equally applicable to the interpretation of § 1123(b)(5).

[81] § 1322(d)(2) (providing that "the court may not approve a period that is longer than 5 years").

Priority claims are treated similarly. Both chapters require that priorities be paid in full over the life of the plan.[82] This will include domestic support obligations, which are entitled to first priority.[83] In Chapter 11, however, claims entitled to priority under §§ 507(a)(2) and (3), as well as claims held by a dissenting class, must be paid in full, in cash, on the effective date of the plan.[84]

f. Plans

The deadline for proposing a plan in Chapter 13 is exceedingly short—within 14 days of the petition, unless extended for cause[85]—and only the debtor may file it.[86] Chapter 11, by contrast, has no deadline for filing the plan,[87] and the exclusivity period will expire in 4 to 6 months from the date of filing.[88]

---

[82] §§ 1129(a)(9) & 1322(a)(2). In both chapters, the holder of the claim may agree to different treatment.

Section 1129(a)(9) has an apparent drafting error—it does not, by its terms, cover the requirements regarding claims entitled to priority under §§ 507(a)(9 and (10). The error first appeared when the priorities were renumbered in 1994; it was not fixed in 2010, when a parallel error in § 726(b) was rectified.

[83] Prepetition domestic support obligations may be paid under the plan. Postpetition DSOs, on the other hand, must be satisfied before the plan can be confirmed. § 1129(a)(14) (requiring that the debtor "has paid . . . such obligation[s] that first become payable after the date of the filing of the petition"); § 1322(b)(8) (requiring that the debtor "has paid all amounts that are required to be paid under a domestic support obligation and that first become payable after the date of the filing of the petition").

[84] § 1129(a)(9)((A) & (B).

[85] Rule 3015(b).

[86] § 1321.

[87] The exception is in small business cases, under which the plan must be filed within 300 days of the order for relief. § 1121(e)(2).

[88] § 1121(c) (terminating the exclusivity period, regarding a debtor who is not a small business, 120 days after the order for relief, or 180 days after such order if the plan has not been accepted by an impaired class); § 1121(e) (providing a 180-day exclusivity period for small business cases, subject to extension for cause, and the 300-day rule referred to above).

Payments under a Chapter 13 plan must begin 30 days after the filing of the petition,[89] but Chapter 11 has no such deadline. It merely requires that payments begin upon the effective date of the plan, which is normally shortly after confirmation.[90] This substantial delay in the requirement for beginning payments may benefit debtors who lack the wherewithal to pay creditors at the time of filing, but who anticipate income at a later date.

g. Small Business Debtors

Chapter 11 provides special rules, often in the form of streamlining, applicable to small business debtors. These rules have no equivalents in Chapter 13.

A small business debtor is a person engaged in commercial or business activities, except the owning and operating of real estate,[91] whose debts total no more than $2,490,925,[92] and for whom no unsecured creditors committee has been appointed.[93] The supervisory role of the United States Trustee is enhanced in a small business case, both at the beginning of the case and during its pendency.[94] The small business debtor may use a simplified form for its disclosure statement, and, in addition to the special deadlines already mentioned, may use a single hearing to approve the disclosure statement and to confirm the plan.[95]

---

[89] § 1326(a)(1).

[90] Rule 3021 provides that, after plan confirmation, "distribution shall be made to creditors whose claims have been allowed."

[91] This is an important exception in the context of this study, given the number of our debtors who owned multiple pieces of real estate.

[92] § 101(51D). The dollar limitation is subject to adjustment every 3 years, under § 104(b).

[93] No committee will be appointed when the court so orders, for cause, under § 1102(a)(3).

[94] *See* 28 U.S.C. §§ 586(a)(3)(H) & 1116.

[95] § 1125(f)(3).

h. Conversion and Dismissal

Cases are often converted from one chapter to another, but the rules differ depending upon whether conversion is sought by the debtor or by another party, and upon the chapters involved.

A debtor in Chapter 7 has an apparently-absolute right to convert to another chapter, including Chapter 11, as long as the debtor is eligible under the destination chapter.[96] This apparently absolute right is subject to two exceptions, however—one statutory and the other judicial. The statutory exception is that conversion is unavailable if the case was previously converted into Chapter 7. The judicially-created exception applies when bad faith is involved. In *Marrama v. Citizens Bank of Massachusetts*[97] the Chapter 7 debtor attempted to hide assets from the trustee. When the trustee discovered those assets, the debtor sought to prevent their loss by converting from Chapter 7 to Chapter 13. The Court denied conversion on the basis of the debtor's bad faith.

A Chapter 11 debtor may convert into either Chapter 7, 12 or 13.[98] The right to convert to Chapter 7 is absolute if the case was filed voluntarily and no trustee has been appointed. Upon the request of a party in interest, the court may convert a Chapter 11 case to Chapter 7 for cause, unless appointment of a trustee or examiner would better serve the best interest of creditors.[99] No conversion is permissible if it does not serve the best interest of creditors, the debtor or another party in interest

[96] § 706(a).

[97] 549 U.S. 365 (2007).

[98] § 1112(a) & (d).

[99] § 1112(b)(1).

established that a plan is likely to be confirmed within designated time frames, and the reason for conversion includes an act or omission by the debtor that was reasonably justified and can be cured.[100]

Conversion from Chapter 11 to Chapter 13 is governed by different rules. Such a conversion must be requested by the debtor and must occur before discharge[101]—a provision with entirely different bite now that, post-2005, individual Chapter 11 debtors are not discharged upon confirmation of the plan.

The debtor has the right to dismiss a Chapter 13 case "at any time."[102] The only exception applies when the case was previously converted into Chapter 13 at the debtor's request (which is, of course, the only route into that chapter). A Chapter 13 case may also be dismissed for cause, such as unreasonable delay by the debtor and the improbability of successful rehabilitation.[103] The 2005 amendments added to the list the debtor's failure to pay a domestic support obligation that first becomes payable postpetition.[104] In addition, the 2005 amendments added a provision permitting dismissal (or conversion, depending on the best interests of

---

[100] § 1112(b)(2).

[101] § 1112(d).

[102] § 1307(b). This right appears to be absolute, but some debate has arisen when the debtor has sought dismissal in order to thwart a creditor's motion to convert the case to Chapter 7. *See, e.g.*, Jacobsen v. Moser (*In re* Jacobsen), 609 F.3d 647 (5th Cir. 2010) (following Ninth Circuit's opinion in Rosson v. Fitzgerald (*In re* Rosson), 545 F.3d 764 (9th Cir. 2008), and holding that *Marrama*'s rejection of absolute right to convert under § 706 applies equally to supposed absolute right to dismiss under § 1307(b)).

[103] § 1307(c).

[104] § 1307(c)(11).

creditors and the estate) upon the debtor's failure to file four-year's worth of tax returns,[105] if the United States Trustee or a party in interests so requests.[106]

A Chapter 11 debtor does not have the right to dismiss his or her case. Rather, dismissal (or conversion) depends upon a finding of "cause," which requires determination of the best interests of the creditors and the estate. The Code includes a laundry list of possible grounds giving "cause," including the debtor's failure to file documents required by the Code, gross mismanagement, and continuing losses coupled with no reasonable likelihood of rehabilitation.[107] Thus, an individual Chapter 11 debtor may be unable to get out of bankruptcy, once he or she gets in.

i. Closure During Payment Period, to Avoid Fees

Chapter 11 debtors are required to pay quarterly fees to the United States Trustee for each calendar quarter during which the case remains open, and is not converted, dismissed or closed.[108] Thus, debtors are often interested in closing the case while making payments under the plan, subject to reopening it in order to obtain a discharge.

The Code requires that the bankruptcy court close a case that has been "fully administered,"[109] but it does not define that phrase. Thus, courts usually look to the 1991 Advisory Committee Notes to Rule 3022, which lists relevant factors:

---

[105] Such a filing is required by § 1308(a).

[106] § 1307(e).

[107] § 1112(d)(4).

[108] 28 U.S.C § 1930(a)(6). Chapter 13 debtors also face administrative costs, but those fees typically are substantially less than costs incurred in Chapter 11.

[109] § 350(a).

> Factors that the court should consider in determining whether the estate has been fully administered include (1) whether the order confirming the plan has become final, (2) whether deposits required by the plan have been distributed, (3) whether the property proposed by the plan to be transferred has been transferred, (4) whether the debtor or the successor of the debtor under the plan has assumed the business or the management of the property dealt with by the plan, (5) whether payments under the plan have commenced, and (6) whether all motions, contested matters, and adversary proceedings have been finally resolved.[110]

Most significantly, the Notes assert that "[e]ntry of a final decree closing a chapter 11 case should not be delayed solely because the payments required by the plan have not been completed." The United States Trustee Program has stated that it "will not object to an individual chapter 11 debtor's request to close the case before discharge, subject to reopening for the entry of a discharge upon the completion of plan payments, if the estate has been fully administered and any trustee has been discharged."[111] In the absence of a trustee, the question turns on whether the case has been fully administered.

The authorities appear to be divided on the propriety of this strategy, although several clearly endorse this maneuver.[112] Even cases denying the debtor's motion to close the case, however, are less than categorical.[113]

---

[110] Fed. R. Bankr. P. 3022, Advisory Committee Note (1991).

[111] Walter W. Theus, Jr., *Individual Chapter 11s: Case Closing Reconsidered*, 29 AM. BANKR. INST. J., Feb. 2010, at 1.

[112] *In re* Necaise, 443 B.R. 483 (Bankr. S.D. Miss. 2010) (applying factors in Advisory Committee Note); *In re* Johnson, 402 B.R. 851 (Bankr. N.D. Ind. 2009) (granting motion after all issues pertaining to plan had been resolved, and noting that fees could continue for "potentially unlimited duration" if debtor's mortgage were paid through the plan); *In re Sheridan*, 391 B.R. 287, 290 n.2 (Bankr. E.D.N.C. 2009) (noting that most cases in Eastern District of North Carolina are closed upon substantial consummation, to be reopened—without payment of fee—for entry of discharge).

[113] *See* Shotkoski v. Fokkena (*In re* Shotkoski), 420 B.R. 479 (B.A.P. 8th Cir. 2009) (affirming, under abuse of discretion standard, lower court's refusal to close debtor's case, and asserting that other cases might come out differently upon case-by-case inquiry); *In re* Belcher, 41 B.R. 206 (Bankr. W.D. Va. 2009) (finding Advisory Committee Notes inapplicable to individual Chapter 11 cases, and

j. Plan Modification

The rules governing the modification of plans under Chapters 11 and 13 are quite similar, albeit with a few notable differences.

A Chapter 13 plan may be modified either before[114] or after confirmation.[115] Only the debtor may modify a plan before confirmation, but postconfirmation modifications may also be sought by the trustee or the holder of an unsecured claim. Modification after confirmation must be sought before payments are completed, and may increase or decrease payments under the plan.

Postconfirmation modifications under Chapter 11 are similar in that parties with standing include the debtor, United States Trustee, any appointed trustee, and unsecured creditors.[116] Other similarities are that such a modification may seek to increase or decrease payments, and must be sought before the completion of payments. One significant difference, however, is that such a modification may take place even though the plan has been substantially consummated.[117] "Substantial consummation" is defined as the transfer of all or substantially all property the plan proposed to be transferred, assumption by the debtor or its successor of the

---

refusing to grant motion to close case, but observing that debtor could move to modify plan if fee obligation became too burdensome).

[114] § 1323.

[115] § 1329.

[116] Before 2005, only the debtor and a plan proponent had standing to seek modification of a confirmed plan. That remains the rule, post-2005, for the plan of a Chapter 11 debtor who is not an individual. The 2005 amendments expanded the list of appropriate parties, when individual Chapter 11 cases are involved.

[117] § 1129(e). Subsection (e), which applies only in individual Chapter 11 cases, was added to the Code in 2005. Pub. L. No. 109-8, § 321(e).

business or management of plan property, and commencement of distributions under the plan.[118]

Courts have not developed standards for postconfirmation modification of an individual debtor's Chapter 11 plan, although at least one court has imported chapter 13's standard—namely, a substantial change in the debtor's income or expenses that was not anticipated at the time of confirmation.[119]

k. Discharge

One of the most important changes wrought by the 2005 amendments was to move the moment of discharge for an individual debtor from the date of confirmation to the completion of the plan.[120] An exception, however, is available "for cause."

In ascertaining "cause," courts generally focus on the likelihood that creditors will be paid in accordance with the plan.[121] In one of the few cases finding "cause" sufficient to support early discharge,[122] *In re Sheridan*,[123] the court stated the usual rule—that creditors will receive amounts promised under the plan. The necessary

---

[118] § 1101(2).

