

Individual Chapter 11 Bankruptcies: Powerful Tools and a Few Pitfalls

by Dean A. Langdon

We think of chapter 11 as a tool companies use to reorganize their business, restructure their debt and exit bankruptcy hoping for a return to profitability, but chapter 11 is also available to individuals. Chapter 11 should be considered when economic distress brings individuals to your door. This article presumes a general familiarity with bankruptcy law, and is not intended as guidance on how to prepare and practice a chapter 11 case. The goal is to give those with basic chapter 11 knowledge insight into the benefits and risks of chapter 11 for individuals. Individuals normally reorganize under chapter 13 of the Bankruptcy Code; however chapter 13 has debt limits. Only individuals with less than \$360,475 of unsecured debt and \$1,081,400 in secured debt are eligible to file a chapter 13 case.¹ These limits apply to “noncontingent, liquidated” debts and the amounts are adjusted every three years. The first step in evaluating chapter 11 versus chapter 13 is totaling your client’s secured and unsecured debts, then evaluating their contingent or unliquidated status. Individuals who guarantee the primary debts of closely held businesses often exceed the unsecured debt limit in chapter 13. If so, chapter 11 may be the best option for your client.

Individuals must complete pre-filing credit counseling before filing chapter 11² and Official Form B-22B, a version of the means test, which sheds light on their current monthly income. The chap-

ter 11 version of the means test does not address expenses, but may factor into calculating the debtor’s projected disposable income – a confirmation issue.³ Individuals also face increased costs in a chapter 11. Legal fees routinely exceed those allowed in chapter 13 cases and the filing fee is \$1,039 versus \$274 for a chapter 13 case.

Issues arising prior to plan confirmation

A preliminary issue is whether an individual is a “small business debtor.” A small business debtor has less than \$2,343,300 in noncontingent, liquidated debt and either no committee of unsecured creditors is appointed or the court determines the committee is not active enough to oversee the debtor.⁴ Individual chapter 11 cases rarely have large legal budgets, so avoiding the costs associated with a committee can lower administrative expenses. A small business debtor must file its most recent balance sheet, statement of operations, cash-flow statement and federal income tax return, and allow the United States trustee to inspect the debtor’s records and premises.⁵ This provision seems to be a trade-off for the lack of committee oversight, and provides additional information about the debtor’s finances to all creditors.

A small business debtor may use standard forms to create a plan and disclosure statement.⁶ A debtor may dispense with a disclosure statement if the court determines the plan has adequate information or the disclosure statement may be conditionally

approved to solicit votes and resolve disclosure issues at the confirmation hearing.⁷ A small business debtor has the exclusive right to file a plan for 180 days (rather than 120) after the order for relief, but must file a plan within 300 days.⁸ Once a plan is filed it must be confirmed within 45 days.⁹ To extend the time periods for filing or confirming a plan, the debtor must show confirmation is likely, a new deadline must be set, and the order must be entered before the existing deadline runs.¹⁰ The 45-day deadline is absolute and you risk dismissal if confirmation is not timely.¹¹ If an individual is willing to make the additional financial disclosures, the extra two months of exclusivity plus the ability to combine a plan and disclosure statement for consideration at one hearing saves time and money.

Individuals must also disclose information on closely-held companies. If an individual holds a “substantial or controlling interest” in a company (20% or greater), a report of the “value, operations and profitability” of each entity must be filed at least seven days prior to the meeting of creditors, and at least every six months thereafter until the effective date of a plan, conversion or dismissal.¹² This requirement may be modified, but you must notify each affected entity and its interest holders, who may seek a protective order.¹³ However, such a request does not alter or stay the requirement to file the report.¹⁴ Depending on how your client has structured their business(es), the report could be minimal or an intrusive financial disclosure. Ongoing business relations and operations could be impacted by these financial disclosures. If your client owns or controls numerous businesses, assessing the business records and the ability to comply with Bankruptcy Rule 2015.3 must be done before a case is filed.

