Individual Chapter 11 Bankruptcies in Minnesota after BAPCPA: Uncharted Territory[1]

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I. Introduction

BAPCPA made significant changes to individual chapter 11 cases, many of which import concepts and rules from chapter 13. The result has been described as a hybrid of the pre-BAPCPA chapter 11 and 13, but many of the provisions of chapter 13 do not appear to fit comfortably within chapter 11.

This outline the principal BAPCPA amendments affecting individual chapter 11 cases, analyze a few potential pitfalls, and provide some analysis and references to other resources that will hopefully assist both debtors and creditors in navigating BAPCPA's changes.

II. Statistics

How common is an Individual Chapter 11? Of the 14,191 Chapter 11s filed in fiscal 2009, only 1912 13.5% were "non-business" Chapter 11s which counts all the individual chapter 11s where the debts are consumer debts – the government doesn't count the individual chapter 11s that were designated "business" bankruptcies. One commentator estimated that up to 35% of all chapter 11 bankruptcies are filed by individuals. Ed Flynn, *Bankruptcy by the numbers: Who Is Filing Chapter 11?* Am. Bankr. Inst. L.J. 30 (1999). Another way to look at is that no matter how many have been filed in the past, the number is growing every year, quadrupling in size from Fiscal 2007, the first year of BAPCPA (bankruptcy filings as a whole have only doubled since then). Fully 21% of those individual "non-business" chapter 11s are in three counties, Maricopa county Arizona, los Angeles county California and Clark county Nevada.

III. Alternatives to Individual Chapter 11s:

A client who has more than the Chapter 13 limit and who might flunk the means test is going to be forced into a Chapter 11, however, you need to make sure that that individual can't get around the means test if the majority of their debt is business debt – in that case, they'll qualify for a Chapter 7 despite a high income – a Chapter 7 has many advantages over an Individual Chapter 11!

Another option is staying out of bankruptcy all together. This may be more beneficial – if a multi-million dollar house is owned by a couple in joint tenancy, and only one of the spouses has the debt that is dragging them into bankruptcy, under Minnesota law, no matter what the equity, a judgment creditor can't sell the house out from under the wife to satisfy the debt (Kipp v. Sweno). In a bankruptcy, that protection goes away.

IV. Overview of Changes in the Law Under BAPCPA

- Under the revised 11 U.S.C. § 1115, an individual debtor's estate includes earnings and property acquired after filing – this provision is very similar to §1306.
- Under the new version of 11 U.S.C. § 1123(a)(8), an individual debtor's plan must provide for the distribution of postpetition earnings (and other future income) to creditors as necessary for execution of the plan – this provision now resembles §1322(a)(1).
- Under the revised 11 U.S.C. § 1127(e), an individual debtor's confirmed plan may be modified to alter the amount or duration of payments to certain creditors – even after substantial consummation of such plan.
- Under the revised 11 U.S.C. § 1129(a)(15), an individual debtor's plan cannot be confirmed over the objection of an unsecured creditor unless the plan either: (i) provides for payment of the allowed amount of the objecting creditor's claim, or (ii) the value of the property to be distributed under the plan is not less than the projected disposable income of the debtor for at least five years following the first payment date (importing the disposable income test from §1325(b)).
- The new version of 11 U.S.C. § 1129(b)(2)(B) modifies cramdown rules for individual debtors. Specifically, it allows an individual debtor to retain property included in his/her bankruptcy estate under 11 U.S.C. § 1115
- Under the new version of 11 U.S.C. § 1141(d), discharge for an individual chapter 11 debtor is delayed until the payments under his/her plan have been completed (much like the requirement in §1328(a)).
    - This delay of discharge remains subject to the court's discretion, however. 11 U.S.C. § 1141(d)(5) (similar to the hardship discharge provided for under §1328(b)). For a thorough discussion of this issue, *see* Walter W. Theus, Jr., *Individual Chapter 11s: Case Closing Reconsidered*, Am Bankr. Inst. J. 1 (February 29, 2010).
- Finally, BAPCPA added 11 U.S.C. § 1127(e), which allows for plan modification even after substantial consummation (for purposes similar to § 1329(a)).