[119] *In re Mercer*, 09-04088-8-ATS, 2013 WL 6507585, at *3-4 (Bankr. E.D.N.C. Dec. 12, 2013) (applying § 1329(a)'s standard to decide whether to grant modification to individual chapter 11 debtor; rejecting arguments for "more liberal standard").

[120] § 1141(d)(5)(A).

[121] *See, e.g.*, *In re* Grogan, BR 11-65409-FRA, 2013 WL 4854313 (Bankr. D. Or. Sept. 10, 2013) (based on totality of the circumstances, debtor must establish "ability to make plan payments with a high degree of certainty"); *In re* Beyer, 433 B.R. 884, 888 (Bankr. M.D. Fla. 2009) (requiring more than "just substantial consummation" of the plan; rather, debtor must show ability to "make all future payments with a high degree of certainty").

[122] For an example of a case refusing early discharge, *see In re* Beyer, 433 B.R. 884, 889 (Bankr. M.D. Fla. 2009) (holding "unknown, potential federal tax liability," that might be incurred upon surrender of real estate collateral to secured creditors in full satisfaction of obligations, insufficient to support early discharge).

[123] 391 B.R. 287, 291 (Bankr. E.D.N.C. 2008).

assurance was based on the stable income of one debtor (a lawyer), and the securing of obligations to otherwise unsecured creditors by a second deed of trust against the debtors' home with equity.

On the other hand, a desire to avoid the payment of quarterly fees to the United States Trustee is not cause for early discharge.[124]

II. PACER Report Data

We begin our empirical analysis with data collected from spreadsheets created by the courts themselves.[125] We collected information on all bankruptcy cases filed in 2010 for thirty-four jurisdictions. These jurisdictions together accounted for sixty percent of all bankruptcy filings and seventy-two percent of all Chapter 11 filings in the United States in that year.[126] So that we could compare individual Chapter 11 filings to somewhat similar bankruptcy cases, we retained all cases for which PACER lists either Chapter 11 or Chapter 13 as the current or previous chapter. We were limited to the variables that the courts chose to record, but these variables still allow us to draw some interesting preliminary conclusions.

When deciding on the period to study, we faced a difficult trade-off. We wanted to choose a set of cases filed sufficiently long ago that the debtors had time to receive plan approval and then make payments for a number of years. Unlike Chapter 13 plans,[127] however, Chapter 11 plans can, and do, extend well beyond five

---

[124] *In re* Belcher, 410 B.R. 206, 217 (Bankr. W.D. Va. 2009).

[125] PACER provides a link to present reports in spreadsheet form. We began by downloading all bankruptcy cases filed in each jurisdiction of our study during 2010. Because this data set was so massive, we dropped cases in which neither the current nor previous chapter was Chapter 11 or 13.

[126] *See* http://www.uscourts.gov/Statistics/BankruptcyStatistics.aspx.

[127] § 1322.

years.[128] Thus, we expected that few of our debtors would have completed a plan of reorganization unless we examined cases filed far in the past. If we drew a sample of cases filed too long ago, on the other hand, our results would be skewed by the financial crisis and possibly even by BAPCPA. We settled on 2010. We recognized that many of our cases would still be active, but courts would have had four years to identify and dispose of the failures. We realized that our results would be skewed by the financial crisis and real estate collapse, but we hope that this bias is less pronounced than if we had looked at 2008 or 2009. We will discuss this problem more thoroughly in Section IV.

Part A provides some basic facts about individual Chapter 11s and compares these cases to Chapter 13s and to corporate Chapter 11s. Part B asks whether creditors are forcing individuals into Chapter 11 involuntarily. Part C asks whether Chapter 11 is "successfully" serving the interests of individuals and their creditors.

A. Some Basic Facts about Individuals in Chapter 11

PACER records a case as Chapter 11 if it is currently in Chapter 11 or if it was closed in Chapter 11. We were also interested in cases filed under Chapter 11 and then later converted to another chapter, however. We therefore designated a case as *all11* if the PACER Report states that the current or previous chapter is Chapter 11.[129] Among these cases, we were interested in those filed by an individual. Table 1 lists the type of debtor for these *all11* cases as listed in the PACER Reports.

[128] *See, infra* Section III.C.

[129] This approach may miss some cases that were once in Chapter 11, if they were later converted to two other chapters. For example, we would miss a case that was filed in Chapter 11, converted to Chapter 13 and then converted to Chapter 7. We suspect that such cases are extremely rare.

Individual filings comprise roughly thirty-one percent of all Chapter 11 cases in our sample. We will sometimes compare individual Chapter 11 cases to corporate Chapter 11 cases, another 64% of the Chapter 11s. We ignored the remaining five percent of cases in which the debtor is listed as a partnership or other. It is possible that a court could consolidate a corporate bankruptcy case with an individual case, but we will have to return to this issue in Section III as this data only identifies one type of debtor for each case.

Table 1: Debtor Type for Chapter 11 Cases (*all11*)

Debtor Type	**Frequency (Pct. Total)**
Individual	3,312 (31%)
Corporation	6,746 (64%)
Partnership	371 (3%)
Other	189 (2%)

We are examining Chapter 11 filings from one year, 2010, and from a subset of districts. To get a sense of whether our data is representative of other districts and other years, we used Harvard's Bankruptcy Data Project to estimate the number of individual Chapter 11 filings made across the nation in each year from 2006 to 2012, as well as the percentage of Chapter 11 petitions filed by individuals.[130] Figure 1 presents the results. The Bankruptcy Data Project's estimate for the percent of Chapter 11 petitions filed by individuals in 2010—twenty-seven percent—is a little lower than our estimate of thirty-one percent. The difference is probably due to the fact that we are examining a subset of districts or that we are also examining cases converted into Chapter 11. Estimates from the Bankruptcy Data Project suggest that the number of individual Chapter 11 petitions rose

[130] *See* http://bdp.law.harvard.edu/.

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

Hector B. Rossa ("Rossa") is a financial consultant, artist (d/b/a Black Chest Creations and Dead Women's Pearls) and the 100% owner of Calipso Enterprises PSC ("PSC"), a financial advising service that employs five people. Unfortunately, an investment by Rossa in Isle De Mortra Spa Inc. ("Isle") went bad due to the apparent fraud by the island's owner, Charlie "Lord" Beckett ("Beckett"). Hector financed his investment in Isle with a personal guarantee of Isle's mortgage and the pledge of a $2,000,000 CD, owned by PSC, to Isle's secured lender, Aztec Ltd. Bank ("Aztec").

Due to a mix up by PSC's non-bankruptcy counsel, Rageatti and Pintel ("R&P"), Rossa 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 for the last 5 years.

At the present time Rossa and PSC's balance sheets look as follows:

Assets

	Rossa Assets	PSC Assets
Cash	$50,000	$25,000
Accounts Receivable		$675,000 (all collectible)
Real Estate	$1,000,000 (Home) Vacation home in Aspen $500,000 $1,500,000 (Total)	
Total Service Contracts		4 deals (?): each with $100,000 per month base compensation
Personal Property	$2,250,000 Total PSC Stock $500,000 (Est.) $250,000 Household & personal items 1,000,000 art work $500,000 investment in other companies	$25,000 $2,000,000 CD (Pledged on the Aztec debt)
Intellectual and	(?)	(?) Value of Good Will

Other Property	Lawsuit against Beckett for fraud	
Total Assets	$3,800,000+	$2,725,000+

Liabilities

	Rossa Liabilities	PSC Liabilities
Taxes Due	$400,000 (2014 Income Tax) 2015 taxes are estimated at $400,000.	None Current on tax liabilities
Secured Debt	Residence $1,500,000 (ABC Bank) Vacation Home $100,000 (Gibbs Nat'l Bank $1,600,000 (Total)	$1,100,000 ABC Bank All assets
Unsecured Business Debt		$500,000
Attorney Fees	(R&P $75,000)	$100,000
Unsecured Consumer Debt	$400,000	
Guaranteed Debts	$4,000,000 (Isle debt w/Aztec)	$4,000,000 (Isle debt w/Aztec)
Total Liabilities	$6,475,000	$5,700,000
Total Assets	$3,800,000 (+)	$2,725,000 (+)
Total Debts	$6,075,000	$5,700,000

$1.1 million of the ABC Bank debt and all of the guaranteed Isle debt are owed both by Rossa and PSC. Isle is totally "under water" and it has no assets to satisfy the Guaranteed Debt. PSC also has a 10-year lease on its offices with Norington Properties.

Rossa and PSC have the following monthly income and expenses (averaged for past 12 months). Rossa is married to Mary Clung and has two sons, Jocard and James.

	Rossa 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

	Rossa Expenses Family monthly Living Expense
Food	$8,000
Auto	$9,000
Country Club Dues	$9,000
Mortgages	$12,000
Credit Cards for personal living expenses	$18,000
Misc. Household Expenses	$5,000
Private Schools	$8,000
Insurance	$8,000
Taxes	$27,000
Total	$98,000

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

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

Rossa's business is highly variable with earnings dependent on the market and Rossa's referral network. Rossa's art business, gold jewelry, is very stable and could expand if Rossa devoted more time to his work. Rossa is the Driving force behind PSC's Business and does not want his or his family's standard of living.

QUESTIONS ABOUT EXPENSES AND INCOME

1. Rossa asks you if there is any exemption planning you can do for him prior to his bankruptcy filing. 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 equity to pay his taxes and convert as many of his non-exempt assets to exempt assets. Can you advise him on his exemption issues and still be his counsel in an individual Chapter 11 case?

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

(a) Can you represent Rossa in opposing this motion assuming you are bankruptcy counsel in Rossa's individual Chapter 11? Can you be awarded fees for this representation?

(b) Assuming you can represent Rossa, what should you advise Rossa to do in his Chapter 11 concerning his expense situation?

(c) Assuming Aztec does not file a motion would you be required to seek Court approval under Section 363 to use post petition earnings (property of the estate) to pay the $98,000 in monthly expenses?

(d) What expenses can Rossa reasonably expect to be allowed to incur post petition?

3. Rossa 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 Rossa concerning his fiduciary duties to maximize earnings for the bankruptcy estate?

BACKGROUND AND LEGAL DISCUSSION

One of the most vexing questions confronting both attorney and individual chapter 11 debtors is whether an individual debtor's "living expenses"[12] can be paid as

---

[1] In re Webb, 262 B.R. 685 (Bkrtcy.Ed.Tx. 2001) (Discussing reasonable and necessary expenses in context of a Chapter 13).

[2] 11 U.S.C. § 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.

ordinary course of business expenses under 11 U.S.C. § 363(c)(1) and 11 U.S.C. § 1108[3] or whether notice and a hearing under 11 U.S.C. § 363(b)(1)[4] is required for living expenses to be paid.

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 which considered the question held that normal living expenses of an individual chapter 11 debtor did not need court approval[5], while others indicated that some form of court approval would be necessary at least in cases of significant expenses[6]. Indeed one early pre-BAPCPA decision In re Vincent[7] held there was no authority for the payment of living expenses from the Chapter 11 estate for a chapter 11 individual debtor and his family under the Bankruptcy 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. [8]

Perhaps the best analysis of the need for oversight of expenses of individual chapter 11 cases in 11 U.S.C. § 1115 is In re Villalobos, 2011 Bankr. LEXIS 4329 (BAP 9th Cir. July 21, 2011). There, the debtor filed his individual chapter 11 and requested approval of his post-petition expenses of $128,052 per month including payments on five luxury cars, college tuition for grandchildren, and various other "variable" expenses. Over the objection of creditors, the full budget was approved by the court without any specific findings. The BAP reversed, holding: "individual chapter 11 debtors no longer have the option to pay expenses with post-petition income . . . . Instead, individual chapter 11 debtors must now seek payment of personal expenses from estate property which may create problems . . . ."

A related 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[9]. Should

---

[3] 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.

[4] 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."

[5] 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).

[6] 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)

[7] 4 B.R. 21 (Bankr. M.D. Tenn. 1979). See also In re Walter, 83 B.R. 14 (9th CAP 1988)

[8] 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 non-estate property in connection with determination of debtors' good faith). See also In re Villalobos, 2011 Bankr. LEXIS 4329 (BAP 9th Cir. 2011).

[9] 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 Rodriquez, 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. D.N.H. 1994); In re Jones, 55 B.R. 462 (Bankr. D. Minn. 1985).

Courts adopt a disposable income test similar to 11 U.S.C. § 1325(b) or 1129(a)(15)[10] or will they impose the "minimal" standard of living tests imposed on parties seeking to discharge student loans[11].

While none of these questions have clear answers yet 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.[12] However even in the leading case on this issue, Villalobos, while the court considered the issue of what constituted reasonable living expenses, it refused to articulate a specific standard for determining what expenses were reasonable.

Finally, there is the question of whether individual chapter 11 debtors can pay reasonable living expenses for members of their family. While this question almost seems to be the paranoid fears of a madman, 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?