An individual debtor must file a budget of ongoing living expenses, including potential adequate protection payments, because all of an individual debtor’s postpetition earnings are property of their bankruptcy estate.¹⁵ The budget impacts issues such as the length

of a plan and the absolute priority rule, which are addressed below. Counsel must analyze a debtor's income and expenses and think ahead to creating and obtaining confirmation of a plan. The budget is important because an individual debtor's plan cannot be confirmed over objections unless it proposes to pay five years of "projected disposable income" to creditors.¹⁶ Projected disposable income is derived (but not defined) from a chapter 13 provision,¹⁷ which in turn relies upon a newly defined term: "current monthly income."¹⁸ Current monthly income is the amount reflected by the means test (Official Form B-22B), and disposable income is the amount left after deducting the costs of "maintenance and support" of the debtor and his or her family, certain charitable contributions and the necessary costs of operating an ongoing business.¹⁹

The definitions of current monthly income and disposable income make calculation of a debtor's projected income concrete, and this amount should be available to fund a plan. An individual debtor may not be able to control income, but expenses are a different matter. Expenses may be established under the means test in chapter 13, but not in chapter 11.²⁰ The court evaluates each case individually and determines what expenses are reasonable. In general, judicial discretion leads to a better result than the inflexible expense amounts of the means test. For example, a court ruled that a chapter 11 debtor's expenses associated with the support and medical care for a partner of 20 years were reasonable in calculating projected disposable income, although the cost of caring for 15 dogs was not.²¹ From a practice standpoint, consider how preparing the initial budget will impact "projected disposable income," and how projected disposable income will affect plan confirmation.

Another issue which may affect the plan is the treatment of nonresidential real property leases. The deadline to assume a nonresidential real property lease is initially 120 days in both chapter 11 and chapter 13.²² Because chapter 13 debtors have only 14 days after the

order for relief to file a plan, confirmation will usually occur before the assumption deadline.²³ Individual chapter 11 debtors have 120 days to file a plan, which may be extended,²⁴ so a chapter 11 debtor may not have filed a plan before the assumption deadline runs. The maximum extension for assumption is 210 days in the absence of consent from the other contractual party.²⁵ If your client relies on one or more nonresidential real property leases for income or operation of a business, docket this deadline and the need to extend it or have a plan filed and confirmed before it runs.

Plan drafting and confirmation

There are multiple requirements for creating and confirming a chapter 11 plan,²⁶ but this section focuses only on individual chapter 11 plan issues.

Individual debtors may have domestic support obligations. Prepetition domestic support obligations are priority claims and must be paid in full as of the effective date of the plan unless the

creditor agrees otherwise or the class of creditors accepts the plan.²⁷ Accordingly, if a large prepetition domestic support obligation exists, the ability to fully satisfy it upon plan confirmation must be addressed. Domestic support obligations usually continue postpetition. For a plan to be confirmed, a debtor must be current on all postpetition domestic support obligations.²⁸ In comparison, chapter 13 debtors must be current on postpetition domestic support obligations to confirm a plan,²⁹ but prepetition obligations can be paid in deferred payments over the life of the plan without the creditor's consent.³⁰

Tax debts regularly appear in reorganization cases and some are afforded priority status.³¹ Unlike domestic support obligations, priority taxes may be paid in regular installment payments, as long as they are paid within five years of the filing date (not the plan effective date).³² "Regular" installment payments are distinct from "equal" installment payments, so a chapter 11 plan may provide for step or balloon payments on



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priority tax debts.³³ Being current on postpetition taxes is not required for confirmation of a chapter 11 plan, but failure to pay postpetition taxes or domestic support obligations is grounds for dismissal or conversion of a chapter 11.³⁴ If your client has struggled with taxes or domestic support obligations in the past, changing that behavior is crucial to a successful case.

A major benefit of chapter 13 before the 2005 passage of the Bankruptcy Abuse Prevention and Consumer Protection Act (“BAPCPA”) was the ability to cramdown secured debts on property other than a residence. The “hanging paragraph” added to Section 1325(a)(9) now limits the ability to cramdown purchase money secured debts for vehicles and personal property. No similar limitation exists for chapter 11 plans and cramdown is specifically allowed if certain conditions are met.³⁵ However, a BAPCPA amendment to chapter 11 added a prohibition against modifying a claim secured only by a debtor’s residence.³⁶ For individuals with a tight budget and substantial secured debt a partial plan payment could be generated by cramming down secured claims.