V. Unanswered Questions

BAPCPA changes relating to individual chapter 11 cases were intended to create "super-sized" chapter 13s. It appears, however, that some of the concepts underlying these two chapters of the Code may be at odds.

A. The Debtor's Payment of Attorneys' Fees

- Work for the Debtor in Possession versus work for the Debtor

- *Lamie v. U.S. Trustee*, 540 U.S. 526 (2004).
- Inapplicability of 11 U.S.C. § 330(a)(4)(B).
- Retainers.
- New Rule 1.5 of the Minnesota Rules of Professional Responsibility.
- Application for Court Order Allowing Representation.

Under 11 U.S.C. § 1115 involving Chapter 11s for individuals; all of their post-petition income comes into the estate. This is similar to 11 U.S.C. § 1306 for Chapter 13 cases. In individual Chapter 11 case where the attorney has been appointed to represent the estate, there is no problem with getting attorney's fees for work for proposing a plan, bringing motions for the use of cash collateral and the like.[2] However, the few courts that have ruled on the issue are unified in their opposition to paying the debtor's lawyer for work done for the debtor him/herself, for things such as responding to dischargeability actions. 11 U.S.C. § 330(a)(4) says:

> **(A)** Except as provided in subparagraph (B), the court shall not allow compensation for—
>
> **(i)** unnecessary duplication of services; or
>
> (ii) services that were not—
>
> (I) reasonably likely to benefit the debtor's estate; or
>
> (II) necessary to the administration of the case.
>
> **(B)** <u>In a chapter 12 or chapter 13 case in which the debtor is an individual, the court may allow reasonable compensation to the debtor's attorney for representing the interests of the debtor in connection with the bankruptcy case based on a consideration of the benefit and necessity of such services to the debtor and the other factors set forth in this section.</u>

Section 330(b)(4)(B) is the section of the bankruptcy code used in *Lamie v. U.S. Trustee*, 540 U.S. 526 (2004) to deny a debtor's attorney working in a Chapter 7 case to be paid from the assets of the estate. The problem is more acute in Chapter 11 cases where all income earned, even income earned after the filing of a Chapter 11, is property of the estate (as opposed to a Chapter 7 case where it is not). Note that Chapter 12 and Chapter 13 lawyers don't have this problem. Section 330(a)(4)(B) provides an exception to the "must benefit the estate" rule for chapter 13 lawyers, where all income of the debtor similarly comes into the estate. Congress didn't see fit, when it changed the individual Chapter 11 rules under BAPCPA, to add individual Chapter 11 debtors to the exception (much less individual Chapter 7 debtors). At least one

[2] This is a bold statement and assumes appropriate approval of counsel by the court and no objection to fee applications filed for this work.

attorney has argued that this is an absurd result, *Morrison, P.C., v. U.S. Trustee*, (2010 WL 2653394 (E.D.N.Y.)), to no avail.

So, how, under the new individual Chapter 11, can an attorney get paid for work done to benefit the debtor only, as opposed to benefitting the estate?

First, there is no case law in this district and no "best practices." Cases are getting filed, presumably lawyers are getting paid and cases are getting confirmed. This state of affairs will only last until the first time a creditor or the U.S. Trustee's office complains about fees sought to be paid for a divorce or for non-estate related work. Thus, doing work for an individual chapter 11 debtor and getting paid for is a trap for the unwary. More than that, it is a trap for the wary.

Prior to the filing of the petition, it may be possible to use funds of the debtor to obtain a retainer. Careful counsel can divide the retainer into funds available for work done for the estate and work done solely for the debtor. (Example Forms attached). However, the rules concerning pre-petition retainers are tricky and getting trickier. Any unearned retainer held by an attorney at the time of the filing of the bankruptcy belongs to the estate, so you're right back where you started. In fact, you may be worse off, since if an attorney holds property that is determined to be property of the estate, he or she is under a duty as a representative of the estate (lawyer for the Debtor in Possession) to sue him or herself for the return of those funds to the estate, thus creating a conflict and making it impossible for the lawyer to be paid for ANY of the work that they do, either for the debtor or for the estate. See 3 *Collier on Bankruptcy* ¶ 327.04[2][b] (15th rev. ed. 2006).