While spouses, former spouses, children of the debtor and other designated parties are entitled to first priority payments for their domestic support obligations and chapter 13 debtors are expressly authorized to pay for the support of their dependents in their cases, there appears to be no similar direct and expenses authorization in Chapter 11 of the Bankruptcy Code permitting an individual chapter 11 debtor to pay for his or her family's support from estate funds[13]. 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 which allowed living expenses of the individual chapter 11 debtor's spouse and minor children to be paid from estate funds[14]. While Courts should be able to distinguish Sutton on its unique (and very bad) facts, it does illustrate the problems with 11 U.S.C. § 1115[15].

---

[10] 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).

[11] 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).

[12] 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).

[13] See 11 U.S.C. §§ 101(14A); 507(a)(1) and 1112(b)(4)(P).

[14] 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).

[15] For a discussion of this issue in the context of chapter 7 and 13 cases, see In re Webb, 262 B.R. 685 (Bkrtcy.Ed.Tx. 2001) (Discussing reasonable and necessary expenses including the cost of monthly hair care) and In re Butler 277 B.R. 917 (N.D. Iowa 2002) (Dismissing a chapter 7 as being filed in bad faith where debtor, **a disabled veteran** who had no work or travel obligations, and who had stable income of $4,179.00 per month in disability benefits, had ability, by modifying his spending choices to "a reasonable extent", to pay off two-thirds to three-quarters of unsecured debt with no hardship).

QUESTIONS ABOUT ATTORNEY CLIENT PRIVILEGE IN INDIVIDUAL CHAPTER 11

4. Assuming Rossa files and individual chapter 11 and either the case is converted to a Chapter 7 or a chapter 11 Trustee is appointed, who will control the Rossa's attorney client privilege? Rossa of his Trustee

5. What happens if both Rossa and PSC file chapter 11s and are jointly represented by the same firm. If a Trustee is appointed for PSC or PSC is converted to a Chapter 7 would the Trustee be able to obtain documents and discovery attorney client privileged discussions?

BACKGROUND AND LEGAL DISCUSSION

A problem which frequently arises in bankruptcy cases concerns the control of an individual's attorney client privilege. The issue of who holds a Chapter 11 debtor's attorney/client privilege has been often litigated[16] and has been largely resolved in the area of business entities by the Supreme Court's decision in Commodity Futures Trading Commission v. Weintraub[17] . However, while the Weintraub Court held that the debtor in possession or trustee held a Chapter 11 corporate debtors' attorney/client privilege[18] and could waive it even over the objection of the debtors' pre-bankruptcy management, the Weintraub Court refused to extend its reasoning to individual debtors' attorney/client privilege ruling:

[O]ur holding today has no bearing on the problem of individual bankruptcy, which we have no reason to address in this case. As we have stated, a corporation, as an inanimate entity, must act through agents. When the corporation is solvent, the agent that controls the corporate attorney-client privilege is the corporation's management. Under our holding today, the power passes to the trustee because the trustee's functions are more closely analogous to those of management outside of bankruptcy than are the functions of the debtor's directors. An individual, in contrast, can act for himself; there is no "management" that controls a solvent individual's attorney-client privilege. If control over that privilege passes to a trustee, it must be under some theory different from the one that we embrace in this case.[emphasis added][19]

Lower courts have taken three general positions[20] with regard to who holds an individual Chapter 11 debtor's attorney/client privilege. One line of mainly older cases has held that an individual Chapter 11 debtor's attorney/client privilege (for both pre and

---

16 See generally In re O.P.M. Leasing Services, Inc., 670 F.2d 383 (2d Cir. 1982); Citibank N.A. v. Andros, 666 F.2d 1192 (8th Cir. 1981).

17 471 U.S. 343 (1985).

18 Id. at 354.

19 Id. at 356-357.

20 In re Bame, 251 B.R. 367, 377-378 (Bkrtcy. D.Minn. 2000).

post-bankruptcy periods) remains with the individual debtor and does not pass to the bankruptcy estate or a subsequently appointed trustee[21]. These courts have generally held that due to the greater privacy concerns that arise when an individual holds an attorney/client privilege, there is no justification for the transfer of attorney/client privilege to either the bankruptcy estate or the individual debtor's trustee[22].

Another group of cases, led by In re Williams[23], has held that the right to who holds the attorney/client privilege does not change merely because a debtor is an individual and not a business entity. These cases have generally held that an individual debtor in possession must exercise its attorney/client privilege in a manner consistent with its fiduciary duty to creditors and that includes the transfer or waiver of its attorney/client privilege for the benefit of the estate[24]. These courts have found that the individual Chapter 11 Debtor's attorney client privilege passes to his or her bankruptcy estate and does not remain in the hands of the individual[25].

The final[26] and largest line of authority concerning individual Chapter 11 debtor's attorney/client privilege has stated that courts must determine who holds the attorney/client privilege on a case by case basis by balancing the policies underlying the attorney/client privilege and the potential harm of disclosure to the individual against the trustee's duty to maximize the value of the estate[27].

Under this line of reasoning, courts have generally determined that an individual debtor has no attorney/client privilege for any post-petition discussions the individual has with the estate counsel, holding that the estate counsel generally cannot give individuals legal advice, in their capacity as an individual, while acting as the estate's counsel.

---

[21] See In re Hunt, 153 B.R. 445 (Bkrtcy. N.D.Tx. 1992) (Trustee under confirmed plan not entitled to waive the attorney/client privilege); In re Silvio De Lindegg Ocean Dev. Of America, Inc., 27 B.R. 28 (Bankr. S.D. Fla. 1982) (same)

[22] In re Hunt, 153 B.R. at 454. But see In re Fairbanks, 135 B.R. 717 (Bkrtcy. D.N.H. 1991) (Finding "other theory" to hold that trustee controlled chapter 11 debtor's attorney/client privilege).

[23] 152 B.R. 123 (Bkrtcy N.D.Tx. 1992); See also In re Smith, 24 B.R. 3 (Bkrtcy. S.D. Fla. 1982) (Pre Weintraub)

[24] In re Williams, 152 B.R. at 128 (noting that under Toibbv Radloff, 501 U.S. 157 (1991) (Individual Debtor had fiduciary responsibilities of a corporate debtor in possession).

[25] See e.g. In re Wittmer, 2011 Bankr. Lexis 4727 (Bankr. N.D. Ohio 2011) (trustee of an individual Chapter 7 debtor investigating legal malpractice claim against could waive the Privileges attorney could not raise Privilege claims to thwart discovery against them); In re Tarkington, 2010 Bankr. Lexis 1208 (Bankr. E.D. N.C. 2010) (2004 exam of individual Chapter 11 debtor's counsel allowed to go forward to determine assets in corporation owned by debtor)

[26] There is also a group of cases involving the waiver of an individual debtor's attorney/client privilege in the context of legal malpractice claims against a debtor's attorney. In these cases bankruptcy courts have generally held that the trustee holds and has the right to waive the attorney/client privilege for the purpose of investigating the malpractice action. See In re Bazemore, 216 B.R. 1020 (Bkrtcy. S.D. Ga. 1998), In re Tomarolo, 205 B.R. 10 (Bkrtcy. D. Mass. 1997) But see McClarty v. Gudenau, 166 B.R. 101 (E.D. Mich. 1994) (Individual Chapter 7 debtor holds attorney/client privilege as to file involved in malpractice action).

[27] See generally In re Foster, 188 F.3d 1259 (10th Cir. 1999); In re Benum, 339 B.R. 115 (Bkrtcy. D.N.J. 2006); In re Eddy, 304 B.R. 591 (Bkrtcy. D. Mass. 2004); In re Miller, 247 B.R. 704 (Bkrtcy. N.D. Ohio, 2000).

These courts have also held that pre-bankruptcy discussions with attorneys are subject to an individual attorney/client privilege[28].

Under all of these lines of cases, the estate's counsel should carefully advise the individual as to who they represent in the chapter 11 (the bankruptcy estate generally)and the issues that may arise related to the individual attorney/client privilege (or lack thereof) when filing a Chapter 11 case.

I. General Overview of Attorney/Client Privileges In Joint Client Situations

Initially, it is well settled that the trustee or DIP of a corporate Chapter 11 debtor holds the attorney/client privilege of that legal entity. See Commodity Futures Trading Commission v. Weintraub, 471 U.S. 343 (1985) (trustee succeeds to attorney/client privilege of debtor corporations). The Sixth Circuit, in Reed v. Baxter, 965 F.2d 126 (6th Cir. 1992) states that:

> The question of whether the attorney/client privilege applies is a mixed question of law and fact, subject to de novo review. See In re Grand Jury Proceedings October 12, 1995, 78 F.3d 251, 253-54 (6th Cir.1996). Questions of privilege are to be determined by federal common law in federal question cases. Fed.R.Evid. 501. The elements of the attorney/client privilege are as follows: (1) Where legal advice of any kind is sought (2) from a professional legal adviser in his capacity as such, (3) the communications relating to that purpose, (4) made in confidence (5) by the client, (6) are at his instance permanently protected (7) from disclosure by himself or by the legal adviser, (8) unless the protection is waived. Fausek v. White, 965 F.2d 126, 129 (6th Cir.1992) (citing United States v. Goldfarb, 328 F.2d 280, 281 (6th Cir.1964)).

The privilege is based on two related principles. The first is that loyalty forms an intrinsic part of the relationship between a lawyer and client in our adversary system. This loyalty is offended if the lawyer is subject to routine examination regarding the client's confidential disclosures. Kenneth S. Brown, et al., McCormick on Evidence § 87, at 205-06 (3rd ed.1984). The second principle is that the privilege encourages clients to make full disclosure to their lawyers. A fully informed lawyer can more effectively serve his client and promote the administration of justice. Id. § 87, at 205; id. § 89, at 212.

---

[28] See In re Bame, 251 B.R. 367, 375-376 (Setting forth a 5 part test to see if individual received individual legal advice from estate counsel [which would be subject to the individual's attorney client privilege] or advice as debtor in possession [which would not be subject to the individual attorney client privilege, but to the bankruptcy estate's privilege]).

The privilege serves these purposes, but it comes with substantial costs. The privilege excludes relevant evidence and stands "in derogation of the search for the truth." United States v. Nixon, 418 U.S. 683, 710, 94 S.Ct. 3090, 3108, 41 L.Ed.2d 1039 (1974). When an organization, such as a corporation, is the client the costs imposed by application of the privilege increase. Given the number of employees who may have information relevant to litigation by or against a corporation, administration of the privilege by the courts proves difficult. More significantly, "[w]here corporations are involved, with their large number of agents, masses of documents, and frequent dealings with lawyers, the zone of silence grows large." David Simon, The Attorney/Client Privilege as Applied to Corporations, 65 Yale L.J. 953, 955 (1956); see also 24 Charles Alan Wright & Kenneth W. Graham, Jr., Federal Practice and Procedure: Evidence § 5476, at 189 (1986); id. § 5476, at 29 (1997 Suppl) (noting that corporations may use the privilege to prevent the disclosure of information useful to adversaries simply by funneling it through lawyers).

Assuming that a valid joint defense agreement exists between Law firm X's clients (Subsidiary and Individual A) and Lawfirm Y's clients, (Individuals A, B, Subsidiary and Parent Company) and that all privileged discussions were made between the law firm and each client and no other clients were present at the discussions between the law firm and the client.

A dual or joint representation, absent an agreement to establish a "joint defense" between clients, may render any attorney/client privilege inapplicable because non-clients were parties to the privileged communications. See Matter of Bevill Breslder & Schulman Asset Management Corporation, 865 F.2d 120, 124-126 (3rd Cir. 1986); In re Indiantown Realty Partners, Lmt. Partnership, 270 B.R. 532 (Bankr. S.D. Fla. 532, 539-540) (Bankr. S.D. Fla. 2001). See also In re Miracle Enterprises, Inc., 40 B.R. 503 (Bankr. D. R.I. 1984) (no attorney/client privilege with respect to communications between Defendant bank and attorney, where attorney served as secretary of Debtor and counsel to bank); U.S. v. Moss, 9 F.3d 543 (6th Cir. 1993). ("Generally, the attorney/client privilege extends to "(c)onfidential disclosures by a client to an attorney made in order to obtain legal assistance."); Haines v. Liggett Group, Inc., 975 F.2d 81, 94 (3rd Cir. 1992) (quoting, Fisher v. United States, 425 U.S. 391, 403, 96 S.Ct. 1569, 1577, 48 L.Ed.2d 39 (1976)). A joint defense extension of the attorney/client privilege has been applied to confidential communications shared between co-defendants which are "part of an on-going and joint effort to set up a common defense strategy." Haines, 975 F.2d at 94 (quoting Eisenberg v. Gagnon, 766 F.2d 770, 787 (3rd Cir.), cert. denied, 474 U.S. 946, 106 S.Ct. 342, 88 L.Ed.2d 290 (1985). The burden to establish the applicability of the privilege is upon the defendants. Haines, 975 F.2d at 94.

