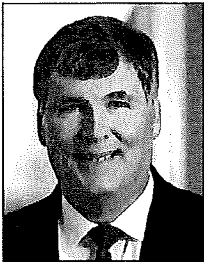
By William L. Norton III

Need for Bankruptcy Code Reform for Individual Chapter 11 Cases



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The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) made sweeping changes to the Bankruptcy Code related to individual chapter 11 cases.[1] Unfortunately, these changes were made without any legislative history to provide a statement of congressional intent regarding the new provisions. In addition, there were several aspects of individual chapter 11 cases that were not addressed by the legislation, notwithstanding the existence of similar provisions that are applicable in chapter 13 cases. The aspects of individual chapter 11 cases that need legislative attention include the following: (1) compensation of officers (11 U.S.C. § 330(a)(4)(B)); (2) use of property of estate (11 U.S.C. § 363(b)(1)); (3) dual taxable estates (26 U.S.C. § 1398); (4) absolute-priority rule (11 U.S.C. § 1129(b)(2)(B)(ii)); and (5) discharge (11 U.S.C. § 1141(d)(5)).

Compensation of Officers

Section 330(a)(4)(B) was added under the Bankruptcy Reform Act of 1994[2] to provide an exception for bankruptcy counsel for individual debtors in chapter 12 or 13 cases to permit reasonable compensation to the debtor's attorney for personal services provided to the debtor during the bankruptcy case. BAPCPA failed to add chapter 11 to the exceptions provided under § 330(a)(4)(B). Without this provision, § 330(a)(1) does not authorize compensation to a debtor's attorney from estate funds for work performed for the individual debtor unless counsel is employed to work for the estate pursuant to § 327. This interpretation was made clear in *Lamie v. U.S. Trustee*, wherein the U.S. Supreme Court held that an attorney for the debtor cannot be paid from estate funds after the conversion of the debtor's case to chapter 7 unless the attorney is employed by the chapter 7 trustee.[3]

Section 330(a)(4)(B) should be amended to add chapter 11 debtor's counsel to the exception already provided to counsel for debtors in chapter 12 and 13 cases. There does not appear to be any justification to permit debtor's counsel to be compensated for personal services provided to individual debtors in chapter 12 and 13 cases, but to deny compensation to counsel for individual debtors for such services in chapter 11 cases. Moreover, permitting counsel to the debtor to be compensated by the estate subject to the court's approval would eliminate ambiguities about the individual debtor's ability to compensate counsel for services provided to the individual debtor during the course of the chapter 11 case.[4]

Use of Property of the Estate

Section 363(b)(1) permits a debtor to "use, sell, or lease" property of the estate without court permission if the use is in the ordinary course of the debtor's business. The Bankruptcy Code has no provision qualifying the extent to which an individual debtor's personal expenses are authorized to be paid "as ordinary course of business" expenses, and BAPCPA did not address this issue. Further complicating this issue is the fact that § 1115, which was added by BAPCPA, deems earnings from services performed by the debtor after the commencement of the case to be property of the estate. Thus, the use of property of the estate for the payment of the debtor's personal expenses is arguably subject to court scrutiny when such payments do not provide any benefit to the creditors.

Pre-BAPCPA, the Fifth Circuit concluded that it was inappropriate for an individual chapter 11 debtor and his family to be paid up to $10,000 per month for living and travel expenses from funds of the bankruptcy estate.[5] Since BAPCPA, it remains uncertain as to the appropriate standard that should be applied to determine the reasonableness of such post-petition expenses.[6]

This issue can be addressed by adding a new provision at the end of § 363 to permit the debtor to use property of the estate for the "reasonable maintenance and living expenses of the debtor," and to also authorize any party-in-interest, such as the U.S. Trustee or an unsecured creditor, to request that the court determine the reasonableness of such living expenses. The approval of a budget at the beginning of a chapter 11 case involving an individual debtor is recommended, but the procedures for individual debtors in chapter 11 cases vary widely nationwide. Thus, a uniform provision within § 363 would be beneficial. The determination of standards for "reasonableness" of such living expenses should be a judicial decision. Here is a proposed amendment to 11 U.S.C. § 363:

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1 Pub L. No. 109-08, 119 Stat. 37, § 321 (2005).
2 Pub. L. No. 103-394, § 224 (1994).
3 540 U.S. 526, 529 (2004).
4 *See* the proposed amendment to § 363 presented later in this article.
5 *See U.S. v. Sutton*, 786 F.2d 1305 (5th Cir. 1986) (rejecting a broad reading of § 105(a)).
6 *See In re Villalobos*, 2011 WL 4485793 (B.A.P. 9th Cir. Aug. 19, 2011) (given the uncertainty in allowance of personal expenses of individual chapter 11 debtors, it is important for bankruptcy court to articulate legal rule being applied and explicit findings of fact that support legal rule; fact that debtor may have historically paid certain expenses is insufficient).

(q) In a case under Chapter 11 in which the debtor is an individual, property of the estate can be used for the reasonable maintenance and living expenses of the debtor and debtor's dependents without notice or a hearing. Any party-in-interest may request the court to determine the reasonableness of the maintenance and living expenses to be paid by property of the estate.

Dual Taxable Estate

BAPCPA added § 1115 to include as property of the estate all post-petition income from services earned by the debtor after the commencement of the case. When this change was made to the Bankruptcy Code, no corresponding change was made to 26 U.S.C. § 1398, which creates a separate taxable entity under the Internal Revenue Code in chapter 11 cases. Because the post-petition earnings are now property of the bankruptcy estate in chapter 11 cases, the post-petition earnings are taxable to the bankruptcy estate under § 1398 of the Tax Code.

This statutory disconnect has created significant tax accounting difficulties for individual debtors in chapter 11 cases because their current earnings are typically used by the individuals for personal living expenses, but the same earnings are taxable to the bankruptcy estate. In chapter 13 cases, in which § 1306 also includes post-petition earnings as property of the estate, there is no separate taxable entity for the bankruptcy estate under § 1398 of the Tax Code.

The Section of Taxation for the American Bar Association recommended in its letter dated Aug. 9, 2012, an amendment to § 1398 that deletes the reference therein to "Chapter 11," thus eliminating the creation of a separate taxable estate upon the filing of an individual chapter 11 petition. Here is a proposed amendment to 26 U.S.C. § 1398(a):

> (a) Cases to which section applies — Except as provided in subsection (b), this section shall apply to any case under chapter 7 (relating to liquidations) of title 11 of the United States Code in which the debtor is an individual.

Confirmation of Plan

Subsection (a)(15) was added to § 1129 by BAPCPA to impose a projected-disposable-income requirement similar to § 1325(b) in chapter 13 cases. The original provision became applicable only if there was an objection by the holder of an allowed unsecured claim. In practice, creditors voting against a plan may not wish to incur the cost of filing an objection to the plan. In such circumstances, the debtor does not have to satisfy the projected-disposable-income provision, even though the debtor has to seek a cramdown of the plan and satisfy the absolute-priority-rule provisions of § 1129(b)(2)(B). If the absolute-priority rule is eliminated as it applies to individual chapter 11 debtors, the provisions of § 1129(a)(15) should be required in all nonconsensual individual chapter 11 cases to ensure that the debtor's plan is fair and equitable.

In addition, § 1129(a)(15)(B) should be amended to make it clear that the debtor's projected disposable income is deter-

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mined without "the application of § 1325(b)(3)." The existing provision is vague in that it only refers to § 1325(b)(2) and does not specifically exclude the application of § 1325(b)(3).

Finally, § 1129(a)(15)(B) should be further amended to make it clear that the period for which the debtor's projected disposable income is to be paid under the plan should extend "during the period for which the plan provides payments *for unsecured claims (except for claims that are nondischargeable)*." This would make it clear that payments under the plan on long-term mortgage obligations are not intended to extend the period of time required for the distribution of projected disposable income. Here are proposed amendments to 11 U.S.C. § 1129(a)(15):

> (15) In a case in which the debtor is an individual and in which the holder of an allowed unsecured claim *votes to reject the plan pursuant to section 1126(a):*
>
> > (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) *without the application of section 1325(b)(3)*) to be received during the five-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 *on unsecured claims (except for claims that are nondischargeable)*, whichever is longer.

