



# THE INDIVIDUAL CHAPTER 11 CASE: STILL PROBLEMATIC AFTER ALL THESE YEARS

BY LAURY MACAULEY, ESQ.

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005<sup>1</sup> (BAPCPA), brought sweeping changes to bankruptcy practice, including significant amendments to the Bankruptcy Code's treatment of individual debtors in Chapter 11 cases.<sup>2</sup> Many commentators viewed these changes as aimed at making individual Chapter 11 debtor cases more like Chapter 13 cases. Unlike Chapter 11, which was designed as a vehicle for business reorganizations, Chapter 13 was created to assist individuals with their debts. But BAPCPA's amendments to the eligibility tests for Chapter 7 and Chapter 13 (setting new upper limits on debts and income) also meant that more individual debtors would have to file Chapter 11, because they no longer qualified for any other chapter.

Although more than eight years have passed since BAPCPA was enacted, individual Chapter 11 debtor cases remain mired in unique legal issues. This article highlights several of these problems.

## **Payment of "Ordinary" Living Expenses**

Chapter 11 debtors are normally allowed to "use property of the estate in the ordinary course of business without notice or a hearing." 11 USC § 363(c)(1). So the question arises: can individual debtors use their property (i.e. post-petition wages, salary, income, etc.) to pay ordinary living expenses not associated with the operation of a business?

Prior to BAPCPA, an individual Chapter 11 debtor's post-petition wages were not included in the bankruptcy estate and could be used for living expenses. 11 USC §

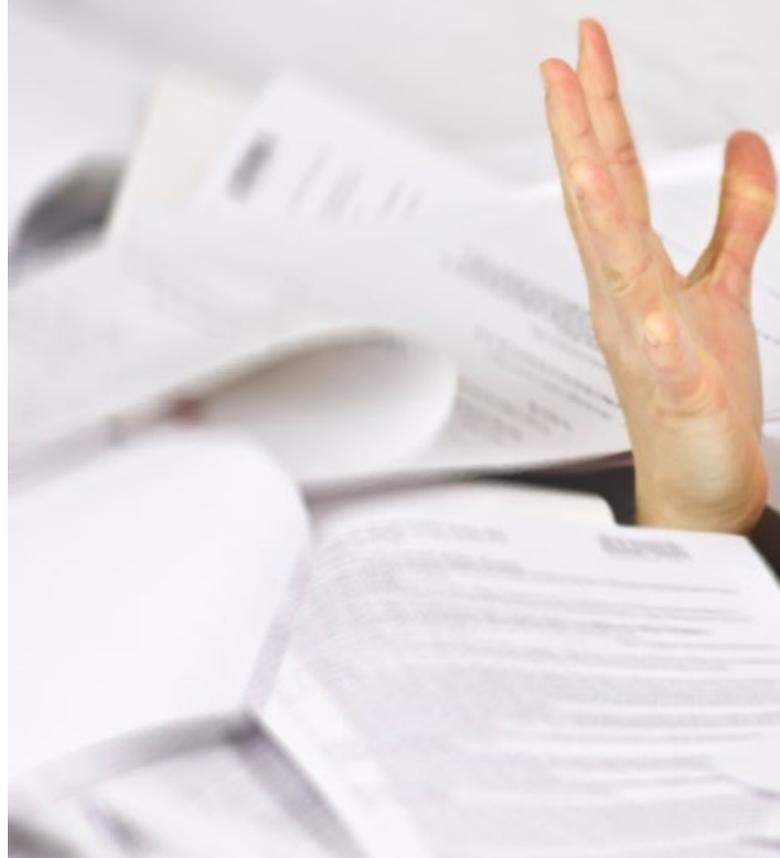
**continued on page 18**

# THE INDIVIDUAL CHAPTER 11 CASE: STILL PROBLEMATIC AFTER ALL THESE YEARS

continued from page 17

541(a)(6). However, BAPCPA's addition of Bankruptcy Code Section 1115 changed that rule, providing that most earnings (wages, salary, income) and property acquired post-petition constitute part of the bankruptcy estate.