Even assuming that a joint defense privilege exists, however, it has been universally held that communications that are otherwise privileged under the common interest or joint defense doctrine are not privileged in subsequent litigation between the parties to the joint defense agreement. See Simpson v. Motorists Mutual Insurance Company, 494 F.2d 850 (7th Cir. 1974) (recognizing the existence of the doctrine in a diversity case governed by Ohio law); Duncan v. Duncan, 2001 WL 1837384 (Va. Cir. Ct. July 16, 2001) (Not reported in S.E.2d) ("The clear majority of reviewing courts has held that the attorney/client privilege does not preclude an attorney who originally represented both

parties in a prior matter from disclosing information in a subsequent action between the parties."). See also Abbott Laboratories v. Alpha Therapeutic Corp., 200 F.R.D. 401 (N.D. Ill. 2001); Securities Investor Protection Corporation v. Stratton Oakmont, Inc., 213 B.R. 433 (Bankr. S.D. N.Y. 1997); In re Megan-Racine Associates, Inc., 189 B.R. 562 (Bankr. N.D. N.Y 1995). Therefore, Parent Company may be able to obtain all otherwise privileged communications of all other parties under a joint defense agreement.

II. Specific Questions

Question A: Can a Parent Company DIP or trustee waive Subsidiary's or the Individual A's privilege?

The Parent Company DIP or trustee cannot waive, under any circumstances, the attorney/client privilege between either Lawfirm X or Lawfirm Y and Individual A as the Parent Company bankruptcy estate has no interest in or control over Individual A's attorney/client privilege. While some courts have allowed trustees to waive the attorney/client privilege of individual debtors, see, generally, In re Eddy, 304 B.R. 591 (Bkrtcy. D. Mass. 2004); In re Williams, 152 B.R. 123 (Bkrtcy. N.D. Tx. 1992), no court has ever permitted a corporation to waive its individual owner's attorney/client privilege. See generally In re Bakalis, 199 B.R. 443, 449 (Bkrtcy. E.D. N.Y 1996) (trustee of Chapter 7 estate of majority owner of a corporation could not compel corporation to waive its attorney/client privilege).

If it is established that Individual A was given advice by either Lawfirm X or Lawfirm Y, as an officer or employee of Subsidiary, however, then Individual A's ability to claim, as an individual, an attorney/client privilege will be greatly compromised. See In re National Trade Corporation, 76 B.R. 646 (N.D. Ill. 1985); In re Southern Air Transport, Inc., 225 B.R. 706 (Bkrtcy. S.D. Ohio 2000); In re Fidelity Guarantee Mortgage Corp., 150 B.R. 854 (Bkrtcy. D. Mass. 1993); In re Cumberland Inv. Corp., 120 B.R. 627 (Bkrtcy. D. R.I. 1990).

As to the attorney/client privilege of Subsidiary, Parent Company as the owner of Subsidiary, may not directly waive the Subsidiary's attorney/client privilege. As noted in Bakalis, the owner of the stock in a corporation may not waive the attorney/client privilege for that corporation absent certain specific showings of good cause, which will permit the owner of the corporation to obtain the privileged documents. Bakalis, 199 B.R. at 449; see also Fausek v. White, 965 F.2d 126, 130-131 (6th Cir. 1992).

A Parent Company DIP or trustee could indirectly cause Subsidiary to waive its own attorney/client privilege if they either gain control of the individuals who were actually running the Subsidiary bankruptcy or were able to use their corporation ownership to cause a change in control of the management of Subsidiary in its Chapter 11 case. See In re Lionel Corporation, 30 B.R. 327 (Bkrtcy S.D. N.Y. 1983) (holding that "shareholders of Chapter 11 Debtors generally retain their state controlled rights to control a Chapter 11 Corporation within the requirements of the Bankruptcy Code"). However, the change of management of a Chapter 11 could be subject to Bankruptcy Court approval, see Matter of Gaslight Club, Inc., 782 F.2d 767 (7th Cir. 1986); Matter of

Lifeguard Industries, Inc., 37 B.R. 3 (Bkrtcy. S.D. Ohio 1983). However, even with these limitations, a Parent Company DIP or trustee, by meeting the proper legal standards, could cause Subsidiary to waive its attorney/client privilege.

Question B: Can Subsidiary's waive the attorney/client privilege of Individual A?

As discussed above, Subsidiary may not waive the individual attorney/client privilege between Individual A and either Lawfirm X or Lawfirm Y because Subsidiary does not have any interest in or control over Individual A's attorney/client privilege. See, generally, In re Bevill, Bresler and Schulman, 805 F.2d 120, 123 (3rd Cir. 1986) (corporate officer may assert a personal attorney/client privilege for communications made to his or her own counsel concerning personal liability unrelated to the corporation or his role as a corporate officer).

Subsidiary can waive its own attorney/client privilege as to any communications Lawfirm X or Lawfirm Y had with Individual A, if those communications were made in the course of Lawfirm X's or Lawfirm Y's representation of Subsidiary, and not as part of their representation of Individual A. See In re National Trade Corporation, 76 B.R. at 647 (corporate officers barred from asserting privilege for communications made in their corporate capacity to corporate counsel); In re Southern Air Transport Inc., 255 B.R. at 710-712 (corporate officers cannot assert attorney/client privilege to prevent debtor corporation from obtaining testimony from its own attorney); In re Fidelity Guarantee Mortgage Corp., 150 B.R. at 867-869 (corporate waiver of corporate debtor's attorney/client privilege extends to words and actions of corporate debtor's officers and directors).

Question C: Can a third party force Subsidiary to waive its own attorney/client privilege or the attorney/client privilege of Individual A?

Initially, it is clear that a creditor or other third party cannot force Subsidiary to waive Individual A's attorney client privilege, as Subsidiary itself may not waive the attorney/client privilege between Lawfirm X, Lawfirm Y and Individual A because Subsidiary has no interest in or control over Individual A's attorney/client privilege.

A creditor or other party in interest could ultimately require Subsidiary to waive its own attorney/client privilege, however, either by obtaining the appointment of a trustee in the Subsidiary bankruptcy case, see Commodity Futures Trading Commission v. Weintraub, 471 U.S. 343 (1985), or by filing a motion to force the Debtor to waive the attorney/client privilege. See, generally, In re Gibson Group Inc., 66 F.3d 1436 (6th Cir. 1995) (creditor granted standing to pursue preference suit where debtor unjustifiably refused to bring preference action). While there is no established case law permitting a third party to force a debtor to waive its attorney/client privilege, under the authority of the Gibson Group case, such a motion would have merit in the circuits which have adopted this position.

United States Bankruptcy Appellate Panel
For the Eighth Circuit

No. 15-6001

In re: Suzette Woodward

Debtor

Heritage Bank

Creditor - Appellant

v.

Suzette Woodward

Debtor - Appellee

National Association of Consumer Bankruptcy Attorneys

Amicus on Behalf of Appellee(s)

Appeal from United States Bankruptcy Court
for the District of Nebraska - Lincoln

Submitted: July 22, 2015
Filed: August 13, 2015

Before FEDERMAN, Chief Judge, SCHERMER, and SHODEEN, Bankruptcy Judges.

SCHERMER, Bankruptcy Judge

Heritage Bank (Heritage) appeals from a Bankruptcy Court order confirming Suzette Woodward's (Debtor) Fifth Amended Chapter 11 Plan. The confirmation order is a final order of the Bankruptcy Court over which we have jurisdiction on appeal. *See* 28 U.S.C. § 158(b). The Notice of Appeal and Statement of Election also references an April 29, 2014 order denying the Debtor's Third Amended Plan. We believe that the denial of confirmation of the Debtor's Third Amended Plan is not a final order and cannot be the subject of this appeal. *Bullard v. Blue Hills Bank*, 135 S.Ct. 1686 (2015). Therefore, the sole basis of this appeal is the order confirming the Debtor's Fifth Amended Chapter 11 Plan. For the following reasons, the confirmation order is reversed and the case is remanded for a new confirmation hearing.

ISSUES

1.Whether an impaired class of claims has accepted the Debtor's Fifth Amended Plan.

2.Whether 11 U.S.C. §§ 1129(b)(2)(B)(ii)'s absolute priority rule prevents individual debtors in Chapter 11 from retaining property acquired prior to the filing of the bankruptcy petition when not all creditors' claims will be paid in full.

3. Whether the value of the property to be distributed under the Fifth Amended Plan is less than the Debtor’s disposable income.

BACKGROUND

The Debtor is a practicing pathologist in Grand Island, Nebraska. She is a member of Pathology Specialists, LLC. On April 4, 2011, the Debtor filed for relief under Chapter 7 of the Bankruptcy Code. Heritage holds an allowed, unsecured claim in the amount of $270,566.00.

On May 15, 2012, the Debtor acquired property at 2604 Arrowhead Road in Grand Island, Nebraska as her principal residence from Leland and Marie Elliott (Elliotts). As part of the purchase price, the Debtor signed a promissory note in favor of the Elliotts in the amount of $169,900, and granted the Elliotts a security interest in the property. The Elliotts perfected their lien in the Debtor's property. In addition to regular monthly payments, the terms of the note required the Debtor to make a balloon payment on June 1, 2013. The Elliotts subsequently agreed to extend the date on which the balloon payment was due by one year.

The case was converted to a proceeding under Chapter 11 on September 10, 2012. The Elliotts filed a proof of claim asserting secured status with respect to the principal residence. Heritage objected to the Elliotts' proof of claim, not because it arose postpetition, but based on the timeliness of its filing. The Bankruptcy Court overruled the objection and allowed the claim in the amount of $158,724.54. Heritage did not appeal the order allowing the claim, but instead continued to object to the Elliotts' voting on the plan as an impaired class, on the ground that the claim was a postpetition claim. At plan confirmation, the Bankruptcy Court essentially held that the Elliotts had an allowed claim, that the plan altered the treatment of their claim, and, thus, that the Elliotts were an impaired class entitled to the vote on the plan.

The Bankruptcy Court entered an order confirming the Debtor's Fifth Amended Plan on December 23, 2014. The Elliotts, the sole members of their class, voted in favor of the plan. No other impaired classes voted to accept the plan. On appeal,

Heritage argues that the plan should not have been confirmed because: (1) an impaired class did not accept it; (2) it violated the absolute priority rule; and (3) it does not call for payment of all of the Debtor's disposable income.

STANDARD OF REVIEW

We review the bankruptcy court's findings of fact for clear error and its conclusions of law de novo. *In re Walker*, 528 B.R. 418, 427 (B.A.P. 8th Cir. 2015) (citing *Heide v. Juve* (*In re Juve*), 761 F.3d 847, 851 (8th Cir.2014)). Determining whether the Elliotts may vote on the plan and whether the absolute priority rule applies in individual Chapter 11 cases involve purely legal questions of statutory interpretation. We exercise de novo review with respect to each issue. *In re Johnson*, 509 B.R. 213, 214-15 (B.A.P. 8th Cir. 2014) (citing *Graven v. Fink* (*In re Graven*), 936 F.2d 378, 384-85 (8th Cir.1991). We find it unnecessary to reach the third issue.

DISCUSSION

1. An Impaired Class of Claims has Accepted the Plan

Heritage asserts on appeal that since the Debtor's obligation to the Elliotts arose postpetition, the Elliotts were not "creditors," as that term is defined in § 101(10), and so the Elliotts were not entitled to vote on the plan. Thus, Heritage asserts, the Bankruptcy Court erred in treating them as a consenting class under § 1129(a)(10). We disagree and think that Heritage's argument misses the mark under the circumstances of this case.

The issue is not whether the Elliotts were "creditors" under § 101(10), as Heritage asserts, because the time to litigate the Elliotts' creditor status has long since passed. As a result, Heritage is now foreclosed from raising the argument on appeal. Although it is true that Heritage objected to the Elliotts' proof of claim, the objection

was based on the timeliness of its filing. Heritage never objected to the claim's foundation in postpetition debt. Heritage did not appeal the Bankruptcy Court's order allowing the Elliotts' claim, and review is now precluded by principles of *res judicata*. Heritage may not raise the issue now. We hold that the Elliotts have an allowed claim.

We do question, however, whether the Elliotts *should have been* holders of an allowed claim because we are not convinced that the Bankruptcy Code allows for a postpetition claim such as this. *See, e.g.,* Bankr. Law Manual § 6:24 (5th ed.) (although recognizing that the Code provides for specific, identified, exceptions to the rule, stating that "[i]n general, only those claims that exist as of the date of the filing of the bankruptcy petition, commonly referred to as prepetition claims, may be allowed as claims against the estate.").