Finally, it is currently possible to obtain a non-refundable retainer, however, as of July 1, 2011 the rules on what is considered appropriate for retainers that are deemed property of the attorney are changing (see http://www.lawlibrary.state.mn.us/archive/supct/1012/ORADM108005-1217.pdf for new rule 1.5 of the Minnesota Rules of Professional Responsibility concerning "advance payments" and "availability retainers.") Just how a bankruptcy court will interpret these new rules is unknown but it is a virtual certainty that bankruptcy trustees will challenge advance fees to find out whether the bankruptcy courts will support this new rule of professional responsibility in the bankruptcy context.

B. Use of Estate Funds in the Ordinary Course

- Is Section 363(c)(1) enough?
- Dichotomy of code's treatment of Business and Living Expenses in Chapter 13
- Dichotomy of code's treatment of living expenses pre-confirmation (non-existent) and post-confirmation
- Court Order probably a good idea, although untried in this district.

This issue of how bankruptcy Debtor's counsel is to be paid is intimately connected with issues concerning what a Chapter 11 debtor can spend, even if there are no holders of cash collateral.

The reason that there has been no immediate panic over the issue of what an individual Chapter 11 Debtor can spend is that section 363(c)(1) provides that a debtor may use property of the estate ***in the ordinary course of business*** without notice or a hearing. Although Congress made attempts to conform the provisions of an individual Chapter 11 debtor to be more like a Chapter 13, unfortunately, Congress failed to amend Section 363(c)(1) to also include ordinary course living expenses, which may be different. For example, Section 1325(b) allows a Chapter 13 debtor to spend funds for costs that are reasonably necessary for the "maintenance or support of the debtor or a dependent of the debtor" AND necessary business expenses. There is no such provision in the Chapter 11 sections. It simply can't be that Congress wouldn't allow a Debtor to pay for their groceries. See, e.g., *In re Goldstein*, 383 B.R. 496 499 (Bankr. C.D. Cal. 2007). In addition, a debtor may be able to rely on the fact that an administrative expense, that is, actual and necessary costs of persevering the estate, Section 503(b)(1) can be paid (except for professional fees) without a court order. However, that doesn't cover your daily trip to Caribou. In fact, other than the argument that an expenditure made by an individual Chapter 11 debtor post-petition is made "in the ordinary course of business" or is an administrative expense, the law provides no guidance on what can be spent during the course of the case (pre-confirmation).

All of the statutes concerning what a Chapter 11 individual debtor can spend concern expenditures AFTER the plan is confirmed (Section 1129). To avoid motions to dismiss the case by a creditor who is trying to claim that the expenses being made by a Chapter 11 debtor are either too high or not allowed, the Debtor can seek an order of the court that allows the Debtor to pay reasonable expenses. This of course tees up the issue of what expenses are allowable, and if the Debtor is seeking to spend whatever they can get away with to maintain their previous lifestyle, that may be a tough sell for Debtor's counsel. However, this is an issue that is going to be faced sooner or later upon confirmation anyway, and if a Debtor is only allowed certain expenses under their plan that are significantly less than they have spent during the case up to that date, they may face a Section 549 motion by the US Trustee if those expenses have not be pre-approved by the Court. This is also a method of again attempting to allow the debtor funds to pay its bankruptcy attorney or divorce attorney. The issue of payment of non-estate counsel and approval of living expenses can be brought in one motion, the form of which has been successfully used in other districts, however, not yet in Minnesota.

