

Individual Chapter 11 Cases After BAPCPA

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I. Reasons for Individuals to File Chapter 11

- A. Allows individuals who are ineligible for Chapter 13 (or who will not survive scrutiny under BAPCPA's new Chapter 7 means testing) to maintain control over assets while receiving bankruptcy protections such as automatic stay and discharge.
- B. Lessens bankruptcy stigma by allowing debtor to restructure debts and pay them rather than have trustee liquidate, and creates opportunity for higher return to creditors.
- C. **Under BAPCPA: BAPCPA restricts the flexibility afforded to individual Chapter 11 debtors (as it also does with corporate debtors), and makes it far more difficult for such a debtor to confirm a plan and receive a Chapter 11 discharge. The specific changes are discussed throughout these materials.**

Under BAPCPA, Chapter 11 more closely resembles a "high-end" version of Chapter 13. For example, new §1115 makes post-petition earnings of a Chapter 11 debtor (like those of a Chapter 13 debtor under §1306(a)) subject to creditor claims. §1129(a)(15) adds a "disposable income" confirmation requirement similar to §1325(b), and §1127(e) permits post-confirmation modification of a plan.

II. Authority for Individuals to File Chapter 11

- A. 11 U.S.C. § 109(d): "Only a person that may be a debtor under chapter 7 of this title, except a stockbroker or a commodity broker, and a railroad may be a debtor under chapter 11 of this title."
- B. Toibb v. Radloff, 501 U.S. 157, 111 S.Ct. 2197, 115 L.Ed.2d. 145 (1991): Individual debtors not engaged in business are eligible to file under Chapter 11. The inclusion of many provisions in chapter 11 that are manifestly inapplicable in individual cases (such as § 1102, authorizing formation of an equity security holders' committee) "reflect an understandable expectation that Chapter 11 would be used primarily by debtors with ongoing businesses; they do not constitute an additional prerequisite for Chapter 11 eligibility beyond those established in § 109(d)."
- C. ".... Chapter 11 also embodies the general Code policy of maximizing the value of the bankruptcy estate. ... Under certain circumstances a consumer debtor's estate will be worth more if reorganized under Chapter 11 than if liquidated under Chapter 7. Allowing such a debtor to proceed under Chapter 11 serves the

congressional purpose of deriving as much value as possible from the debtor's estate." *Toibb, supra*, 501 U.S. 157 at 163-164.

D. Under BAPCPA: Is §303(a) now unconstitutional as applied to individual Chapter 11 debtors?

1. Under §303(a)(unchanged under BAPCPA), an involuntary case may not be commenced under Chapter 13, but may be commenced under Chapter 11.
2. In *Toibb, supra*, the Supreme Court discussed constitutional concerns about involuntary "reorganization" cases and said:

... Congress' primary concern about a debtor's being forced into bankruptcy under Chapter 13 [was] that such a debtor, whose future wages are not exempt from the bankruptcy estate, §1322(a)(1), would be compelled to toil for the benefit of creditors in violation of the Thirteenth Amendment's involuntary servitude prohibition. See H.R.Rep. No. 95-595, at 120. *Because there is no comparable provision in Chapter 11 requiring a debtor to pay future wages to a creditor, Congress' concern about imposing involuntary servitude on a Chapter 13 debtor is not relevant to a Chapter 11 reorganization.*

Id., 111 S.Ct. at 2202 (emphasis added). The legislative history to Chapter 13, alluded to by the Court in *Toibb*, states:

.... 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.

H.R.Rep. No. 95-595, 95th Cong. 1st Sess. 322 (1977), at 120; S.Rep. No. 95-989, 95th Cong.2d Sess. 94 (1978) at 32, U.S. Code of Cong. & Admin. News 1978, at 6080.

3. Under BAPCPA: There are now "comparable provisions" (new §§ 1115, 1123(a)(8), and 1129(a)(15)) that effectively require a debtor to

pay future wages to creditors. Does this mean that §303(a), as applied to involuntary Chapter 11 debtors, is unconstitutional? Is the new §1129(b)(2)(B)(ii) (permitting an individual debtor to cramdown unsecured creditors while retaining post-petition earnings) the “fix” to the constitutional problem? Does it work?