Nevertheless, because the Elliotts were the "holders of a[n] [allowed] claim," they were entitled to vote on the plan under the plain language of § 1126(a). That section provides that *"[t]he holder of a claim or interest allowed under section 502* of this title may accept or reject a plan" (emphasis added). Furthermore, § 1129(a)(10) provides that, in order to confirm a plan, "[if] a class of claims is impaired under the plan, at least one *class of claims* that is impaired under the plan has accepted the plan, determined without including any acceptance of the plan by any insider" (emphasis added). "[A] class of claims or interests is impaired under a plan, unless," as relevant here, the plan "leaves unaltered the legal, equitable, and contractual rights to which such claim or interest entitles the holder of such claim or interest." 11 U.S.C. § 1124. We believe that the Elliotts' claim is impaired. They agreed to alter their rights under the note when they extended the date on which the balloon payment was due. In so doing, the Elliotts also waived § 1123(b)(5)'s prohibition against the modification of security interests in a debtor's principal residence. The antimodification provision can be waived by the creditor holding such

a claim.[1] *See, e.g.*, *In re Arns*, 372 B.R. 876, 882-83 (Bankr. N.D. Ill. 2007) (holding that a lender can waive the antimodification provision in § 1123 by agreeing to the plan and not pursuing an objection to confirmation); *In re Canovali*, 2011 WL 307374 at 6 (Bankr. E.D. N.C. Jan. 27, 2011) (same); *In re Mayberry*, 487 B.R. 44, 46 (Bankr. D. Mass. 2013) ("*Absent the creditor's agreement* the debtor cannot obtain confirmation of a chapter 13 plan which proposes to modify a claim secured by the debtor's principal residence. *If the creditor opts to agree to different treatment, it is certainly free to do so*.") (quoting *In re Wofford*, 449 B.R. 362, 365 (Bankr. W.D. Wis. 2011) (emphasis added); *In re Smith*, 409 B.R. 1, 4 (Bankr. D. N.H. 2009) ("[N]othing prevents a secured creditor from consenting to the modification of its claim.").

Heritage cites *In re Kliegl Bros. Universal Electric Stage Lighting Co.*, which held that, since § 1126(a) provides that only the holder of a claim or interest allowed under § 502 may accept or reject a plan, and since postpetition secured lenders are not mentioned or implied in § 502, the class containing such a postpetition lender as its sole member was not entitled to vote on the plan. 149 B.R. 306, 307 (Bankr. E.D. N.Y. 1992) (citations omitted). However, in contrast to this case, *Kliegl Bros*. did not say whether the lender there actually had an allowed claim, as the Elliotts do here. Again, maybe the Elliotts should not have had an allowed claim, but the fact is, they do. To the extent *Kliegl Bros.* can be read to prohibit the Elliotts – as the holders of an allowed claim impaired by the plan – from voting on the plan, we believe such a reading is contrary to the language of the statutes discussed above.

Consequently, we do not believe that the Bankruptcy Court erred in permitting the Elliotts' ratifying vote to serve as the sole basis for the satisfaction of §

[1] The modification of a residential mortgage such as this could, conceivably, raise good faith issues if the modification was done to create a favorable impaired class, but good faith is not an issue raised in this appeal.

1129(a)(10)'s requirement that an impaired class of claim holders vote in favor of the plan. As the holders of an allowed claim and sole members of their impaired class, the Elliotts' ratifying vote satisfied § 1129(a)(10).

2. <u>The Absolute Priority Rule Applies in Individual Chapter 11 Cases</u>

"[T]he 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 reorganization plan." *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 202 (1988) (quoting *Ahlers v. Northwest Bank (In re Ahlers)*, 794 F.2d 388, 401 (8th Cir. 1986)); 11 U.S.C. § 1129(b)(2)(B)(ii). However, Congress amended the bankruptcy code in 2005 to include a statutory exception permitting individual Chapter 11 debtors to retain property *included in the estate under section 1115*…" without first paying creditors (emphasis added). 11 U.S.C. § 1129(b)(2)(B)(ii). Although most courts agree that § 1115 defines "property of the estate" as property and income acquired after commencement of the case in addition to the prepetition property specified in § 541, defining what "property [is] included in the estate under section 1115" has divided courts. Whether prepetition property is "property included in the estate under section 1115" will ultimately determine whether the absolute priority rule has any continuing application in individual debtor Chapter 11 cases.

In order to determine whether clarity exists in the murky jurisprudence surrounding the absolute priority rule, we think an overview of Congress's thinking with respect to individual Chapter 11 cases would be illuminating. Congress grafted many aspects of Chapter 13 onto the individual Chapter 11 framework. For instance, § 1123(b)(5) generally mimics § 1322(b)(2)'s treatment of claims secured only by the Debtor's principal residence. In addition, § 1129(a)(15) imports § 1325(a)(5)'s concept of disposable income, and § 1141(d)(5) does the same with respect to § 1328(a)'s limitations on discharge. Finally, like § 1306, § 1115 brings into the estate postpetition earnings and property. Other similarities exist.

Although Congress was able to import many elements of Chapter 13 into the individual Chapter 11 arena, it was not a perfect fit. In fact, in certain respects, it did not fit at all. The absolute priority rule states, in full, that:

> [T]he 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 [relating to payment of domestic support obligations].

§ 1129(b)(2)(B)(ii). We suggest that there is no "interest" holder in an individual Chapter 11 case. The concept plainly applies to equity holders in the corporate or partnership Chapter 11 context, for example, but we do not believe that there is an *individual* Chapter 11 analogue. *Ahlers* simply assumed, without discussion, that the Debtors were interest holders. *Northwest Bank Worthington v. Ahlers*, 485 U.S. at 966. But how can one hold an interest in oneself? We do not think this is possible. In any event, one cannot avoid the fact that this is a Chapter 11 case. If Congress intended for all Chapter 13 specific law to apply in individual Chapter 11 cases, it could have afforded higher income debtors the ability to seek reorganization under Chapter 13. It did not.

We hold that the absolute priority rule still applies in individual Chapter 11 cases to prevent debtors from retaining prepetition property. Our holding is supported by: (1) the language and context of § 1129(b)(2)(B)(ii) and 1115; (2) the absence of a clear indication by Congress of an intent to abrogate; and (3) the weight of existing authority.

A. The Relevant Statutory Language and Context Supports the Absolute Priority Rule's Continuing Application

"In determining the meaning of a statutory provision, 'we look first to its language, giving the words used their ordinary meaning." *Lawson v. FMR LLC*, 134 S. Ct. 1158, 1165 (2014) (quoting *Moskal v. United States*, 498 U.S. 103, 108 (1990)). "Whether a statutory term is unambiguous, however, does not turn solely on dictionary definitions of its component words. Rather, '[t]he plainness or ambiguity of statutory language is determined [not only] by reference to the language itself, [but as well by] the specific context in which that language is used, and the broader context of the statute as a whole." *Yates v. United States*, 135 S. Ct. 1074, 1081-82 (2015) (citing *Robinson v. Shell Oil Co.*, 519 U.S. 337, 341 (1997)).

The language of §§ 1129 and 1115 favors the absolute priority rule's continuing application. That postpetition property is the only "property included in the estate under section 1115" follows from § 1129's use of the word "included." "The action described by 'include' is either 'to take in as a part, an element, or a member …[C]onverted into the active voice, § 1129(b)(2)(B)(ii) refers to property that § 1115 includes in the estate, which naturally reads as 'property that § 1115 takes into the estate… ." *Ice House America, LLC v. Cardin* (*In re Cardin*), 751 F.3d 739 (6th Cir. 2014). Contextually, the only property that § 1115 can take into the estate is postpetition property and income because prepetition property is already part of the estate under § 541. "Section 1115 cannot take into the estate property that was already there [prepetition property under § 541] … what § 1115 takes into the estate-is property 'that the debtor acquires after the commencement of the case." *Id*.

The text of § 1115(a) leads to the same conclusion. It states that "property of the estate includes, *in addition to the property specified in section 541*– all property of the kind specified in section 541 that the debtor acquires after the commencement of the case… .” (emphasis added). The inclusion of "in addition to" as a modification

of the "property specified in section 541" separates the "property specified in section 541" from all of the other property mentioned in § 1115, thereby channeling all of the other property into "property included in the estate under section 1115" while filtering from this definition "the property specified in section 541." In other words,

> [T]he phrase, 'the property specified in section 541' cannot be viewed in isolation. The phrase is part of the prepositional phrase beginning with 'in addition to,' and is thus not the direct object of the transitive verb, 'includes,' so it does not relate to the subject of the sentence, 'property of the estate… .

In re Arnold, 471 B.R. 578, 602 (Bankr. C.D. Cal. 2012).

The broader statutory context provides further support. "Because § 541 independently includes all § 541 property in the estate, it would be a redundancy to 'reinclude' that property through the § 1115 language." *In re Maharaj*, 681 F.3d 569 (4th Cir. 2012). Consequently, we are left to conclude that the "property specified in section 541" – that is, prepetition property – is not "property included in the estate under section 1115" that is excluded from the absolute priority rule. Section 541 cannot operate as a "subset" of § 1115 as some "broad view" courts have suggested. *Id*. at 569 (discussing *Friedman v. P+P, LLC* (*In re Friedman*), 466 B.R. 471 (B.A.P. 9th Cir. 2012)). Therefore, the statutory language and context suggests that Congress did not abrogate the absolute priority rule in individual Chapter 11 cases.

B. Congress has not Evinced a Clear Indication of an Intent to Abrogate the Absolute Priority Rule

The concept of the absolute priority rule was first articulated in 1913. *N. Pac. R. Co. V. Boyd*, 228 U.S. 482, 508 (1913). We believe that Congress would have employed clearer language to abrogate the absolute priority rule if it had so intended.

It could have "expressly exempted individual debtors at the beginning of § 1129(b)(2)(B)(ii)." *Dill Oil Company, LLC v. Stephens* (*In re Stephens*), 704 F.3d 1286 (10th Cir. 2013). It could have omitted "in addition to the property specified in section 541" from the introductory clause of § 1115(a), while including the words "before and" directly preceding "after" in (a)(1) of the statute. The language of the statute, then, would read, "property of the estate includes [comma and text omitted] – all property of the kind specified in section 541 that the debtor acquires before and after the commencement of the case." Congress did not make these changes, however, and we see no reason to read them into §§ 1129 or 1115.

Furthermore, any mention of the absolute priority rule's abrogation is conspicuously absent in The Bankruptcy Abuse and Prevention Act of 2005's (BAPCPA) legislative history. PL 109-8, April 20, 2005, 119 Stat 23." BAPCPA's legislative history lists several debtor protections but makes no mention of eliminating the APR … had Congress intended such a drastic change, it surely would have included the amendment in its list of debtor protections. Instead, the amendments are best understood as preserving the status quo." *Stephens*, 704 F.3d at 1286 (citing H.R. REP. NO. 109-31, pt. 1, at 2, 17-18 and *Maharaj*, 681 F.3d at 572). "[W]e will not read the Bankruptcy Code to erode past bankruptcy practice absent a clear indication that Congress intended such a departure." *In re Lively*, 717 F.3d 406 (5th Cir. 2013) (quoting *Hamilton v. Lanning*, 560 U.S. 505, 517 (2010)).

C. The Overwhelming Weight of Authority has Upheld the Absolute Priority Rule

Finally, the majority of courts to address the issue, including the Fourth, Fifth, Sixth, and Tenth Circuits, follow the "narrow view." *See Ice House*, 751 F.3d at 734; *Lively*, 717 F.3d at 406; *Stephens*, 704 F.3d at 1279; *Maharaj*, 681 F.3d at 558. They have held, as we do today, that § 1115 merely augments existing estate property as set out in § 541 by drawing in postpetition property and income. In fact, no circuit

court has ruled otherwise. Therefore, we are comfortable in concluding that the absolute priority rule still has application in individual Chapter 11 cases.

3. Determining whether the Debtor is Contributing Less than Her Disposable Income to the Plan is Unnecessary

When the holder of an allowed unsecured claim objects to plan confirmation in a Chapter 11 case involving an individual debtor, § 1129(a)(15) requires that all unsecured claims be paid in full or that the debtor pay all of her disposable income into the plan for five years. "[D]isposable income" is defined in § 1325(b)(2) as "current monthly income received by the Debtor ... less than amounts reasonably necessary to be expended ... ." The Bankruptcy Court determined the Debtor's income and the reasonableness of her expenses.