As in chapter 13, an individual chapter 11 debtor must commit all of their “projected disposable income” to payments under a plan for the longer of five years or the length of the plan.³⁷ This requirement is triggered by an objection from an unsecured creditor, and the five year period runs from the first payment under the plan.³⁸ Unlike chapter 13, the projected disposable income of an individual chapter 11 debtor is not devoted only to unsecured debts, but to all creditors paid under a plan.³⁹ When calculating projected disposable income, remember that expenses are not dictated by the means test in chapter 11 cases. The Supreme Court has made it clear that judicial discretion may also be a factor in chapter 13 cases when determining projected disposable income.⁴⁰

The most active issue in individual chapter 11 cases is the interplay between a new definition of property of the estate and the absolute priority rule. Prior to BAPCPA, property of the estate was determined as of the petition date.⁴¹ That remains true for companies filing chap-

ter 11, but BAPCPA added a provision defining property of the estate for individual debtors. Section 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.

This language is virtually identical to the definition of estate property in chapter 13.⁴² While including postpetition earnings in an individual debtor’s estate fulfills BAPCPA’s goal to repay creditors to the fullest extent possible, Section 1115 has caused confusion in light of another well-established requirement of chapter 11 cases: the absolute priority rule.

The absolute priority rule applies when a debtor attempts to cramdown a plan on a class of impaired creditors which votes against confirmation. In essence, the rule requires that a junior class of creditors or interest holders may not receive or retain anything under a plan until the senior creditors or interest holders are fully paid or satisfied.⁴³ The consequence for a company is that equity holders may not retain any interest in the company unless unsecured creditors are paid in full (or have accepted the plan). The consequence for an individual is that the debtor may not retain any property unless unsecured creditors are satisfied.⁴⁴

Through BAPCPA, Congress modified the absolute priority rule, as follows:

...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.⁴⁵ (emphasis added).

Courts interpreting this clause have focused on the meaning of the phrase “included in the estate under section 1115” and two lines of authority have developed. A straightforward explanation of the ambiguity of this clause comes from bankruptcy judge Bruce A. Markell:

If “included” means only property which is added by Section 1115, then Section 1129(b)(2)(B)(ii) has a very narrow meaning: it refers only to postpetition income from services – and not to property originally specified in Section 541. Section 1115, however, itself includes Section 541(a) property. Thus, “included” could refer to all property Section 1115 itself references, and this would then be a reference to the superset of Section 541(a) property *and* the debtor’s postpetition service income. Put another way, if Section 1115 entirely supplants Section 541 by specifically incorporating it and adding to it, the “included” has a very broad meaning, essentially exempting individuals from the absolute priority rule as to unsecured creditors.⁴⁶

Under a broad reading of the new clause in Section 1129(b)(2)(B)(ii), a debtor may keep not only postpetition earnings but prepetition property of the estate without paying unsecured creditors in full, effectively eliminating the absolute priority rule for individuals. However, this doesn’t mean individual debtors get a “head start.” They must still fund the plan from future earnings or income⁴⁷ and, upon objection, contribute at least five years of projected disposable income.⁴⁸ After analyzing legislative history, chapter 13 parallels, existing case law⁴⁹ and the “general rehabilitative aim of chapter 11,” Judge Markell held that the absolute priority rule had been abolished for individual debtors.⁵⁰

The competing line of cases gives a

narrow interpretation to the new language in Section 1129(b)(2)(B)(ii) and holds that only postpetition earnings are excluded from an individual's estate.⁵¹ This line of cases reasons that the subject language is not ambiguous, that eliminating the absolute priority rule for individual debtors moots the voting rights of unsecured creditors, and that BAPCPA's intent was not to enhance the fresh start for individual debtors.⁵² Subsequent decisions address whether exempt property must be devoted to satisfaction of the absolute priority rule. At least one recent case holds exempt property does not constitute property of the estate.⁵³ This issue continues to develop,⁵⁴ and practitioners should be familiar with any local rulings on the issue. As of the submission date of this article, the author was unable to locate any opinions from any Kentucky bankruptcy court addressing the absolute priority issue for individual debtors.