III. Issues in Individual Chapter 11 Cases

A. Conversion or Dismissal

1. Good Faith/ Bad Faith Filing

- a. *See, e.g., In re Paolini*, 312 B.R. 295 (Bankr.E.D.Va. 2004): “The monthly payments proposed by Paolini under the Plan are *de minimis* compared to the substantial non-essential personal living expenditures which Paolini made prior to bankruptcy and continues to incur since filing his petition in this Court. Paolini’s only sincere plan to financially reorganize is to reverse the adverse ruling of the District court and prevail on his claims against Albertson’s. There is no good faith attempt on the part of Paolini to utilize the bankruptcy process for the legitimate purpose of reorganizing his personal finances; rather, the totality of the circumstances here convince this Court that Paolini filed his case solely to evade the decision of the District court to not permit him a supersedeas without the posting of bond.” *Id.* at 310.
- b. *In re Tejano*, 135 B.R. 686 (Bankr.D.Kan. 1991)(if an individual without a business is to file a Chapter 11 case, and reorganization rather than liquidation of assets is the goal, then the debtor must devote his or her income to that goal).

2. Under BAPCPA: New §1112(b)(4) adds a number of defined examples of “cause” for conversion or dismissal which apply to all Chapter 11 cases. It also adds §1112(b)(4)(P), which applies only in individual cases, and which defines “cause” to include “failure of the debtor to pay any domestic support obligation that first becomes payable after the date of the filing of the petition.”

B. Inclusion of Post-Petition Earnings in Estate

1. Prior to BAPCPA, there was a split of authority on this issues. Some courts held that all post-petition earnings of an individual Chapter 11 debtor were excluded from the estate under § 541(a)(6). *See, e.g., Roland*

- v. UNUM Life Ins. Co. Of America, 223 B.R. 499 (E.D.Va.1998) (individual Chapter 11 debtor could use post-petition earnings to retain criminal defense attorney, even though such earnings represented sole source of funding for future plan of reorganization); In re Powell, 187 B.R. 642 (Bankr.D.Minn. 1995); In re Keenan, 195 B.R. 236 (Bankr.W.D.N.Y. 1996); In re Larson, 147 B.R. 39 (Bankr.D.N.D. 1992); In re Molina Y Vedia, 150 B.R. 393 (Bankr.S.D.Tex. 1992); Gautier v. El-Amin, 126 B.R. 855 (Bankr.E.D.Va. 1991); In re Fernandez, 97 B.R. 262 (Bankr.E.D.N.C. 1989).
2. Other courts held that the income should be split based on how it was generated, with "earnings" being excluded and "proceeds" of property of the estate being included. *See, e.g.,* In re FitzSimmons, 725 F.2d 1208 (9th Cir. 1984); In re Cooley, 87 B.R. 432 (Bankr.S.D.Tex. 1988); In re Altchek, 124 B.R. 944 (Bankr.S.D.N.Y. 1991).
 3. Under a third view, all post-petition earnings are included in the estate, under § 541(a)(7). *See, e.g.,* In re Herberman, 122 B.R. 273 (Bankr.W.D.Tex. 1990).
 4. *Cf. In re Harp*, 166 B.R. 740 (Bankr.N.D.Ala. 1993)(stating that proper way for individual Chapter 11 debtor to receive benefit of post-petition earnings was as "employee" of his own Chapter 11 estate, subject to court supervision).
 5. **Under BAPCPA:**
 - a. New §1115 moots the pre-BAPCPA split of authority and provides that, in individual Chapter 11 cases, property of the estate includes "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. §1115 also includes within property of an individual Chapter 11 debtor's estate "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."
 - c. §1123(a)(8) provides that, to be confirmable, an individual debtor's Chapter 11 plan must "provide for the payment to creditors under the plan of all or such portion of earnings from

personal services performed by the debtor after the commencement of the case or other future income of the debtor *as is necessary for the execution of the plan.*" (Emphasis added).

- d. **§1129(a)(15) gives dissenting unsecured creditors who are not to be fully paid under the plan absolute veto power over the plan unless the debtor contributes an amount equal to all of his projected disposable income over the longer of (i) 5 years or (ii) the plan payment period.**

C. Debtor's Use of Estate Property

- 1. "Individual debtors in Chapter 11 may be faced with the inconsistent roles of acting both as a zealous representative of the estate and a champion of their own personal rights. The inconsistencies in these roles presents an inherent conflict for an individual debtor-in-possession." In re Devine, 131 B.R. 952, 956 (Bankr.S.D.Tex. 1991).
- 2. In re Bradley, 185 B.R. 7 (Bankr.W.D.N.Y. 1992)(an individual Chapter 11 debtor who earns no personal service income, may spend proceeds of non-exempt estate property for ordinary course personal living expenses).
- 2. § 549 may also serve as a check on excessive post-petition expenditures.