Absolute-Priority Rule

BAPCPA made an exception to the absolute-priority rule under § 1129(b)(2)(B). The scope of this amendment was not made clear in the legislation, and bankruptcy courts disagree as to what Congress intended. The "broad" view adopted by some courts reads the language of this statute to abrogate the absolute-priority rule in individual chapter 11 cases.[7] However, four circuits have applied the principles of statutory construction to hold that the exception is limited only to property of the estate that was earned by the debtor for services incurred after the filing of the chapter 11 case.[8] These courts point out that the absolute-priority rule is an important protection to unsecured creditors under the cramdown provisions of § 1129(b)(2)(B), and Congress failed to express any intention to abrogate this important protection through BAPCPA's enactment.

The better policy is that the absolute-priority rule should not apply to individual debtors in chapter 11 cases. Instead, similar to chapter 13, unsecured creditors should be provided fair and equitable protections by compelling the debtor to pay the projected disposable income as set forth under § 1129(a)(15). This recommendation is similar to the changes made in 2020 with the enactment of subchapter V under chapter 11.[9] This proposed amendment would merely make the elimination of the absolute-priority rule applicable to individuals who have debts too great to qualify for chapter 13 or who are not engaged in a business that would qualify for subchapter V. Here is a proposed amendment to 11 U.S.C. § 1129(b)(2)(B):

> (B) With respect to a class of unsecured claims —
>
> > (i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or
> >
> > (ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property, except that in a case in which the debtor is an individual, the debtor may retain property included in the estate under §§ *541 and* 1115, subject to the requirements of subsection (a)~~(14)~~*(15)* of this section.

Discharge

BAPCPA added § 1141(d)(5) to specifically address the effect of confirmation on individuals in chapter 11 cases. The discharge for individuals in chapter 11 cases does not occur "until the court grants a discharge and completion of all payments under the plan." This provision is unclear as to how it is to be applied when the plan provides for the continuation of long-term payments on a secured claim, such as a residential mortgage. This provision should be amended in a manner that is similar to the aforementioned recommendation regarding § 1129(a)(15) to make it clear that the completion of all payments under the plan will occur when the debtor has completed payments required under the plan to "unsecured claims (except for claims that are nondischargeable)." Here is a proposed amendment to 11 U.S.C. § 1141(d)(5):

> (5) In a case in which the debtor is an individual —
>
> > (A) unless after notice and a hearing the court orders otherwise for cause, confirmation of the plan does not discharge any debt provided for in the plan until the court grants a discharge on completion of all payments under the plan *to unsecured claims (except for claims that are nondischargeable)*.

Conclusion

These proposed changes to the Bankruptcy Code would be important to support its effective use in individual chapter 11 cases, and to achieve the results intended by Congress in such proceedings. abi

7 *See, e.g., In re Friedman*, 466 B.R. 471 (B.A.P. 9th Cir. 2012); *In re Shat*, 424 B.R. 854 (Bankr. D. Nev. 2010).

8 *See In re Ice House Am. LLC*, 751 F.3d 734 (6th Cir. 2014); *In re Lively*, 717 F.3d 406 (5th Cir. 2013); *In re Stevens*, 704 F.3d 1279 (10th Cir. 2013); *In re Maharaj*, 681 F.3d 558 (4th Cir. 2012).

9 ABI recently established the Subchapter V Task Force, which is reviewing this legislation. Public hearings will be held throughout 2023 on various subchapter V aspects, which will contribute to a final report that is slated to be released in April 2024. Learn more at subvtaskforce.abi.org.

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ing from commercial or business activities for an individual doctor debtor's subchapter V eligibility.[14] When Dr. Laura Reis filed a subchapter V case in 2022, she had $645,869 in medical school debt, of which $319,028.34 was principal. When faced with a challenge as to her eligibility to be a subchapter V debtor, Dr. Reis argued that her medical school student loans should count as business debts and not as consumer debts.

In considering the question, the bankruptcy court examined the history of the debtor's obligations and found that they had been incurred over a five-year period from 2005-09. After the debtor graduated from medical school in 2009, she completed a three-year residency in Florida and thereafter worked continuously as a non-owner employee for multiple medical agencies. In 2018, the debtor filed for chapter 7 and listed her student loans as primarily consumer debts, but listed her student loans as not primarily consumer debts in her 2022 case. In the interim between her filings, the debtor began to practice under her own limited liability company.