Heritage, however, believes that the Debtor's income tax return should be used to determine "current monthly income" rather than an average of her previous six monthly "draws" from Pathology Specialists, LLC. Heritage also disputes the reasonableness of the Debtor's expenses. Because we have determined that the absolute priority rule applies to individuals in Chapter 11, it is unnecessary to address the Bankruptcy Court's determination of the Debtor's disposable income. The Debtor's "disposable income" as defined in § 1325(b)(2) is "property included in the estate under section 1115" which the Debtor may retain. Heritage stated at oral argument that it will only accept full payment on its claim. Therefore, any determination of disposable income on appeal is unnecessary.

CONCLUSION

For the reasons stated above, we remand the case for a new confirmation hearing.

NOTICE TO BAR REGARDING INDIVIDUAL CHAPTER 11 CASES

There has been a recent spate of individual Chapter 11 cases filed by attorneys who have neither the experience nor the education nor the competence to venture into Chapter 11. I believe that there are very few bankruptcy lawyers other than State Bar certified specialists who should be contemplating representation of Chapter 11 debtors in possession.

I see rampant errors being made in issues relating to cash collateral, conflicts of interest, and compensation.

The use of cash collateral without permission, even for necessary expenses, is usually fatal to Chapter 11 cases. There are procedures in place to obtain emergency permission to use cash collateral. If you don't know them, you should not be taking Chapter 11 cases.

A Chapter 11 is not just a big Chapter 13. If you represent a Chapter 11 debtor in possession, your client is the *estate*, not the debtor personally. Failure to understand this results in serious liability exposure.

Forget about trying to fix your compensation. You will be paid what I allow, period. I suggest you not spend retainers until your fees are allowed to avoid having to return money you have already spent.

I see frequent malpractice in individual Chapter 11 cases and I am quick to note it on the record. Your employment will not be approved unless you have substantial current malpractice insurance. If you are going "bare," don't even think about taking a Chapter 11 case.

Dated: September 9, 2009

Alan Jaroslovsky
U.S. Bankruptcy Judge

Issues for Attorneys Representing Individual Chapter 11 Bankruptcy Estates

I. Introduction

As noted by former Judge once again professor Bruce Markell, in his article: *The Sub Rosa Sub Chapter: Individual Debtors in Chapter 11 after BAPCPA*,[1] flesh and blood individuals have had a hard and rocky path in Chapter 11. The passage of The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") made that already dangerous path far much more treacherous by implementing many changes to how an individual must proceed in and confirm their Chapter 11 cases.[2]

II. Beginning at the Beginning: Credit Counseling for Individual Chapter 11 Debtors

Section 109 of the Bankruptcy Code ("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 section 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.

---

[1] 2007 U.Ill.L.Rev. 67 (2007) noting that until the U.S. Supreme Court decision in *Toibb v. Radloff*, 501 U.S. 157 (1991) there was even a serious question as to whether individuals could even file Chapter 11 cases.

[2] Issues arising since the changes made to Individual Chapter 11 practice by BAPCPA have been the subject of several scholarly articles and presentations including: Jennis & DiSanto, How Disposable is Your Individual Chapter 11 Debtor's Income, 30 Am Bankr Inst. J. 1 (Oct. 2011); ("Disposable Income"); Jennis & DiSanto, Application of Absolute Priority Rule and New Value Exception in Individual Chapter 11's (July/Aug. 2011) ("New Value Exception"); Jennis & DiSanto, Make Yourself "Necessary:" How to Get Paid as Debtor's Counsel in Individual Chapter 11's (June 2011) ("Necessary"). 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"); 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).

During the time since BAPCPA became effective, many courts have addressed Section 109(h), including in the context of Chapter 11 cases. *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); *see also In re Borges*, 440 B.R. 551 (D.N.M. 2010) (wife dismissed from joint chapter 11 case with husband for failing to obtain pre-petition credit counseling).[3]

While most of the cases address the credit counseling requirement in the context of Chapters 7 and 13 cases, Section 109(h) does not except Chapter 11 debtors from its requirements.[4] Chapter 11 and Chapter 12 cases have also been dismissed due to a debtor's failure to comply with Section 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 Section 109(h)(2), (3) and (4), respectively. *See In re Hedquist*, 342 B.R. 295 (8th Cir BAP 2006) ("[T]he requirements of Section 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: (i) the United States 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.

---

[3] For example, *see In re Rodriguez*, 336 B.R. 462, 477 (Bankr. D. Idaho 2005) (eligibility requirements of section 109(h)(1) were not met); *In re Talib*, 335 B.R. 417 (Bankr. W.D. Mo. 2005) (same); *In re Sukmungsa*, 333 B.R. 875 (Bankr. D. Utah 2005) (same). "). S*ee 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] *In re Borges*, 440 B.R. at 562, *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 (Bkrtcy. 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 prepetition credit counseling requirement, was to dismiss, not strike, bankruptcy case).

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

Subsection (h)(2) requires that the Office of the United States Trustee formally determine that credit counseling is not sufficiently available throughout the district. This occurred only 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.

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.[9] 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 debtor failed attempt to avoid dismissal for lack of credit counseling involved an argument of excusable neglect.[10] 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 Section 109(h)(3). *Id.* at 880.

The conclusion of the court in *In re Cleaver*[11] accurately describes the conclusions of the courts addressing Section 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."[12] Therefore, Chapter 11 attorneys must ensure compliance with these provisions to ensure that Chapter 11 will not "die" shortly after its inception.

However, it is important to note that debtors cannot use the failure to comply with credit counseling requirement to dismiss their own cases. The prime example of this is *In re Osborne*, 440 B.R. 75 (Bankr. S.D.N.Y. 2013). There, the debtors filed a husband and wife joint chapter 11 in 2010 which was dismissed in early 2011. The wife filed her own individual chapter 11 in August of 2011 which was dismissed in December of 2011.

However, in November 2011, the husband and wife filed a joint chapter 7 case, but used their credit counseling certificates from their 2010 joint chapter 11 (which were invalid and stale). They received a discharge in their chapter 7.

However, after their case was closed, the trustee discovered the debtors omitted a significant asset (a malpractice claim against their chapter 11 counsel) and had the case reopened. The debtors moved to dismiss their case because they had failed to properly take credit counseling. Not surprisingly, this position was soundly rejected by the court.

---

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

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

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

11 333 B.R. 430 (Bankr. S.D. Ohio 2005).

12 *Id.*

III. Property is the Root of all Confusion. 11 U.S.C. § 1115?

Section 1115 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 performed" after the commencement of the case, but before the case is closed, constitute property of the estate.

> 11 U.S.C. § 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 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.
>
> **(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.

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.[13] However, a sizeable minority of Courts found that at least a portion of post post-petition profits generated by professionals and sole proprietors were not earnings subject to 541(a)(6) exception[14] 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 post-petition income will be treated in his or her Chapter 11.

IV. $120 for Haircuts![15] What we have is a failure to communicate: Chapter 11 personal expenses after BAPCPA.

One of the most vexing questions confronting both attorney and individual chapter 11 debtors is whether an individual debtor's "living expenses" can be paid as ordinary

---

[13] *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).

[14] *See, e.g., In re Harp*, 166 B.R. 740 (Bankr. N.D. Ala. 1993); *In re Heberman*, 122 B.R. 273 (Bankr. W.D. Tx. 1990); *In re Cooley*, 87 B.R. 432 (Bankr. S.D. Tx. 1984).

[15] *In re Webb*, 262 B.R. 685 (Bkrtcy.Ed.Tx. 2001) (Discussing reasonable and necessary expenses in context of a Chapter 13).

course of business expenses under 11 U.S.C. § 363(c)(1)[16] and 11 U.S.C. § 1108[17] or whether notice and a hearing under 11 U.S.C. § 363(b)(1) is required for living expenses to be paid.[18]

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 which considered the question held that normal living expenses of an individual chapter 11 debtor did not need court approval,[19] while others indicated that some form of court approval would be necessary at least in cases of significant expenses.[20] Indeed one early pre-BAPCPA decision *In re Vincent*[21] held there was no authority for the payment of living expenses from the Chapter 11 estate for a chapter 11 individual debtor and his family under the Bankruptcy 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.[22]

Perhaps the best analysis of the need for oversight of expenses of individual chapter 11 cases in 11 U.S.C. § 1115 is *In re Villalobos*, 2011 Bankr. LEXIS 4329 (BAP 9th Cir. July 21, 2011). There, the debtor filed his individual chapter 11 and requested approval of his post-petition expenses of $128,052 per month including payments on five luxury cars, college tuition for grandchildren, and various other "variable" expenses. Over the objection of creditors, the full budget was approved by the court without any specific findings. The BAP reversed, holding: "individual chapter 11 debtors no longer have the option to pay expenses with post-petition income . . . . Instead, individual chapter 11 debtors must now seek payment of personal expenses from estate property which may create problems . . . ."

A related 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

---

[16] 11 U.S.C. § 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.

[17] 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.

[18] 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."

[19] *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).

[20] *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).

[21] 4 B.R. 21 (Bankr. M.D. Tenn. 1979). *See also In re Walter*, 83 B.R. 14 (9th CAP 1988)

[22] *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 non-estate property in connection with determination of debtors' good faith). *See also In re Villalobos*, 2011 Bankr. LEXIS 4329 (BAP 9th Cir. 2011).

living in determining what constitutes reasonable living expenses.[23] Should Courts adopt a disposable income test similar to 11 U.S.C. § 1325(b) or 1129(a)(15)[24] or will they impose the "minimal" standard of living tests imposed on parties seeking to discharge student loans.[25]

While none of these questions have clear answers yet 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.[26] In *Villalobos*, the court considered the issue of what constituted reasonable living expenses, but refused to articulate a specific standard for determining what expenses were reasonable.[27]

Finally, there is the question of whether individual chapter 11 debtors can pay reasonable living expenses for members of their family. While this question almost seems to be the paranoid fears of a madman,[28] 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?

While spouses, former spouses, children of the debtor and other designated parties are entitled to first priority payments for their domestic support obligations[29] and chapter 13 debtors are expressly authorized to pay for the support of their dependents[30] in their cases, there appears to be no similar direct and expenses authorization in Chapter 11 of the Bankruptcy Code permitting an individual chapter 11 debtor to pay for his or her family's support from estate funds.[31] 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 which 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 (and very bad) facts, it does illustrate the problems with 11 U.S.C. § 1115.

---

[23] 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 Rodriquez*, 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. D.N.H. 1994); *In re Jones*, 55 B.R. 462 (Bankr. D. Minn. 1985).

[24] *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).

[25] *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).

[26] *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).

[27] *Villalobos*, 2011 Bankr. LEXIS 4329 at *26-27.

[28] Consider the author, this just might be true.

[29] *See* 11 U.S.C. §§ 101(14A); 507(a)(1) and 1112(b)(4)(P).

[30] *See* 11 U.S.C. § 1325(b)(2).

[31] *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).

V. Do I Get to Keep This as a Person or as the Estate Exemptions of Post-Petition Earnings in Chapter 11 Cases?

An area of possible confusion concerns an individual Chapter 11 debtors' right to claim exemptions both before and during their Chapter 11s. First, how do you claim exemptions in an individual Chapter 11 case? As a Chapter 11 debtor owes a fiduciary duty to his creditors, can he or she take assets "away" from the creditors by claims of exemptions? Also would Chapter 11 debtors have a duty to oppose their claimed exemptions?

A new issue arising under the BAPCPA 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 law[32] 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 individual Chapter 11 cases. The question which may shortly confront Courts and debtors is whether an individual Chapter 11 debtor can use state law to exempt from estate property, some or all 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 and if so, how can they be asserted?

VI. War of the Codes: Bankruptcy vs. the Internal Revenue Code

One of the more difficult issues arising under the BAPCPA is how post-petition earnings will be treated for tax purposes under the Internal Revenue Code. In the leading article on this topic, "Tax Consequences of Post-Petition Income as Property of the Estate in an Individual Debtor Chapter 11 Case and Tax Disclosure in Chapter 11[33] ("Tax Consequences") by Jack Williams and Jacob L. Todres, the authors note several tax issues arising from 11 U.S.C. § 1115.

- How are post-petition earnings paid to individual debtor's estates and reported?
- How are the post-petition earnings transferred from the estate to the individual (for use in personal expenses) treated for tax purposes?
- Will there be double taxation at the estate level and the individual level for amounts of post-petition earnings which are paid or used by debtors as individuals?

While there is no definitive answer to these issues, a detailed reading of Tax Consequences is highly recommended for a more complete understanding of these problems, as well as consulting with tax accountants and counsel.