Equally important is that over median income individuals under a chapter 13 are subject to the means test spending limits, whereby all disposable income in excess of those expenses is the be paid into a Chapter 13 plan (section 1325(b)(3).) However, there is no means test for expenses in individual Chapter 11 cases (only 1325(b)(2) (the test for calculating disposable income under the means test neutered by the *Lanning* decision) are imported into individual chapter 11 cases, not 1325(b)3) (expense limits that guide how much of the disposable income must be committed to a Chapter 13 plan). Therefore, the question is, what is the amount that an individual Chapter 11 debtor can spend after plan confirmation? Notice that this is a continuation of the issue noted above, that there is no section in the Bankruptcy Code that provides what a debtor can spend prior to confirmation. This lapse in the code concerns what a debtor can spend after confirmation.

Note that 1129(a)(15) only forces you to pay in all of your disposable income into your plan for five years if an unsecured creditor objects. SIGNIFICANTLY, many times unsecured creditors can't be bothered to pay attention to what is happening in a Chapter 11 case – the guardian of the

rights of the Chapter 11 unsecured creditors in those cases, the US Trustee, is NOT empowered to object to the debtor's plan merely because it provides for less than 5 years worth of payments or because it provides 90% of disposable income rather than 100% over 5 years. However the US trustee can always argue that a plan is not proposed in good faith which is another confirmation hurdle under Section 1129.

C. Does the Absolute Priority Rule Apply in Individual Chapter 11 Cases?

- Interplay Between 11 U.S.C. §§ 1115, 541, 1129(b)(2)(B)(II), 1123(a)(8), and 1129(a)(15).

- Absolute Priority Rule Does NOT Apply

  - *In re Shat*, 424 B.R. 854 (Bankr. D. Nev. 2010)
  - *In re Bullard*, 358 B.R. 541 (Bankr. D. Conn. 2007)
  - *In re Tegeder*, 369 B.R. 477 (Bankr. D. Neb. 2007)
  - *In re Roedemeier*, 374 B.R. 264 (Bankr. D. Kan. 2007)

- Absolute Priority Rule DOES Apply

  - *In re Gbadebo*, 431 B.R. 222 (Bankr. N.D.Cal. 2010)
  - *In re Gelin*, 437 B.R. 435 (Bankr. M.D. Fla. 2010)
  - *In re Mullins*, 435 B.R. 352 (Bankr. W.D.Va. 2010)

D. Does BAPCPA Create a Windfall for Wealthy Debtors?

- Many individual debtors possess substantial assets or significant sources of income. Despite BAPCPA's changes, many contend that the Code still does not provide a comprehensive solution to potential abuses.

- A debtor is not required to show regular income to file an individual chapter 11 case.

- A chapter 11 filing creates a new estate that can be taxed as a separate entity under 26 U.S.C. § 1398. This may create an advantage for debtors with capital gains upon the sale of a large asset (since tax liability would be paid by the estate).

- Even assuming that a court chooses to apply the absolute priority rule in an individual chapter 11 case, under the exception to the absolute priority rule applying only to individual, chapter 11 debtors, a debtor may retain substantial property even if creditors (and perhaps even senior creditors) do not receive full payment.

- Under 1129(a)(15) all individual Chapter 11 debtors are subject to running their income through the means test to determine the "disposable income" available to pay creditors using a formula that looks at the previous 6 month's income. For Chapter 11 debtors this is a meaningless provision. Under the US

Supreme Court's June 2010 decision, *Hamilton v. Lanning*, 560 U.S. ___, 130 S.Ct. 487 (2010), the Court decided that under Section 1325(b)(2) (and, by implication under an individual Chapter 11 under section 1129(b)) that the actual disposable income for the future, if different from the pre-filing income, should be used instead. Therefore, the Means test on the income side is pretty meaningless (in above-median Chapter 13 debtor cases as well as all individual debtor Chapter 11 cases).