D. Estate Administration

- 1. Notification re Domestic Support Obligation Claims
 - a. **Under BAPCA: BAPCPA adds §1106 (c), which will apply only in individual Chapter 11 cases and which requires trustees (and debtors-in-possession) to provide certain notifications to holders of domestic support obligation claims and to state child support enforcement agencies.**

E. Plan Formulation and Confirmation

- 1. Modification of Debts
 - a. In re DeSeno, 17 F.3d 642 (3d Cir. 1994): Chapter 11 debtor has the ability, under § 1123(a)(5)(G), to propose a plan that modifies a state court mortgage foreclosure judgment; court notes that this

would not be the case in Chapter 13 because of § 1322(b)(2).

- b. § 1123(b)(5) prohibits plan modification of the rights of the holder of a lien secured only by the debtor's personal residence. *See, e.g., In re Dailey*, 289 B.R. 707 (Bankr.C.D.Ill. 2003)(denying confirmation of plan that proposed to "strip down" lien on home mortgage).

2. Good Faith (§ 1129(a)(3))

- a. In re Weber, 209 B.R. 793, 798 (Bankr.D.Mass. 1997): "[T]he fact that a debtor's postpetition earnings are not property of the estate does not mean that the court is precluded from considering those earnings in connection with a determination of a debtor's good faith in proposing a plan. ... On the contrary, all of the cases which address this issue hold that an individual debtor in Chapter 11 must make a sufficient financial commitment to creditors to satisfy the good faith requirement." Despite noting important differences between Chapter 11 and Chapter 13 (Chapter 13 debtor may dismiss case at any time, and there are no involuntary Chapter 13s), court adopts Chapter 13 "disposable income" test as a "useful ... guideline to determine whether a debtor has committed sufficient available resources to a plan." *Id.* at 799. "A debtor cannot file a Chapter 11 petition and claim an entitlement to live in the style to which he or she has become accustomed. ... A plan in which the Debtor retains 100 percent of the expenditure necessary to support a lavish lifestyle, while proposing to pay a 5 percent dividend to creditors is not proposed in good faith." *Id.* at 800.
- b. In re Harman, 141 B.R. 878, 889 (Bankr.E.D.Pa.1992): "A debtor's failure to make anything close to the best offer of payment to creditors violates § 1129(a)(3)."
- c. In re Walker, 165 B.R. 994, 1001 (E.D.Va. 1994): "The failure of a debtor to use the full reach of its disposable resources to repay creditors is evidence that a plan is not proposed in good faith."
- d. In re Shin, 306 B.R. 397 (Bankr.D.D.C. 2004): Plan by individual Chapter 11 debtor that did not provide for payment of post-petition, "non-administrative" claims (i.e., claims such as a home heating bill "not associated with being a debtor-in-possession") was not proposed in good faith.

3. Compliance with Code and Law (§§ 1129(a)(1) and (3))
 - a. In re Flor, 166 B.R. 512 (Bankr.D.Conn. 1994): Court denied confirmation of a plan with a seven-year payout funded from debtor's future earnings. In the court's view, the effective "assignment" of future earnings violated public policy. "To contend, as the debtors clearly do, that any debtor may evade the carefully-structured restrictions contained in Chapter 13 simply by filing for relief under Chapter 11, is to promote an unacceptable distortion of public policy." *Id.* at 515.
4. Use of Post-Petition Earnings
 - a. Prior to BAPCPA, there was no specific statutory provision governing the obligation of an individual Chapter 11 debtor to use post-petition earnings to fund a plan. To the extent that such earnings were not deemed property of the estate, a debtor could — subject only to general confirmation requirements such as good faith, best interests test, and fair and equitable test — at least theoretically confirm a plan without allocating post-petition earnings to plan payments.
 - b. **UNDER BAPCPA: §1123(a)(8) provides that, to be confirmable, an individual debtor's Chapter 11 plan must "provide for the payment to creditors under the plan of all or such portion of earnings from personal services performed by the debtor after the commencement of the case or other future income of the debtor as is necessary for the execution of the plan."**
5. Payment of Domestic Support Obligations
 - a. **UNDER BAPCPA: BAPCPA adds a new §1129(a)(14), conditioning confirmation of an individual debtor's plan upon full payment of all post-petition "domestic support obligations" (as defined in new §101(14A)).**
6. Cramdown and Absolute Priority Rule
 - a. Notwithstanding certain analytical difficulties that this result

creates, the courts have held that the absolute priority rule applies in individual Chapter 11 case. Unruh v. Rushville State Bank of Rushville, Missouri, 987 F.2d 1506 (10th Cir. 1993); In re Gosman, 282 B.R. 45 (Bankr.S.D.Fla. 2002); In re Davis, 262 B.R. 791 (Bankr.D.Ariz. 2001)(absolute priority rule and 203 N. LaSalle “market test” of new value exception to rule apply in individual Chapter 11 cases); Matter of Yasparro, 100 B.R. 91 (Bankr.M.D. Fla. 1989); In re East, 57 B.R. 14 (Bankr.M.D.La. 1985); In re Cipparone, 175 B.R. 643 (Bankr.E.D.Mich. 1994); In re Bolton, 188 B.R. 913 (Bankr. D.Vt. 1995);