VII. Privileged Position: Individual Chapter 11 and the Attorney Client Privilege

A problem which frequently arises in bankruptcy cases concerns the control of an individual's attorney client privilege. The issue of who holds a Chapter 11 debtor's

---

32 KRS 427.010.

33 13 Am. Bankr. Inst. L. Rev. 701 (2005).

attorney/client privilege has been often litigated[34] and has been largely resolved in the area of business entities by the Supreme Court's decision in Commodity Futures Trading Commission v. Weintraub[35]. However, while the Weintraub Court held that the debtor in possession or trustee held a Chapter 11 **corporate** debtors' attorney/client privilege[36] and could waive it even over the objection of the debtors' pre-bankruptcy management, the Weintraub Court refused to extend its reasoning to individual debtors' attorney/client privilege ruling:

> [O]ur holding today has no bearing on the problem of individual bankruptcy, which we have no reason to address in this case. As we have stated, a corporation, as an inanimate entity, must act through agents. When the corporation is solvent, the agent that controls the corporate attorney-client privilege is the corporation's management. Under our holding today, the power passes to the trustee because the trustee's functions are more closely analogous to those of management outside of bankruptcy than are the functions of the debtor's directors. An individual, in contrast, can act for himself; there is no "management" that controls a solvent **individual's attorney-client privilege**. If control over that privilege passes to a trustee, it must be under some theory different from the one that we embrace in this case.[emphasis added][37]

Lower courts have taken three general positions[38] with regard to who holds an individual Chapter 11 debtor's attorney/client privilege. One line of mainly older cases has held that an individual Chapter 11 debtor's attorney/client privilege (for both pre and post-bankruptcy periods) remains with the individual debtor and does not pass to the bankruptcy estate or a subsequently appointed trustee.[39] These courts have generally held that due to the greater privacy concerns that arise when an individual holds an attorney/client privilege, there is no justification for the transfer of attorney/client privilege to either the bankruptcy estate or the individual debtor's trustee.[40]

Another group of cases, led by *In re Williams*,[41] has held that the right to who holds the attorney/client privilege does not change merely because a debtor is an individual and not a business entity.[42] These cases have generally held that an individual debtor in

---

34 *See generally In re O.P.M. Leasing Services, Inc.*, 670 F.2d 383 (2d Cir. 1982); *Citibank N.A. v. Andros*, 666 F.2d 1192 (8th Cir. 1981).

35 471 U.S. 343 (1985).

36 *Id.* at 354.

37 *Id.* at 356-357.

38 *In re Bame*, 251 B.R. 367, 377-378 (Bkrtcy. D.Minn. 2000).

39 *See In re Hunt*, 153 B.R. 445 (Bkrtcy. N.D.Tx. 1992) (Trustee under confirmed plan not entitled to waive the attorney/client privilege); *In re Silvio De Lindegg Ocean Dev. Of America, Inc.*, 27 B.R. 28 (Bankr. S.D. Fla. 1982) (same)

40 *In re Hunt*, 153 B.R. at 454. *But See In re Fairbanks*, 135 B.R. 717 (Bkrtcy. D.N.H. 1991) (Finding "other theory" to hold that trustee controlled debtor's attorney/client privilege).

41 152 B.R. 123 (Bkrtcy N.D.Tx. 1992); *See also In re Smith*, 24 B.R. 3 (Bkrtcy. S.D. Fla. 1982) (Pre Weintraub)

42 *In re Williams*, 152 B.R. at 128 (noting that under *Toibbv Radloff*, 501 U.S. 157 (1991) (Individual Debtor had fiduciary responsibilities of a corporate debtor in possession).

possession must exercise its attorney/client privilege in a manner consistent with its fiduciary duty to creditors and that includes the transfer or waiver of its attorney/client privilege for the benefit of the estate.[43] These courts have found that the individual Chapter 11 Debtor's attorney client privilege passes to his or her bankruptcy estate and does not remain in the hands of the individual.

The final[44] and largest line of authority concerning individual Chapter 11 debtor's attorney/client privilege has stated that courts must determine who holds the attorney/client privilege on a case by case basis by balancing the policies underlying the attorney/client privilege and the potential harm of disclosure to the individual against the trustee's duty to maximize the value of the estate.[45]

Under this line of reasoning, courts have generally determined that an individual debtor has no attorney/client privilege for any **post-petition discussions** the individual has with the estate counsel, holding that the estate counsel generally cannot give individuals legal advice, in their capacity as an individual, while acting as the estate's counsel.[46] These courts have also held that pre-bankruptcy discussions with attorneys are subject to an individual attorney/client privilege.

Under all of these lines of cases, the estate's counsel should carefully advise the individual as to who they represent in the chapter 11 (the bankruptcy estate generally)and the issues that may arise related to the individual attorney/client privilege (or lack thereof) when filing a Chapter 11 case.

VIII. The Ultimate Collection Device: Involuntary Chapter 11!?

Prior to the enactment of the BAPCPA, involuntary Chapter 11's of individuals were legally possible[47] but of little value as an individual's post-petition income was not property of the estate. However, with the enactment of 11 U.S.C. § 1115 post-petition

---

43 *Id.*

44 There is also a group of cases involving the waiver of an individual debtor's attorney/client privilege in the context of legal malpractice claims against a debtor's attorney. In these cases bankruptcy courts have generally held that the trustee holds and has the right to waive the attorney/client privilege for the purpose of investigating the malpractice action. *See In re Bazemore*, 216 B.R. 1020 (Bkrtcy. S.D. Ga. 1998), *In re Tomarolo*, 205 B.R. 10 (Bkrtcy. D. Mass. 1997) *But see McClarty v. Gudenau*, 166 B.R. 101 (E.D. Mich. 1994) (Individual Chapter 7 debtor holds attorney/client privilege as to file involved in malpractice action).

45 *See* generally *In re Foster*, 188 F.3d 1259 (10th Cir. 1999); *In re Benum*, 339 B.R. 115 (Bkrtcy. D.N.J. 2006); *In re Eddy*, 304 B.R. 591 (Bkrtcy. D. Mass. 2004); *In re Miller*, 247 B.R. 704 (Bkrtcy. N.D. Ohio, 2000).

46 *See In re Bame*, 251 B.R. 367, 375-376 (Setting forth a 5 part test to see if individual received individual legal advice from estate counsel [which would be subject to the individual's attorney client privilege] or advice as debtor in possession [which would not be subject to the individual attorney client privilege, but to the bankruptcy estate's privilege]).

47 *See* Warner, Garnishment Restrictions and the Involuntary Chapter 11: Rethinking Kokoszka in a means test world, 13 Am. Bankr. Inst. L.R. 733, 735 (2005) (hereinafter "Garnishment'); Fagone, Involuntary Individual Chapter 11 Post-BAPCPA as a Collection Device 25 Am. Bankr. Inst. J. 28 (Dec/Jan. 2007) (hereinafter "Involuntary Chapter 11"). See also Toibb v. Radloff, 501 U.S. 157 (1991) (discussing involuntary Chapter 11 cases against the individuals.

income is now property of the estate.[48] This fact, coupled with the liberal discovery provisions of Rule 2004, limitations on the use of estate property and the debtor's inherent fiduciary duty to creditors,[49] means involuntary Chapter 11 may become a more attractive creditor option. The leading reported decision on the constitutionality of involuntary individual chapter 11 cases is *In re Marciano*, 446 B.R. 407 (Bankr. C.D. Cal. 2010), *aff'd* 459 B.R. 27 (9th Cir. BAP 2011); *aff'd* 2013 U.S. App. LEXIS 4073 (9th Cir. 2013).[50] In that case, the Courts refused to dismiss an involuntarily filed Chapter 11 or grant a stay of the involuntary case on constitutional grounds without an in-depth analysis of the constitutionality of involuntary Chapter 11s.

Related to the issue of involuntary individual Chapter 11 cases is a line of fairly recent cases concerning motions to convert high earner Chapter 7s to Chapter 11 cases: *In re Gordon*, 465 B.R. 683 (Bankr. N.D. Ga. 2012); *In re Hardigan*, 490 B.R. 437 (Bankr. S.D. Ga. 2013); *In re Baker*, 503 B.R. 751 (Bankr. M.D. Fla. 2013).

In *Gordon*, the debtor was an international business consultant who had a judgment for over $335,050 (plus another $1 plus million in disputed claims) for breach of his non-compete agreement with his former employer. He filed a Chapter 7 with only $450,000 in unsecured debt and a salary of between $250,000 -- $290,000 per year. The judgment creditor moved to convert the Chapter 7 to an individual Chapter 11. After a detailed analysis of the complex facts, the Court found that: (1) 11 U.S.C. § 706(b) applied to individual non-consumer debtors, 465 B.R. at 691-694l; (2) the conversion which captured the debtor's post-petition income did not violate the Thirteenth Amendment's prohibition of involuntary servitude as the debtor had a choice to be in bankruptcy and a choice of whether to file a confirmable Chapter 11 plan, *Id.* at 695-701; and (3) the conversion did not violate the Anti-Peonage Act (42 U.S.C. § 1994) *Id* at 700-704.[51]

However, merely being a high earning individual does not automatically mean conversion. In the case of *In re Hardigan*, 490 B.R. 437 (Bankr. S.D. Ga. 2013), a 60-year old doctor filed bankruptcy after making several bad real estate deals and had over $2,000,000 in deficiency claims. The debtor, at the time of his filing, had a "gross" salary of between $422,000 and $519,000, but had stopped, taking a part-time position pre-bankruptcy. The U.S. Trustee moved to convert this to a Chapter 11 case under 11 U.S.C. § 706(B) AND 707(B). The Bankruptcy Court, here, found that under the totality of the circumstances, conversion of the case was not warranted, even though conversion to a Chapter 11 would potentially double the distribution to unsecured creditors. The court also indicated that if case was one with primarily consumer debt, if the debtor's

---

[48] However, as noted by Professor Roy Warner in Garnishment, there may be constitutional limitations on the amount of post-petition income which can become estate property in an involuntary individual Chapter 11.

[49] *See generally* Involuntary Chapter 11

[50] For more on this "fun" case, *see Gollieb v. Fahs*, 2012 Cal. App. Unpul. 7870 (Cal. Ct. App. Oct. 29, 2012).

[51] *See also, In re Marciano*, 459 B.R. 27 (9th BAP 2011) (Involuntary Individual Chapter 11s are constitutional).

case did not have to be converted under 11 U.S.C. § 707, then conversion under 11 U.S.C. §706 needs to be closely weighted against the debtor's right to a discharge.[52]

Finally, in *In re Baker*, 503 B.R. 751 (Bankr. M.D. Fla. 2013), yet another doctor filed an individual Chapter 7 with a monthly income of $54,000 and $19,400 in monthly expenses (including $2,000 per month to board pets, $2,150 per month on food for the doctor alone, $1,400 on monthly personal grooming and $1,000 in gifts). The debtor had $1.3 million in tax claims owed to the IRS and a $512,000 deficiency judgment claim, but only $40,000 in assets for distribution to creditors in her Chapter 7 case. The Court found that her bankruptcy estate would greatly benefit as there would be $10,000 per month available for creditors after deducting "reasonable" expenses and that pursuing a Chapter 11 plan would "allow" the debtor to address her issues with the IRS and bank holding the deficiency judgment. *Id.* at 759.

Currently there is no definitive case law on post-BAPCPA involuntary Chapter 11 cases and the use of involuntary 11 as a collection tactic has not yet been fully explored. However it is important to note that involuntary Chapter 11s, like all involuntary bankruptcies, are somewhat risky and should not be undertaken lightly.[53]

IX. Confirmation of Individual Chapter 11 after BAPCPA

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

1. 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.

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, Section 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.[54]

---

[52] *See also In re Snyder*, 509 B.R. 945 (Bankr. D.N.M. 2014) (Motion to Convert 63-year old doctor's case to Chapter 11 denied, noting serious constitutional issues on conversion of a Chapter 7 to a Chapter 11).

[53] See Bowles, The Lawyer Made me Do It, 21 Am. Bankr. Inst. J. 24 (October 2002).

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

2. 11 U.S.C. § 1129(a)(15).

Another creditor friendly charge made by BAPCPA is the addition of section 1129(a)(15) is certainly creditor friendly. Section 1129(b)(15) provides:

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

Section 1129(a)(15) provides creditors 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.

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 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 Section 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.

Of course, if no creditor holding an allowed unsecured claim objects, this section does not apply.[55] Also, the debtor can avoid an objection under subsection (a)(15) if it is a 100% 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. Query, if a creditor is partially secured, may a debtor argue it is not a general unsecured claim?[56] Or, may a

---

[55] *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).

[56] *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988).

debtor object to a claim the day before a confirmation hearing so it is not deemed allowed when the objection is considered?[57]

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. Query, could a debtor affirm an unsecured claim in full to avoid an objection by that creditor?

3. 11 U.S.C. § 1325(b)(2).