Presented with the conundrum that Section 1115 appears to leave individual debtors without the assets necessary to pay living expenses, courts have taken various tacks. The Bankruptcy Court for the Central District of California recently addressed this problem in the context of an objection by a Chapter 7 trustee to the Chapter 11 debtors' prior use of estate funds to pay personal expenses. *See In re Seely*, 492 B.R. 284 (Bkrcty.C.D.Cal. 2013). After examining the practical need of debtors to use post-petition wages, Judge Sheri Bluebond held that Bankruptcy Code Section 363(c)



(1) does indeed authorize an individual debtor-in-possession to use property of the estate to pay post-petition living expenses without court approval, as long as the amounts expended are “ordinary course living expenses.” In so ruling, she relied heavily on Congress’s intent to make individual Chapter 11 cases more like those under Chapter 13, in which debtors can use post-petition wages for certain expenses without court approval.

Certainly, not all courts have agreed that “ordinary course living expenses” can be spent without prior court approval, but to solve the problem, many jurisdictions (including Nevada) have adopted either a local rule or practice requiring the submission and approval of a budget by individual Chapter 11 debtors before they can pay personal living expenses.

Of course, the difficult question remains: what is an “ordinary course living expense?” This problem was front-and-center in a case before the Bankruptcy Appellate Panel (BAP) for the Ninth Circuit, entitled *In re Villalobos*, Nos. NV-11-1061-HKwJu, NV-11-1082-HKwJu, 2011 WL 4485793 (9th Cir. BAP August 19, 2011). In *Villalobos*, the Bankruptcy Court<sup>3</sup> had approved the debtor’s motion for nunc pro tunc approval of, among other things, the payment of certain personal and purported “ordinary course” expenses, including those for the maintenance of luxury automobiles and school tuition for his grandchildren.

The debtor in *Villalobos* argued that the “disposable income test” of Bankruptcy Code Section 1129(a)(15), which mandates the payment of all “disposable income” under a plan of reorganization for five years, but allows the payment of certain reasonable expenses without court approval, should likewise be employed to authorize similar, pre-confirmation



Individual Chapter 11 debtors face special difficulties toward the ends of their cases.

payments. In considering this, the BAP noted the scarcity of authority regarding how and when Chapter 11 debtors can pay personal expenses and seemed sympathetic to the debtor's proposed approach but failed to adopt it. Instead, since the Bankruptcy Court had failed to make any findings as to the reasonableness of the expenses or as to the nature of the test employed to authorize them, the BAP reversed and remanded the case for further findings, leaving practitioners with no additional guidance.

### **“Cram down” and the Absolute Priority Rule**

One of the other major roadblocks that an individual Chapter 11 debtor faces after the passage of BAPCPA occurs if he needs to “cram down” a plan of reorganization.