E. Constitutional Issues

- Questions exist regarding the constitutionality of BAPCPA reforms
  - Do the reforms violate the 13th Amendment prohibition on involuntary servitude? Individual Ch 11 cases may be filed involuntarily, and sections 1115 (including postpetition earnings as property of the Chapter 11 estate) and 1129(a)(15) (requiring an objecting creditor(s) to receive value at least equal to the debtor's projected disposable income for the five years following confirmation) may impose an unconstitutional obligation on a debtor to work for his or her creditors.
  - In addition, due to means testing under Chapter 7 and the possible unavailability of Chapter 13, an individual Chapter 11 debtor may have no choice (short of avoiding bankruptcy altogether) but to work for creditors under the terms of a Chapter 11 plan.
  - Other involuntary aspects of Chapter 11 contribute to the constitutional argument: As noted, creditors can seek to modify a substantially consummated plan without the debtor's consent under 11 U.S.C. § 1127(e), and creditors can move to convert an individual debtor's Chapter 7 case to one under Chapter 11.

F. Payment of US Trustee fees

- Individual chapter 11 cases under BAPCPA are less likely to be closed quickly after plan confirmation, and US Trustee fees must be paid until the case is closed.

- Some courts have held that individual chapter 11 cases cannot be closed until all plan payments are made. *See*, *e.g.*, *In re Ball*, 2008 WL 2223865 (Bankr. N.D. W. Va. 2008).

- Other courts have allowed individual chapter 11 debtors to close their case prior to completing plan payments to eliminate ongoing quarterly US Trustee fees (and increase creditor recoveries). *See*, *e.g.*, *In re Johnson*, 402 B.R. 851 (Bankr. N.D. Ind. 2009).

G. Potential issues with the calculation of projected disposable income

- How does the Code account for a debtor's ability (and incentive) to produce conservative estimates of his/her income?
- Can creditors prevent a savvy debtor from deferring income until after the five years following plan confirmation?
- For a detailed discussion, *see* Stephen J. Shimshak, Brian S. Hermann, and Rebecca R. Zubaty, *Bankruptcy Reforms and the High Net Worth Debtor*, 239 New York L. Journal 11 (March 3, 2008).

VI. Bibliography and Other Resources

A. Walter W. Theus, Jr., *Individual Chapter 11s: Case Closing Reconsidered*, Am Bankr. Inst. J. 1 (February 29, 2010).

B. Stephen J. Shimshak, Brian S. Hermann, and Rebecca R. Zubaty, *Bankruptcy Reforms and the High Net Worth Debtor*, 239 New York L. Journal 11 (March 3, 2008).

C. William L. Norton, III, Hon. Dennis R. Dow, and J. Michael Morris, *Post-BAPCPA Issues for Attorneys Representing Individual Chapter 11 Debtors*, 100110 ABI-CLE 89 (October 1, 2010).

D. Bruce A. Markell, The Sub Rosa Subchapter: Individual Debtors in Chapter 11 after BAPCPA, 2007 U. Ill. L. Rev. 67 (Spring 2007).

Hypotheticals and Miscellaneous Notes:

You've built up a pretty good consumer Chapter 13 caseload over the last few years but have never filed a Chapter 11. One day, in walks a client into your office with over $360,475 in unsecured debt or over $1,081,400 in secured debt. You've heard that a Chapter 11 is kind of a giant Chapter 13. So, should you go ahead and file an individual Chapter 11 as your first ever Chapter 11 filing?

No, because all of the rules concerning Chapter 11s are still in place – there are still concerns over adequate protection payments for secured lenders, cash collateral rights for those creditors who have an interest in the cash of the debtor (in the context of individual chapter 11s the most likely cash collateral holder will be taxing authorities who have filed tax liens) rules concerning use of assets out of the ordinary course of business (do you need court permission to buy a new car that you are going to finance?), United States Trustees reports, perhaps a creditor's committee (God forbid!), and on and on. Especially since the law on individual Chapter 11s is so undeveloped, it would be very, very difficult to try to learn Chapter 11 law on the fly as well as the special rules concerning how individual Chapter 11 cases differ from a corporate Chapter 11.

