NO PAIN – NO GAIN
Individual Chapter 11s

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There are so many complicated issues in individual 11s for counsel and client alike. One that is constant and vexing in many ways is dealing with the personal interests of the client versus the interests of the estate, in light of counsel being employed by the estate under 11 U.S.C. §327 – that issue alone could take a good 30 minutes to address. So where does this concept of No Pain – No Gain come into play in an individual Chapter 11 case?

Principally this concept will impact on your client's pre-petition lifestyle and the choices that will need to be made for an individual Chapter 11 to be successful. The most basic element comes into play when you address the key differences between a current individual 11 and a pre BAPCPA individual 11. Before BAPCPA, in Texas for sure, all of your personal services income that accrued after filing and all lottery winnings, death benefits and other funds that may come to the debtor on the 181st day and beyond, were not subject to any type of control or overview of any significance.

Post BAPCPA, the combination of 11 U.S.C. §§ 541 and 1115 includes as property of the estate everything that is not either pre-petition exempt or its receipt or right to receipt does not make same into property of the estate under otherwise applicable law. Facially, this is just like a Chapter 13, insofar as what is included as property of the estate during the 11 pre-confirmation – [compare §1115(a)(1) and (2) with §1306(a)(1) and (2)] – they are mirrors. There is, however, a wrinkle in Chapter 13 that does not exist in Chapter 11 when addressing matters post confirmation. Section 1327(b) has a different base line position than §1115(b). In a Chapter 11 the default baseline is that "the debtor shall remain in the *possession* of all property of the estate". In a Chapter 13, §1327(b) the default base line states that "the confirmation of a plan vests all of the property of the estate in the debtor." While this distinction in language as between applicable portions of §§1306 and 1327 has caused a significant split in decisions[1]. Nonetheless, for practical comparisons, because of the quick nature of Chapter 13 practice, the Chapter 13 estate generally includes only the monies tendered to the Chapter 13 Trustee pursuant to the plan.

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[1] For an interesting discussion of what underlies the split in the Chapter 13 context see *In re Reynard* 250 B.R. 241 (Bankr. E.D. Virginia – 2000).

An individual Chapter 11 debtor, unlike a Chapter 13 debtor (which can only be an individual), does not step into a system which is designed to normalize the individual bankruptcy process and is not provided a compliance procedure monitored by the equivalent of a Standing Chapter 13 Trustee's office. Thus, while a Chapter 13 debtor has limited rights with regard to certain issues which all individual Chapter 11s must address (a Chapter 13 debtor via 11 U.S.C. § 1303 has rights under 11 U.S.C. §363(b), (non OCB sale, lease or use); §363 (d) adequate protection; §363 (f) sale free and clear requirements and §363 (l) non applicability of *ipso facto* restrictions on use/sale, etc., or trustee appointment which would cause a forfeiture – as to use or sale under 363(b)) – it is not the normal or the predominate circumstance that a Chapter 13 debtor will ever have to address these provisions. As you should know, in any Chapter 11, the DIP is not so restricted. 363(c) applies in Chapter 11 and can be asserted by any DIP to justify normal "ordinary" expenditures. Unless the source that generates the income is subject to a pre-petition lien which attaches to that stream of income, making it some secured creditor's cash collateral, there is no stated restriction on use of income from "earnings" of the Debtor or from any other asset of the Chapter 11 estate that generates income (rents, proceeds, etc.). All parties in the case, creditor and debtor alike, have to assess the sources and claims to generated income and be ready to justify either the use of same or the grounds to prevent such usage.

The only apparent governance requirement (other than having an interest in cash collateral) as to generalized usage of property of the estate in any Chapter 11 is that such usage meet ordinary course of business spending standards. When dealing with an individual Chapter 11, that means addressing the concept of what is the "ordinary course of business" and what is the "business" of an individual. Section 363(c)'s predicate is, if the business of the Debtor is "authorized to operate under §1108" (§1108 presumes a "business" can operate and utilize property of the

estate without notice of hearing). To challenge a Debtor's assertion, use §1108 as a basis for an objection to 363(c) usage of property of the estate, so that what "operating the business" truly means can be detailed and defined as narrowly as possible to prevent usage which seriously uses or depletes the estate's pre-petition asset base without any apparent benefit.