As indicated, Section 1129(a)(15) calculates disposable income by reference to 11 U.S.C. § 1325(b)(2). The Section 1325(b)(2)[58] 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 maintenance and support obligations of the debtor or a dependant and domestic support obligations accruing post petition. The debtor is also allowed a charitable contribution deduction up to 15% 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 Section 707(b)(2)(A) and (B) of the Code. But, Section 1129(b)(15) did not reference to Section 1325(b)(3); only Section 1325(b)(2). Query, does this omission allow an argument that the bankruptcy court should determine what is "reasonably necessary" under Chapter 11 without resort to the Chapter 7 definition, even

---

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

58 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 section 548(d)(3) to a qualified religious or charitable entity or organization (as defined in section 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.

though what is "reasonably necessary" under Chapter 13 is calculated pursuant on subsection 1325(b)(3)?

Overall, these changes plan 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.

X. Absolute Priority and the Individual Debtor.

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 reorganization] plan."[59] This rule applied in individual[60] Chapter 11 cases prior to BAPCPA.[61]

Two of the most important changes made by BAPCPA to individual Chapter 11 cases 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 designates all of the debtor's income, earned from a job or "services performed" after a Chapter 11 is commenced, as property of the estate.[62] 11 U.S.C. §§ 1123 and 1129 establish conditions to confirmation of individual Chapter 11 plans, including a requirement that all projected dispensable income received by the debtor must be paid out under the plan.

The critical question raised by these modifications to the Bankruptcy Code was whether they eliminated or modified the absolute priority rule for confirmation of individual Chapter 11 cases. There are two lines of cases. One line termed the "broad view"[63] holds that the modifications to 11 U.S.C. §§ 1123 and 1129 abrogate the absolute priority rule in individual Chapter 11 case, although in a convoluted way.[64]

A larger line of cases,[65] termed the "narrow view," holds that the absolute priority rule survived the BAPCA changes intact and still applies to individual Chapter 11 debtor plans. As this split of authority is well discussed in these cases we will address primarily

---

[59] *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 202 (1988) (internal citations omitted).
[60] *See* Section E of this article for a discussion whether the absolute priority rule prevented an individual Chapter 11 debtor to retain exempt property.
[61] *See In re Walsh*, 447 B.R. 45, 47 n. 9 (Bkrtcy. D. Mass. 2011); *In re Shat*, 424 B.R. 854, 858 (Bankr. S.D. Ohio 2010).
[62] *See Ghost I* at 98-99 addressing issues arising from this broad definition.
[63] *Friedman v. P+P, LLC (In re Friedman)*, 466 B.R. 471 (B.A.P. 9th Cir. 2012); *In re Shat*, 424 B.R. 854 (Bkrtcy. D. Nev. 2010); *In re Ballard*, 358 B.R. 541 (Bkrtcy. D. Conn. 2007).
[64] Id.
[65] *In re Lively*, 717 F.3d 406 (5th Cir. 2013); *In re Stephens*, 704 F.3d 1279 (10th Cir. 2013); *In re Mahara*, 681 F.3d 558 (4th Cir. 2012); *In re Gelin*, 437 B.R. 435, 442 (Bkrtcy. M. D. Fla. 2010). The trend of courts adopting the narrow 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.

ethical issues confronting individual Chapter 11 debtor's counsel concerning the absolute priority rule.

XI. Good Faith

The initial and overriding issue is whether an attorney[66] can, in good faith, propose a plan for an individual Chapter 11 debtor that does not propose to pay all creditors in full but nevertheless proposes that debtors 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,[67] the Ninth Circuit, based on the absolute priority rule, refused to affirm the confirmation of an individual debtor's Chapter 11 plan that proposed to pay all creditors in full over a 67-month period, but without interest, even though the sole creditor who voted against the plan (and caused a class to vote against the plan), never filed an objection.[68]

The Perez court further stated, *in dicta*

> [W]e are most disappointed in the estate's counsel, who is responsible for proposing and seeking confirmation of these failed plans. . .
>
> 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.[69]

Therefore, if the narrow view of 11 U.S.C. § 1115 prevails and there is no exception to the absolute priority rule,[70]counsel will have to carefully consider the impact of Perez.[71]

XII. Is there a future income problem under Ahlers?

Although not addressed directly by most courts considering the narrow or broad views on the absolute priority rule, an interesting question arises as to whether Norwest Bank Worthington v. Ahlers[72]prohibition against "sweat equity plans" has been (or could be)

---

[66] 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.
[67] 30 F.3d 1209 (9th Cir. 1994).
[68] *Id.* at 1214. *See also In re Lett*, 632 F.3d at 1216 (allowing absolute priority objection to first be raised on appeal).
[69] *Id* at 1219 n. 14. (However, please review this footnote as the assertion of the estate counsel's knowledge is somewhat weak).
[70] 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.
[71] 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.
[72] 485 U.S. 197 (1988).

overruled by 11 U.S.C. §§ 1123(a)(8) and 1129(a)(15), which requires that five years of an individual debtor's projected disposable income be distributed 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 under a plan, could an individual Chapter 11 debtor propose a confirmable plan under the new value exception to the absolute priority rule?

In In re Shat, the Court noted in passing that BAPCPA "effectively overruled Ahlers"[73] on the issue of whether the future labor could constitute value under the absolute priority rule, but only used this observation to support its determination that the broad view of 11 U.S.C. § 1115 was correct. However, the "narrow view" case of In re Lindsey[74] rejects this finding that there was no attempt to overrule Ahlers by BAPCPA. This issue will likely continue to be litigated in the future.

XIII. Is a Debtor's Exempt Property Subject to the Absolute Priority Rule?

An interesting issue that 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 Gosman[75] 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 holding 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,[76] 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 (Bkrtcy. 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." *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).

See also In re Brown, 498 B.R. 486 (Bankr. E.D. Pa. 2013), *aff'd*, 505 B.R. 638 (E.D. Pa. 2014); *In re Muth*, 2014 Bankr. LEXIS 1963 (E.D. Pa. 2014).

---

[73] 424 B.R. at 867.
[74] 453 B.R. 886, 901 (Bkrtcy. E.D. Tenn. 2011).
[75] 282 B.R. 45 (Bkrtcy. S.D. Fla. 2002).
[76] 2010 WL 3528599 (S.D. Ga. 2011).

However, several courts in pre-BAPCPA cases, have held the absolute priority rule, prohibits the use of exempt assets to fund a Chapter 11 plan to satisfy the absolute priority rule. *See, e.g., In re Gosman*, 282 B.R 45 (Bankr. S.D. Fla. 2002).

XIV. Seeing Double: Who (of What) is Your Client in an Individual Chapter 11?

As debtors' attorneys know, or should know, the vast majority of courts have held that counsel for Chapter 11 Debtors represent the bankruptcy estate[77] and not the principals of the Debtor.[78] 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 issues are critical to addressing the challenging ethical problems in individual Chapter 11 cases: (1) the individual debtor's fiduciary duty to creditors and (2) the estate counsel duties to the client in an individual Chapter 11.[79]

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 creditors[80] to act in the best interests

---

[77] *See generally, Everett v. Perez*, 30 F.3d 1209 (9th Cir. 1994); *In re Living Hope Southeast, LLC*, 509 B.R. 629 (Bkrtcy. E.D. Ark. 2014); *In re Cenargo International PLC*, 294 B.R. 571 (Bkrtcy. 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 (Bkrtcy N.D. Ala. 1993); *In re Rusty Jones, Inc.*, 134 B.R. 321 (Bkrtcy. N.D. Ill. 1991); *In re Grabill, Corp.*, 113 B.R. 966 (Bkrtcy. N.D. Ill. 1990); *In re Storms*, 101 B.R. 645 (Bkrtcy. S.D. Cal. 1989). *See also*, Rapoport and 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").

[78] 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. Col. 1994) have held that counsel owe duties to the Debtors-in-possession, not the estate.

[79] 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).

[80] *Id.* at 53-55. *See also, Commodity Futures Trading Commission v. Wentraub*, 471 U.S. 343, 355 (1985).

of their bankruptcy estate.[81] Courts have universally held that individual chapter 11 debtors owe these duties just like other debtors-in-possession.[82]

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 found in this standard.

In the case of *In re Bowman*,[83] a Chapter 7 debtor objected to the Chapter of 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.[84] The Debtor exercised her right[85] to convert her case to a Chapter 11 proceeding. The Court granted the debtors' motion but immediately reconverted 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 debtor in possession. 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.[86]

In a similar fashion, the Court in *In re Tel-Net Hawaii, Inc.*[87] removed the debtor in possession who was the corporation's controlling shareholder due to it failure to pursue preference actions which would have increased its exposure on guaranteed debts.[88] The Court found that in light of the conflicting interests of its controlling shareholder, an independent trustee had to be appointed.

---

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

82 *See generally In re Grusso*, 490 B.R. 500 (Bkrtcy. E.D. Pa. 2013); *In re Hardy*, 319 B.R. 5 (Bankry. 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).

83 181 B.R. at 836.

84 *Id.* at 841.

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

86 *Id.* at 845. However, courts do not automatically require trustees to settle claim where an offer is made to pay creditors' claims in full. *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).

87 105 B.R. 594 (Bankr. D. Haw. 1989).

88 *Id.* at 595.

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 debtor-in-possession)advice as to how he or she could improve their financial condition at the expense of the estate.[89]

XV. The Ultimate Question: What Can I Do and Get Paid For?

If these problems were not enough for an attorney, in an as yet unpublished decision from the Fifth Circuit, *Matter of Woerner*, Case No. 13-50075 (5th Cir. July 15, 2014), the Court held that representing an individual Chapter 11 debtor in defending dischargeability actions and opposing a Motion to Convert (which ultimately succeeded) were not beneficial to the estate and could not be allowed as fees. The Court, under *In re Pro-Shax Distributors, Inc.*, 157 F.3d 414 (5th Cir. 1998), found that these activities did not result in an "identifiable, tangible and material benefit to the bankruptcy estate." While there are unusual facts to this case, this language is something any professional must consider in representing an individual Chapter 11 proceeding.

Further, a recent District Court case, *In re Garcia*,[90] addressed which attorneys are subject to the provisions of 11 U.S.C. § 329 in an individual Chapter 11 case. The facts of *Garcia* are fairly simple.

Prior to his individual Chapter 11 filing, the debtor retained an attorney[91] to represent him several foreclosure actions and short sales. The attorney later advised the debtor to file bankruptcy and helped him find bankruptcy counsel and provided his counsel a list of foreclosure lawsuit for use in the debtor's schedules and statement of financial affairs.

After filing bankruptcy, the debtor filed a motion against the attorney under 11 U.S.C. § 329 seeking disgorgement of fees asserting the value of fees the debtor paid to the attorney exceeded the reasonable value of these services. The bankruptcy court dismissed the motion finding the attorney was not subject to 11 U.S.C. § 329 because the attorney was not the debtor's bankruptcy counsel.

The District Court reversed stating that representing the debtor is not the best for determining whether attorneys are subject to 11 U.S.C. § 329. Rather, the District Court held that the subjective state of mind of the debtor as to whether the debtor's counseling was the key issue in determining whether an attorney is subject to 11 U.S.C. § 329.[92] The

---

[89] *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.

[90] 456 B.R. 361 (N.D. Ill. 2011).

[91] There is a dispute as to whether the debtor paid the attorney $7,000 or $24,000 for her work.

[92] As the Court noted:

> To determine if payments were made "in contemplation" of bankruptcy must consider whether "the underlying professional services were rendered at a time when the debtor was contemplating bankruptcy." *In re Gage*, 394 B.R. 184 (Bankr. N.D. Ill. 2008). Thus, a subjective test of the debtor's state of mind is used in determining a transaction is subject to Section 329. *See Zepecki*, 277 F.3d at 1045; *In re Dixon*, 143 B.R. 671, 675 n3 (Bankr. N.D. Tex. 1992) (articulating the test as "whether, in making the transfer, the debtor is influenced by the possibility or imminence of a

District Court remanded for further finding to determine whether the debtor's dealing with the attorneys were for purposes of avoiding bankruptcy or whether motivated for the possibility of bankruptcy. This opinion, especially in light of the current economy, should be reviewed by all attorneys representing parties who may be debtors.

XVI. Conclusion

In summary, given the problems with individual Chapter 11s, from problems with living expenses, tax issues, plan confirmation problems and Constitutional challenges after the passage of BAPCPA, it is somewhat surprising that an apparently increasing number of individual Chapter 11s are being filed. Although few in number, these individual Chapter 11 present the attorney with difficulties beyond these found in the typical business Chapter 11.

1622027_1.doc

bankruptcy proceeding"); *In re GIC Gov't Securities, Inc.*, 92 B.R. 525, 531 (Bankr. M.D. Fla. 1988) (asserting that fees paid for the purpose of avoiding bankruptcy are "clearly 'in contemplation of bankruptcy'").