Individual Chapter 11 debtor is in bankruptcy, all he has in assets is $1000 in his checking account on the effective date of his plan (that is generally 7 to 30 days after confirmation), all of which he earned in the past 20 days, and he takes Minnesota exemptions – how much of that money must be used in any formula in a Chapter 11 to determine how much to pay his creditors? (1129(a)(7) – debtor has to pay amount equal to what the creditors could have gotten if he filed Chapter 7 on the effective date – so the creditors could force that chapter 11 creditor to pay $750 of that money into his chapter 11 plan.

Second part of hypothetical: What is the homestead limit in Minnesota, as asserted by the Minnesota Department of Commerce ($360.000, for urban homesteads).

If an individual Chapter 11 Debtor files bankruptcy with $360,000 in equity in his homestead on the effective date and his home has $560,000 in equity in his homestead as of day 1825 (the last day of his 5 year plan) – can the creditors seek to modify the plan have that additional $200,000 in equity paid out to his creditors?

No. Why not? 1129(a)(7) doesn't apply here and any appreciation on exempt assets should be allowed to be kept by the debtor so long as other hoops are jumped through as to the payment of disposable income. *Cf. In re Berger*, 61 F.3d 624 (8th Cir.1995) (Sale of an asset in bankruptcy purchased with non-exempt income is not "income" for purposes of determining amount of funds to be paid in a Chapter 12 plan, note, however, that the 8th Circuit seemed ready in a subsequent decision to change this ruling. (*Koch*).

Third part of hypothetical: Since 1129(a)(7) doesn't seem to apply to increases in exempt property after the effective date of the plan, is exempt property included in "disposable income?" Shouldn't the Debtor be allowed to exempt out 75% of his wages from payment of his creditors? Otherwise, what good are Minnesota income exemptions? No, at least where a bankruptcy is voluntary the bankruptcy code provides that you have to contribute your income to the plan no matter what that income consists of – social security benefits, workers compensation benefits, or exempt portions of your paycheck – no one is forcing you to file a chapter 13.) *In re Koch* 109 F.3d 1285 (8th Cir. 1997). What about in the case of an involuntary Chapter 11?

Ed: This argument about the **absolute priority rule**, it only really deals with non-exempt property, correct? If property is exempted out of the estate in the first place, it doesn't even get into the discussion of whether the Debtor can keep "property of the estate" under 1129(B)(2)(b)(2) - which shouldn't? include property that has already been taken out of the estate, right? (NO, THIS IS NOT RIGHT, ESTATE PROPERTY INCLUDES EXEMPT PROPERTY) so if you can't keep "property of the estate" until you pay your creditors in full, that means that if your disposable income for 5 years doesn't pay unsecured creditors in full, and you don't get the votes to approve the plan, you have to liquidate any asset you own that is property of the estate, including EXEMPT Property!) to pay your creditors in full – THAT'S A FINE HOW DO YOU DO, MUCH WORSE THAN CHAPTER 7 OR CHAPTER 13.

Just what is the statutory basis for the Absolute Priority rule (1129(B)(2)(b)(2) – A plan can only be confirmed if a holder of a claim that is "junior" to the claims of the creditors doesn't keep any property if they don't consent – how is keeping property that your allowed to keep under the

bankruptcy code a “junior” claim? Those creditors couldn’t get at that property outside of bankruptcy? (In re Henderson, 341 B.R. 7__, 788 (M.D. Fl. 2005).

Early closing of cases: Walter W. Theos, Jr. of the Executive Office of the UST announced that the USTs would not oppose a request to close a case after full administration (ABI Journal, Feb. 2010 Issue).

Lien Stipping

In Minnesota, bankruptcy courts have held that under the U.S. Supreme Court’s ruling in *Nobelman v. American Savings Bank, 508 U.S.* 324 (1993), a wholly unsecured mortgage may not be stripped. *See In re Wangstad*, No. 09-40451 (Bky. D. Minn. October 26, 2009); *In re Hussmann*, 133 B.R. 490 (Bky. D. Minn. 1991); *In re Hughes*, 402 B.R. 325 (Bky. D. Minn. 2009); *In re Mattson*, 210 B.R. 157 (Bky. D. Minn. 1997).

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