This issue is rarely faced in a Chapter 13 context. The vast majority of Chapter 13 debtors are wage earners, not sole proprietorships, as only individuals within the debt limitation can be a debtor – no entities are allowed. But when it does occur and there are business operations of sole proprietorships to address, Chapter 13 uses §1304 Debtor Engaged in Business to deal with those issues. However, since Chapter 11 is generally for any person who can file a Chapter 7, there was no specific need to address the concept of individuals doing business post-petition. Chapter 11, as you should all know, comes from a combination of old Chapter X and XI under the Bankruptcy Act and when combined with the circumstances of the pre-BAPCPA statutes of only having 541's 180-day forward reach, there was little reason to address this issue statutorily. These problems while still technically out there pre-BAPCPA, did not dominate since personal services income post-petition was not sucked up into the Chapter 11 Estate. So the concept of doing business in §363(c) had not been developed with individual/non sole proprietorship in mind.

Nonetheless, many courts have grappled with the application of the terms "business" and "ordinary course of business" with regard to an individual's expenditures (often times, but not always, considerations of costs of raising / educating children (college, too) or dealing with elderly parents / in-laws, folks with clearly accepted special needs are taken into account). There is no hard and fast rule; you can find cases across the U.S. which vary as to what is "OCB", for a family. But most cases look to what §1129(a)(15) may otherwise require and what

Form 228 reveals for guidance via §1325(b)(2)'s definition of "projected disposable income". As more cases have been filed and the issue addressed, more courts have addressed the issue and most all courts hold that individual 11 debtors are "doing business" in some form or another. *In re Goldstein*, 383 B.R. 496, 499 (Bankr. C.D. Cal. 2007); *In re Villalobos*, 2011 Bankr. LEXIS 4329 (B.A.P. 9th Cir. July 21, 2011). In contrast, in Chapter 13 cases, review of a plan by the Chapter 13 Trustee happens almost immediately after filing, and confirmation is a quick process; therefore, spending money to live is simply not an issue that arises in the context of Chapter 13 cases. Were the Chapter 13 Trustee to see problems with a debtor's spending, he or she could simply seek to dismiss the debtor's case.

Bottom line, an individual Chapter 11 debtor generally can use estate assets from the petition date, often times without a lot of scrutiny, to operate, as most unsecured creditors either: a) can't justify the expenditure to mount an attack; b) or do not know what rights they do have to seek to limit such usage.

It is less problematic, to use of personal services earnings post-petition to support a pre-petition lifestyle than it is for using income from non-exempt assets of the Chapter 11 estate. But just because you could justify such usage at the beginning of the case because of the limited initial restrictions doesn't mean you should: it's only going to be a short term illusory benefit if you can't get a plan confirmed or haven't prepared your client for the burdens that a single unsecured creditor using §1129(a)(15) can impose on your client's lifestyle using the hammer of "projected disposable income".

Some quick points here from §541(b) that may help in addressing the issues – if your client has a IRC §530(b)(a) educational account for the benefit of a proper relative, not pledged for any debt, not excessive in contributions per IRS requirements and which otherwise meets §541(b)(5)(c)'s 720-365 days prior contribution limit of $6,225, and your client has someone who can draw from that

– it's not going to be a 363(c) issue as it is not property of the estate. Section 541(b)(6) – does the same for state tuition programs (not as much in use in Texas as the Texas Tomorrow Fund stopped taking new enrollees some years ago) assuming the other conditions of §541(b)(6) are met.

Also note that under §541(b)(7) the employer withheld funds or employee contributed funds for ERISA qualified employee benefit plans or the like, such as deferred compensation plan under applicable IRC requirements are not property of the Chapter 11 estate. At least some courts have excluded 401(k) contributions from property of the estate pursuant to §541(b)(7), so long as such contributions were not increased post-petition. *See, e.g., In re Egan*, 458 B.R. 836 (Bankr. E.D. Penn. 2011). Because such continuing 401(k) contributions are not property of the estate, they are also not included in the calculation of disposable income. *Id.*

So in counseling your client, the above discussion points up the importance, for both creditors and debtors alike, of the detailed and thoughtful compliance with filling out Schedules I and J, as these likely will be the first evidence and first hard exercise of analysis as to what income and "operating" costs of the debtor were on the petition date. They are some evidence of what might be needed in the future (don't forget 366 utility deposit requirements or the prospect that they may be required, or adequate protection payments if applicable. In contrast, debtors in Chapter 13 cases generally do not worry about utility motions. The cases move so quickly that there is little reason to make deposits as the plan will be confirmed and payments will begin very quickly as compared to in a Chapter 11 case.