While the U.S. Trustee conceded that the debtor was engaged in business activities as of the petition date, it objected to the debtor's eligibility under subchapter V, arguing that (1) § 1182(1)(A) must be interpreted to exclude the subject loans from being characterized as arising from commercial or business activities; and (2) student loans generally are consumer debts. There were two primary interpretation issues presented: (1) whether a majority of Dr. Reis's aggregate noncontingent liquidated debt arose from the commercial or business activity; and, if so, (2) whether such debt must arise from the same commercial or business activities that Dr. Reis was engaged in at the time the petition was filed.

The court noted that there are conflicting opinions on the latter question. However, the *Reis* court agreed with those courts that have held that the statutory language in § 1182(1)(A) does not require a direct linkage of the commercial or business activities on the petition date and the commercial or business activities from which the debt arose. In addressing the percentage-of-debt issue, the court found that more than 50 percent of the debt was allocated to student loans. Specifically, it found that the student loans were not commercial or business debts, in part because "[t]he Debtor's education had nothing to do with buying, selling, financing, or using goods, rather it gave [the] Debtor the opportunity, as a person, to practice a profession," and found that the debtor was not eligible for subchapter V.[15] However, the court made a specific point to note that it was not announcing any sort of *per se* rule that student loan debt can never qualify as debt arising from commercial or business activities.

Noncontingent Liquidated Debt: *Macedon Consulting*

In *In re Macedon Consulting*, the bankruptcy court grappled with whether pre-petition lease obligations for future months are noncontingent and liquidated for purposes of subchapter V eligibility.[16] Macedon Consulting filed for subchapter V and, on the same day, filed its reorganization plan and a motion to reject certain real property leases. Even though the leases were not terminated pre-petition, the debtor included in its schedules estimated amounts of lease-rejection claims as capped under § 502(b)(6). Thus, the court framed the issue as whether it "should consider the full liability under the leases" or "should allow the estimated lease rejection damages to control" the debt amount included for subchapter V eligibility.[17]

> **Given the rapid success and wide adoption of subchapter V, the only clear point is that the question of eligibility will continue to evolve as courts are faced with new factual and legal questions.**

First, the court found that liability under the leases for the entire term of the leases arose pre-petition when they were executed, thus rejecting the argument that the timing of the future rental payments renders the debt contingent. Specifically, the court noted that a future date is certain to occur "[a]bsent the end of the world,"[18] making the obligations under the lease noncontingent and liquidated, therefore they should not be limited to the post-petition § 502(b)(6) cap. Thus, because the debtor's total future obligations under the leases exceeded $7.5 million, the court found that the debtor was not eligible to be a subchapter V debtor.[19]

In reaching its decision, the court distinguished the facts in the case from *In re Parking Management*, one of the first cases to address the issue of unexpired leases on eligibility, which held that pre-petition lease-rejection claims were contingent as of the petition date and therefore not considered in the debt-limitation determination.[20] *Macedon Consulting* creates a clear split in bankruptcy court opinions on how unexpired lease debt factors into subchapter V eligibility.

Conclusion

The case law on the development and refinement of the definition of an eligible small business debtor for subchapter V cases continues to grow. Given the rapid success and wide adoption of subchapter V, the only clear point is that the question of eligibility will continue to evolve as courts are faced with new factual and legal questions. abi

14 *In re Reis*, No. 22-00517, 2023 Bankr. Lexis 1169, at *9 (Bankr. D. Idaho May 2, 2023).
15 *Id.* at *17.

16 *In re Macedon Consulting Inc.*, No. 23-103000, 2023 Bankr. LEXIS 1551 (Bankr. E.D. Va. June 14, 2023).
17 *Id.* at *9.
18 *Id.* at *11.
19 Interestingly, instead of dismissing the debtor's case, on the debtor's request, the court revoked the subchapter V designation and allowed the debtor to proceed under traditional chapter 11.
20 *In re Parking Mgmt.*, 620 B.R. 544, 554 (Bankr. D. Md. 2020).