Post-confirmation issues

Another BAPCPA change delays entry of a discharge for an individual. Previously, a discharge was granted upon confirmation of a plan.⁵⁵ BAPCPA added language providing that "unless the court orders otherwise," no discharge will be granted to an individual until all plan payments have been completed.⁵⁶ At least one debtor has obtained a discharge before completing all plan payments where he included such provisions in the disclosure statement and notice of confirmation hearing, was a practicing attorney, and secured payments to unsecured creditors with a second mortgage against his residence.⁵⁷ Another debtor failed to obtain an early discharge despite giving unsecured creditors a note secured by a Florida condominium and the court's acknowledgment that the plan had been substantially consummated.⁵⁸ To obtain a discharge for your client before all plan payments are completed, start with a provision in your disclosure statement and plan. Also, Section 1141(d)(5)(B) allows entry of a hardship discharge for individual debtors who satisfy the liquidation test and cannot practicably modify their plan.

A related issue is closing a chapter 11 case. Chapter 11 debtors must pay quar-

terly fees to the Office of the United States Trustee, based on the dollar amount of disbursements made.⁵⁹

Delaying a discharge for individuals means cases remain open for five years or longer and United States Trustee fees continue to accrue. Some courts allow a case to be closed after confirmation then reopened for entry of a discharge after plan payments are completed.⁶⁰ Others refuse to allow an individual to close their case pending completion of plan payments, finding it burdens a creditor's right to seek modification of a plan after confirmation.⁶¹ The bankruptcy court for the Western District of Kentucky has adopted a specific rule and forms requiring individual chapter 11 debtors to request a final decree within 60 days after confirmation and to reopen the case to enter a discharge after plan payments are completed.⁶²

Before BAPCPA, once a chapter 11 plan was substantially consummated it could not be modified.⁶³ This remains true for companies under chapter 11, but a new Section 1127(e) allows individual debtors, the United States Trustee or an unsecured creditor to seek modification of a confirmed plan any time before completion of plan payments. Modifications must comply with the requirements for confirmation of a chapter 11 plan, and a revised disclosure

statement and an additional confirmation hearing may be required.⁶⁴

Conclusion

Chapter 11 offers powerful and flexible relief to individual debtors, although not quite as powerful as it used to be. The combination of the streamlined small business debtor procedures and the addition of chapter 13-like provisions for individual chapter 11 debtors can make it economically feasible for individuals to file chapter 11. Watch for the deadlines and additional requirements not present in chapter 13 cases and consider co-counseling the first time you file an individual chapter 11 if you are not familiar with chapter 11 practice. Most importantly, if your client is not eligible for chapter 13 relief, don't assume their only option is chapter 7, but evaluate whether chapter 11 fits the bill. ☺

ENDNOTES

1. 11 U.S.C. § 109 (e).
2. 11 U.S.C. § 109(h).
3. 11 U.S.C. § 1129(a)(15)(B).
4. 11 U.S.C. § 101(51D).
5. 11 U.S.C. § 1116(1), (7).
6. Official Forms B25A, B25B.
7. 11 U.S.C. § 1125(f).
8. 11 U.S.C. § 1121(e)(1),(2).
9. 11 U.S.C. § 1129(e).