It is best if Debtor's counsel, in addition to getting as solid a retainer as you can, address Schedules I and J as soon as possible before, or just after the filing of the case. It enables Debtor's counsel to ascertain if there will likely be disputes as to expenditures or disputes as to use of cash flow pre-confirmation if there is no

lien on that cash flow or it will tell you if the Debtor will have a cash collateral issue if you are seeking to use funds for "operations" of the Debtor.

Bear in mind that this will just be the operating budget for the Chapter 11 – the Debtor needs to be able to show an ability to generate enough to pay something more than what it takes to pay operating expenses pre-confirmation because a Chapter 11 for an individual which generally commits up to 5 years of "disposable" income to the payment of obligations outside of your mortgage and living expenses, is really hard to justify versus a Chapter 7, unless there is non-exempt pre-petition property that needs to be retained.

The considerations noted above should make it abundantly clear: there needs to be some real important reason to subject a client to a 5-year process to address obligations where Chapter 7 is a viable alternative. If Chapter 11 is required because the Debtor simply can't qualify for a 13 due to high consumer debt levels (secured or unsecured), then your 11 will likely not have a significant problem addressing 1129(a)(7)(A)(ii) because the cash flow over 5 years should reasonably exceed any accumulated non-exempt funds (net of administrative costs, etc. as utilized in the tests referenced in 1129 (a)(15)) that the Debtor has on the effective date of the plan.

But the dominant reason that individuals file for Chapter 11 is to try to keep non-exempt assets acquired prior the Petition Date; be they an undivided interest in the family farm the client's parents once owned, a patent, an invention or a copyright on intellectual property as limited partnership interests or ownership interests or controlling ownership interests in an operating business (whether it is also in its own proceeding or not). Post-petition acquired property is not, per the 5th Circuit's *In re Lively,*, 717 F.3d 406 (5th Cir. 2013), is not subject to absolute priority rule requirements in order to retain same under a Plan. It is keeping non-exempt assets that came with the client into the case that is toughest sledding.

First off, as noted, your client has to be weaned off relying on that non-exempt generated income stream so that the income stream can be redirected to pay creditors: (a) enough to meet the Chapter 7 test (unless all classes vote in favor); and (b) enough to meet the disposable income requirements of 1129(a)(15) [while it only takes one creditor's objection to be invoked, it can be an iffy bet to not address and then, at plan confirmation, have it bite you with all the attendant costs and time by not having the proof ready so that you can meet the requirements if invoked – generally it's better to address it up front and accommodate its effect than to have the case crater for not considering the possibility of such an objection].

To further add to the pain to be endured, as it stands currently, upon filing of an individual 11, you create a requirement to file two tax returns: (1) for the estate as to income generated from property of the estate; and (2) the Debtor for wages/salaries and the like.

There are significant potential tax allocation and filing issues as between the income generated from earnings and the income or gains/lossses generated from non-exempt assets. There is the requirement to file monthly operating reports ("MORs") which does not occur in a Chapter 13. MORs are not to be trifled with as they are sworn to under penalty of perjury and need to be carefully prepared. Further, MOR's are used by the United States Trustee to calculate the amount of quarterly trustee fees that need to be paid – a cost which Chapter 13 debtors do not bear.

Now remember discussing what is not property of the estate, either because it is pre-petition exempt or it is excluded by 541(b)? Well, more likely than not, those assets or their cash flow may be your client's only source of paying to retain the non-exempt property they want to retain. Breaking into a client's exempt assets to fund a plan should always require that the Pain vs. Gain assessment be

done as dispassionately and as objectively as possible. Sometimes, in connection with saving a family owned enterprise (whether also in or out of its own chapter proceeding) these exempt assets are all that can be secured to make a run at either a single or dual reorganization.

But that is not the end. Like a Chapter 13 debtor, an individual Chapter 11 debtor must be prepared for the possibility that plan terms may be sought to be changed at any time during the term of the plan, notwithstanding substantial consummation of the Plan. As with a Chapter 13, such changes can be requested by the debtor, the trustee, the U.S. Trustee, or any holder of an allowed unsecured claim. Modifications which can be sought can: (1) increase or reduce the amount of payments on claims of a particular class provided for by the plan; (2) extend or reduce the time period for such payments; or (3) alter the amount of the distribution to a creditor whose claim is provided for by the plan to the extent necessary to take account of any payment of such claim made other than under the plan

The prediction or perception of success by the client should always be tempered by making sure that the client understands all of these risks and elements, the almost certain need for alteration of lifestyle to effectuate the plan (brought on more by wanting to retain pre-petition property than any other reason) and the alternatives to filing for Chapter 11.