- b. Various courts have addressed or applied the “new value exception” to the absolute priority rule in individual Chapter 11 cases. *See, e.g.*, In re Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 108 S.Ct. 963, 99 L.Ed.2d 169 (1988)(holding that, if new value exception survived enactment of Code, debtor’s “sweat equity” contribution of post-petition labor and services did not constitute “new value”); In re Henke, 90 B.R. 451 (Bankr.D.Mont. 1988)(confirming nonconsensual Chapter 11 plan that allowed debtor to retain his farming operation; new value was funded from debtor’s profits from non-farm business).
- c. Courts are split on the issue of whether an individual Chapter 11 debtor must surrender exempt property in order to confirm plan over objection of dissenting creditors. In re Henderson, 321 B.R. 550 (Bankr.M.D.Fla. 2005)(debtor may retain exempt property, if sufficient new value from other sources is provided under plan). *Contra*, In re Gosman, *supra* (§ 1129(b)(2)(B)(ii)’s proscription on debtor’s retention of “any” property for cramdown purposes included exempt property); Matter of Yasparro, *supra* (same); In re Egan, 142 B.R. 370 (Bankr.E.D. Pa. 1992).
- d. **Under BAPCPA:**
 - 1. **BAPCPA adds §1129(a)(15), which requires, as a condition of confirmation, that:**

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.

2. However, §1129(b)(2)(B)(ii) modifies the absolute priority rule to provide that an individual Chapter 11 debtor may cramdown dissenting unsecured creditors even though he or she retains post-petition earnings and property now included in the estate under §1115.
 - a. BAPCPA does not, on its face, resolve the issue of whether an individual Chapter 11 debtor may retain exempt property while cramming down unsecured creditors.
 - b. Does the new language in §1129(b)(2)(B)(ii) create a negative inference that “§1115 property” is the only property that a debtor may retain in a cramdown, i.e., that prepetition exempt property may not be retained?

F. Discharge

1. Debts excepted from discharge under § 523 are not discharged under § 1141. *See* § 1141(d)(2). BAPCA does not change this.
2. When does discharge occur?
 - a. Pre-BAPCPA: Discharge occurred upon confirmation. *See* §1141(d)(1). This is still the law today except for individual Chapter 11 debtors.
 - b. **UNDER BAPCPA:**

1. New §1141(d)(5)(A) postpones discharge in an individual Chapter 11 case until “completion of all payments under the plan.” However, the court can grant the discharge earlier if (A) unsecured creditors have received as much as they would have under Chapter 7; (B) modification of the plan is not practicable; and (C) the court finds that there is no reasonable cause to believe that §522(q)(1) does, or may, apply to the debtor. *See* §1141(d)(5)(B).

A. §522(q) is new under BAPCPA. It is the companion to new §522(p), which establishes a uniform federal exemption cap of \$125,000 for homestead property acquired within 1215 days of bankruptcy. §522(q)(1) applies this new cap to all such property, no matter when acquired, if the debtor has been convicted of a felony, or owes debts arising from federal securities law violations, RICO violations, or intentional or criminal conduct that caused serious physical injury or death to another individual in the preceding five years.

2. Cf. §1328(b), which allows a similar “hardship discharge” under Chapter 13, with the additional requirement that the debtor’s failure to make plan payments arise from “circumstances for which the debtor should not justly be held accountable.”

G. Post-Confirmation Plan Modification

1. Pre-BAPCPA, the debtor could modify a confirmed plan at any time after confirmation and before substantial consummation. *See* §1127(a). This is still the law today except for individual Chapter 11 debtors.
2. **UNDER BAPCPA:** For individual Chapter 11 debtors, BAPCPA adds §1127(e), which is similar to §1329(a) and allows modification, whether or not the plan has been substantially consummated. Modification may be requested by either the debtor, the trustee, the U.S. trustee, or the holder of an allowed secured claim, for the purpose of increasing or reducing the payment amount or payment period on a claim, or to “alter the amount of a distribution to a creditor whose claim is provided for by the plan to the extent

necessary to take account of any payment of such claims made other than under the plan.” *See* Proposed Interim Rule 3019(b) for modification procedures under this section.