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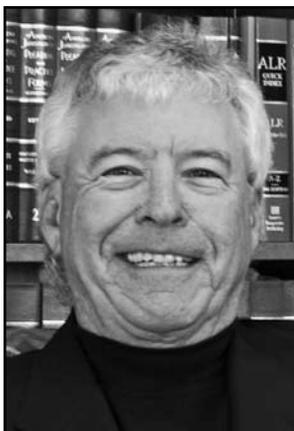
10. 11 U.S.C. § 1121(e)(3).
11. *In re Roots Rents, Inc.*, 420 BR 28 (Bankr. D. Idaho 2009).
12. Rule 2015.3, Federal Rules of Bankruptcy Procedure; Official Form B26.
13. Rule 2015.3(d), (e).
14. Rule 2015.3(f).
15. 11 U.S.C. § 1115(a)(2).
16. 11 U.S.C. § 1129(a)(15)(B).
17. 11 U.S.C. § 1325(b)(2).
18. 11 U.S.C. § 101(10A).
19. 11 U.S.C. § 1325(b)(2)(A).
20. 11 U.S.C. § 1129(a)(15)(B) makes no reference to 11 U.S.C. § 1325(b)(3). See, *In re Roedemeier*, 374 BR 264 (Bankr. D. Kan. 2007).
21. *In re Gray*, 2009 WL 2475017 (Bankr. N.D. W.Va. 2009).
22. 11 U.S.C. § 365(d)(2), (4).
23. 11 U.S.C. § 365(d)(4).
24. Compare Bankruptcy Rule 3015(b) with 11 U.S.C. § 1121(c), (d).
25. 11 U.S.C. § 365(d)(4)(B).
26. See, 11 U.S.C. §§ 1121-1129.
27. 11 U.S.C. § 1129(a)(9)(B).
28. 11 U.S.C. § 1129(14).
29. 11 U.S.C. § 1325(a)(8).
30. 11 U.S.C. 1322(a)(2).
31. 11 U.S.C. § 507(a)(8).
32. 11 U.S.C. § 1129(a)(9)(C).
33. *In re F.G. Metals, Inc.*, 390 BR 467 (Bankr. M.D. Fla. 2008).
34. 11 U.S.C. § 1112(b)(4)(I), (P).
35. 11 U.S.C. §§ 1123(b)(5), 1129(b)(2)(A)(i)(II).
36. 11 U.S.C. § 1123(b)(5).
37. 11 U.S.C. § 1129(a)(15).
38. 11 U.S.C. § 1129(a)(15)(B).
39. Compare 11 U.S.C. § 1129(a)(15)(B) – “value of property distributed under the plan not less than the projected disposable income” – with 11 U.S.C. § 1325(b)(1)(B) – “projected disposable income...applied to make payments to unsecured creditors...”
40. *Hamilton v. Lanning*, 130 S.Ct. 2464; 560 U.S. ____; 177 L.Ed.2d 23 (2010).
41. 11 U.S.C. § 541.
42. 11 U.S.C. § 1306.
43. 11 U.S.C. §§ 1129(b)(2)(B)(ii), 1129(b)(2)(C)(ii).
44. *In re Gosman*, 282 BR 45 (Bankr. S.D. Fla. 2002)(Debtor not allowed to exempt or retain Palm Beach mansion worth \$40,000,000; real property worth \$7,500,000 or artwork worth \$11,000,000 without paying unsecured creditors in full).
45. 11 U.S.C. § 1129(b)(2)(B)(ii). The reference to subsection (a)(14) will not be addressed in this article.
46. *In re Shat*, 424 BR 854 (Bankr. D. Nevada 2010).
47. 11 U.S.C. § 1123(a)(8).
48. 11 U.S.C. § 1129(a)(15)(B).
49. *In re Tegeder*, 369 BR 477 (Bankr. D. Neb. 2007); *In re Roedemeier*, 374 BR 264 (Bankr. D. Kan. 2007).
50. *In re Shat*, 424 BR 854, at 865 (Bankr. D. Nevada 2010).
51. *In re Gbadebo*, 431 BR 222 (Bankr. N.D. Calif. 2010); *In re Gelin*, 437 BR 435 (Bankr. M.D. Fla. 2010).
52. *In re Gbadebo*, 431 BR 222, at 229 (Bankr. N.D. Calif. 2010).
53. *In re Steedley*, 2010 WL 3528599 (Bankr. S.D. Ga. 2010).
54. See, for example, *In re Draiman*, 2011 WL 1486129 (Bankr. N.D. Ill. 4/19/2011), a forty-plus page opin-

- ion dealing with numerous issues applicable to individual debtors.
55. 11 U.S.C. § 1141(d)(1).
56. 11 U.S.C. § 1141(d)(5).
57. *In re Sheridan*, 391 BR 287 (Bankr. E.D. N.C. 2008).
58. *In re Ball*, 2008 WL 2223865 (Bankr. N.D. W.Va. 2008).
59. 28 U.S.C. § 1930(a)(6).
60. *Matter of Johnson*, 402 BR 851 (Bankr. N.D. Ind. 2009); *In re Necaise*, 2010 WL 3294692 (Bankr. S.D. Miss. 2010).
61. *In re Belcher*, 410 BR 206 (Bankr. W.D. Va. 2009).
62. W.D. Ky. L.B.R. 2081-1.
63. 11 U.S.C. § 1127(b).
64. 11 U.S.C. § 1127(f).



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