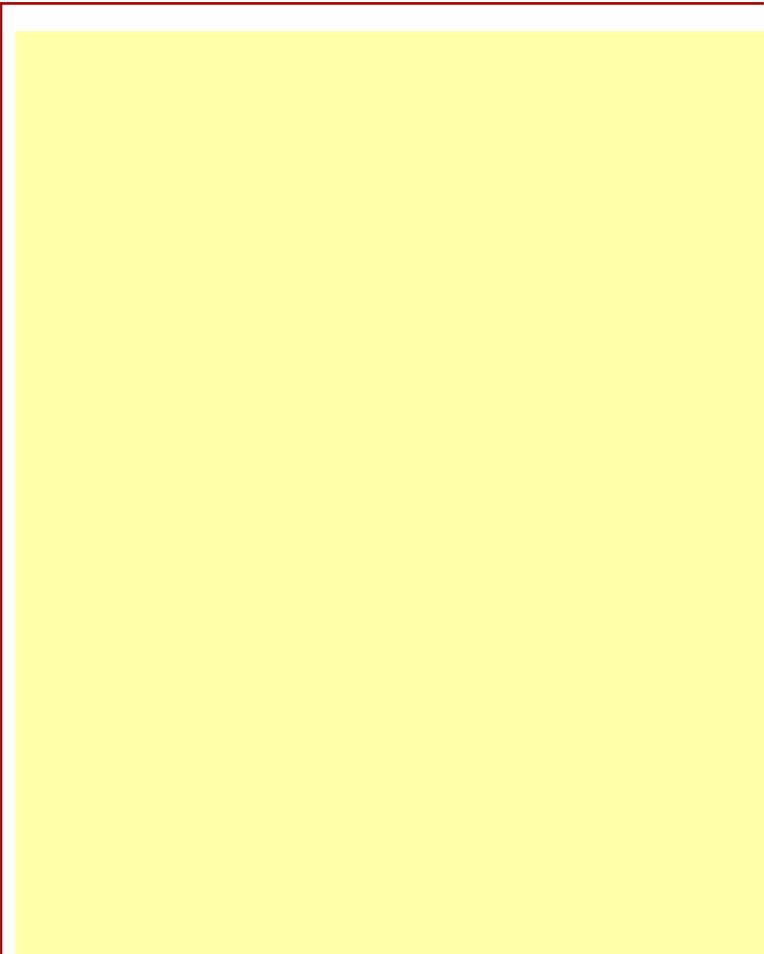
If all necessary classes of creditors do not vote to accept a proposed plan,<sup>4</sup> a debtor can, nevertheless, obtain confirmation through a cramdown by obtaining the acceptance of at least one impaired class of creditors and complying with, among other things, the requirements of the so-called “Absolute Priority Rule” (APR). 11 USC § 1129(b)(2)(B)(ii). This rule requires that a plan be “fair and equitable,” and mandates that, at a minimum, unless every class of unsecured claims receives property with a present value equal to the full amount of their claims, no one with a claim or interest junior to that class of unsecured claims can retain any property.

BAPCPA modified the APR as it applied to individual Chapter 11 debtors, because Bankruptcy Code Section 1129(b)(2)(B)(ii) now allows an

individual debtor to “retain property included in the estate under section 1115...” but courts have diverged in their interpretation of the meaning of that provision. If the provision applies only to post-petition property, an individual Chapter 11 debtor cannot retain any of the property that he owned at the time of his bankruptcy filing (including a business), unless his confirmed plan provides for full payment of every class of unsecured claims and/or provides “new value.”<sup>5</sup> This is a major impediment to confirmation for individual Chapter 11 debtors.

In the District of Nevada, bankruptcy courts have not have not applied the APR to individual Chapter 11 cases. In an early decision on the issue, Judge Bruce Markell penned a lengthy opinion in the case of *In re Shat*, 424 B.R. 854 (Bkrcty. D. Nev. 2010). Relying on the legislative history of BAPCPA and a “broad” statutory interpretation regarding the interplay between Sections 1115 and 541 (referenced in Section 1115),<sup>6</sup> the court ruled that the APR has no application to individual Chapter 11 debtors after BAPCPA.

**continued on page 20**



# THE INDIVIDUAL CHAPTER 11 CASE: STILL PROBLEMATIC AFTER ALL THESE YEARS

continued from page 19

The other bankruptcy judges in the District of Nevada have followed suit in their interpretation of the rule,<sup>7</sup> but many other courts have not done so, instead adopting a “narrow interpretation” as the “majority rule” and finding that the APR *does* apply to cases of individual Chapter 11 debtors. *See, e.g., In re Gbadebo*, 431 B.R. 222 (Bkrcty.N.D.Cal. 2010); *In re Lively*, 717 F.3d 406 (5th Cir. 2013). This split in authority has led to the need for the U.S. Supreme Court to decide this question, but no such end to this conflict is in sight.

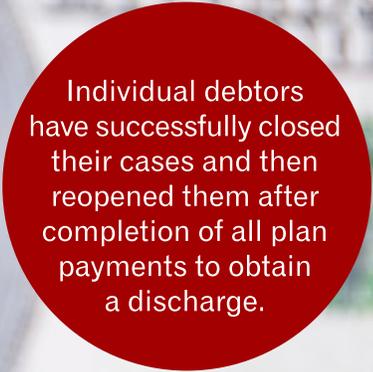


## Closing Cases Prior to Discharge

Finally, it should be noted that individual Chapter 11 debtors face special difficulties toward the ends of their cases. Unlike Chapter 7 debtors, who receive an early discharge, debtors in Chapter 11 must wait until they have completed all payments required by their confirmed plan for their discharges. 11 USC § 1141(d)(5)(A). This process can often be lengthy because, if any unsecured creditor objects to the plan, its claim must either be paid in full or the debtor must commit all of his projected “disposable income” (as defined by the code), for five years or the term of the confirmed plan, whichever is longer. 11 USC § 1129(a)(15).

This rule results in most individual Chapter 11 debtors having to wait more than five years to get a discharge. This delay can be very costly because, while the case remains open, the debtor has to pay quarterly fees to the U.S. Trustee. 28 USC § 1930(a)(6). To get around this problem, individual debtors have successfully closed their cases and then reopened them after completion of all plan payments to obtain a discharge. *See, e.g., In re Johnson*, 402 B.R. 851 (Bkrcty.N.D.Ind. 2009); *In re Mendez*, 464 B.R. 63 (Bkrcty.D.Mass. 2011). Although debtors have to pay a fee and file a motion to reopen their case, that expense usually pales in comparison to the cost of paying the quarterly fees due to the U.S. Trustees for five years.

In Nevada, this solution to the problem has been incorporated into the Local Rules of Bankruptcy Practice of the United States District Court for the District of Nevada, which specifically allow for the closing and reopening of the case prior to discharge. *See* LR 3022.1.



Individual debtors have successfully closed their cases and then reopened them after completion of all plan payments to obtain a discharge.

## Conclusion

As the result of BAPCPA, individual debtors face unique problems when proceeding with their Chapter 11 cases. But courts are continually striving to resolve these legal roadblocks, and Nevada courts have been on the forefront of this endeavor. ■

- 
- 1 *Pub.L. 109–8, 119 Stat. 23, enacted April 20, 2005.*
  - 2 *See Toibb v. Radloff, 501 U.S. 157 (1991)* (individuals not engaged in business can file a petition under Chapter 11 of the Bankruptcy Code).
  - 3 The case was determined by visiting Judge John L. Peterson from the United States Bankruptcy Court for the District of Nevada.
  - 4 11 USC § 1129(a)(8).
  - 5 *See In re Bonner Mall Partnership, 2 F.3d 899 (9th Cir. 1993), appeal dismissed as moot, 513 U.S. 18, 115 S.Ct. 386, 130 L.Ed.2d 233 (1994).* And the courts disagree regarding whether or not an individual Chapter 11 debtor can provide “new value” to get around the APR. *See In re Rocha, 179 B.R. 305 (Bkrtcy.M.D.Fla. 1995); compare In re Cipparone, 175 B.R. 643 (Bkrtcy.E.D.Mich. 1994).*
  - 6 Bankruptcy Code Section 541 defines “property of the estate” as including “all legal or equitable interests of the debtor in property as of the commencement of the case” (pre-petition property).
  - 7 *See also In re Friedman, 466 B.R. 471 (9th Cir.B.A.P. 2012); In re Johnson, 402 B.R. 851 (Bkrtcy.N.D.Ind. 2009).*

---

Author’s biography is on p. 5.