Plan Confirmation Issues in Individual Chapter 11 Cases, Conversion from Chapter 11 to Chapter 7 and Dismissal

Jennifer L. Kneeland
Watt, Tieder, Hoffar & Fitzgerald, L.L.P.
1765 Greensboro Station Place, Suite 1000
McLean, Virginia 22102
(703) 749-1026
jkneeland@watttieder.com

I. Introduction – Plan and Confirmation Issues in Individual Chapter 11 Cases

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") amended the Bankruptcy Code to include a number of provisions that were specifically directed at changing the standards for individuals to confirm Chapter 11 plans. Chapter 11 individual cases, in some ways, have come in line with Chapter 13 cases. However, there remain significant differences between the two chapters regarding plan contents, funding, and confirmation. And, of course, individual Chapter 11 debtors also must comply with substantially all of the other confirmation requirements of Chapter 11.

This presentation will focus on plan funding in individual Chapter 11 cases, cram down and the absolute priority rule. These materials also address conversion to Chapter 11 or dismissal when a plan cannot be confirmed.

II. Plan Funding in Individual Chapter 11 Cases

A. Generally – the plan must be funded from the debtor's post-petition personal service income or other future income to the extent it is needed for the execution of the plan. *See* Section 1123(a)(8).

B. Absent an objection from a creditor, and provided that the plan meets the best interest test of Section 1129(a)(7), an individual debtor's Chapter 11 plan may provide for any amount of disposable income to fund the plan.

C. However, where an unsecured creditor objects, Section 1129(a)(15) applies and the plan cannot be confirmed unless it provides for payment of the debtor's projected disposable income for the longer of five years or the period of the plan.

1. When an unsecured creditor objects, then the debtor is required to distribute property of a value that is not less than the projected disposable income, as defined in Section 1325(b)(2), for the longer of five years or the term of the plan.

2. Section 1129(a)(15) provides –

> In a case in which the debtor is an individual and in which the holder of an allowed unsecured claim objects to the confirmation of the plan –
>
> (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))** to be received during the 5-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, whichever is longer.

a. Section 1129(a)(15) gives unsecured creditors an option to demand that the debtor contribute more money to a plan when it is not satisfied with the amount of value that a debtor contributes to the plan in order to meet the "best interests test" under 1129(a)(7).

b. Note that it is only an unsecured creditor that can trigger Section 1129(a)(15). The U.S. Trustee and secured creditors cannot trigger the requirement to contribute projected disposable income of the debtor.

D. What is projected disposable income? Section 1129(a)(15) references Section 1325(b)(2)'s definition of disposable income. Section 1325(b)(2) can be distilled to a simple, basic formula – current monthly income received by the debtor minus various expenses and with certain exclusions. In re Pfeifer, 2013 Bankr. LEXIS 4358, * 11 (Bankr. S.D. N.Y. 2013) (J. Gropper).

1. The unabridged version of the simple formula explained above is,

a. Current monthly income (other than child support, foster care or disability payments made in accordance with applicable non-bankruptcy law but only to the extent reasonably necessary to be expended for such child), less amounts reasonably necessary to be expended for maintenance and support of the debtor or dependents (including post-petition domestic support obligations), charitable contributions not to exceed 15% of the debtor's gross income and, if the debtor is engaged in business, then expenses necessary for maintaining business operations. Plus, sources of future income such as rental income or inheritance.

b. Official Form 22B is the form that is commonly used to show the calculations. Schedules I and J can be used for identifying reasonably necessary expenses. In re Gray, 2009 LEXIS 2130 (Bankr. N.D. W. Va. 2009).

2. Should the means test be used to calculate disposable income for the debtor? No.

a. Section 1325(b)(3) requires that courts apply the Chapter 7 means test found in Section 707(b)(2) to calculate disposable income for a Chapter 13 debtor. However, Section 1129(a)(15) omits any reference to Section 1325(b)(3), and as a result, the few courts that have addressed the issue have concluded that use of the means test is not a correct method of determining projected disposable income. In re Roedemeier, 374 B.R. 264 (Bankr. D. Kan. 2007); In re Gray, 2009 LEXIS 2130 (Bankr. N.D. W. Va. 2009).

III. **Cram Down**

A. Generally, confirmation of a Chapter 11 plan requires that the debtor (or plan proponent) must meet all of the requirements of Section 1129(a). The sole exception involves Subsection 1129(a)(8), requiring every impaired class of claims or interests to accept the plan. If all of the provisions of Section 1129(a) are met, except for Section 1129(a)(8), then the debtor can still seek plan approval, albeit under Section 1129(b).

Collier on Bankruptcy explains:

a. The condition set forth in Section 1129(a)(8) is the only condition precedent which is not absolutely necessary for confirmation. If a plan satisfies the confirmation criteria set forth in Section 1129, including the requirement that if a class of claims is impaired, at least one impaired class of claims accepts the plan, the plan may be confirmed notwithstanding the opposition of one or more impaired classes of claims or interests, provide the plan satisfies Section 1129(b).

Collier on Bankruptcy, ¶ 1129.02[8] (16th ed. 2012).

b. Thus, if a plan is not consensual, a court may still confirm so long as the plan meets the other requirements of Section 1129(a), does not discriminate unfairly, and is fair and equitable as to any dissenting impaired class in order to meet cram down requirements Section 1129(b). See 11 U.S.C. § 1129(b)(1)

IV. **The Absolute Priority Rule Is Set Forth In Section 1129(b)(2)(B)**

A. Section 1129(b)(2) explains what a plan must include in order to be fair and equitable with respect to a class of claims.

B. Prior to BAPCPA, Section 1129(b)(2)(B) did not contain the language italicized below:

1. (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

2. (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 section 1115, subject to the requirements of subsection (a)(14) of this section.*

C. BAPCPA also added Section 1115. Section 1115 states:

Section 1115 – Property of the estate

1. In a case in which the debtor is an individual, property of the estate includes, in addition to the property specified in Section 541 –

    a. 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

    b. 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.

2. 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.

D. There are two judicial interpretations regarding whether or not the absolute priority rule set forth in Section 1129(b)(2)(B)(ii) applies in a Chapter 11 case filed by an individual. The Fourth Circuit stated that "either construction is plausible." In re Maharaj, 681 F.3d 558, 569 (4th Cir. 2012).

1. "Broad View" – Absolute priority rule is not applicable to individual Chapter 11 cases, and the debtor may keep prepetition property and earnings.

    a. Rationale: The plain language of Section 1115 incorporates Section 541. 11 U.S.C. §1115 ("... In a case in which the debtor is an individual, property of the estate includes, in addition to the property specified in Section 541…). Therefore, under Section 1115, an individual's estate includes prepetition property pursuant to Section 541, plus post-petition property and earnings.

    b. Additional arguments.

        (i) The BAPCPA amendments demonstrate intent to model Chapter 11 after Chapter 13, which does not have an absolute priority rule.

        (ii) One purpose of the Code is to provide the honest but unfortunate debtor with a fresh start.

2. Representative cases: In re O'Neal, 490 B.R. 837 (Bankr. W.D. Ark. 2013); SPCP Group, LLC v. Biggins, 465 B.R. 316 (M.D. Fla. 2011); In re Tegeder, 369 B.R. 477 (Bankr. D. Neb. 2007)

3. "Narrow View" – Absolute priority rule survived BAPCPA and individual Chapter 11 debtors may not keep prepetition property or earnings.

   a. Rationale: Section 1115 only adds to the definition of property of the estate under Section 541. It does not incorporate or replace Section 541 for individual debtors.

   b. Additional arguments.

      (i) Grammar of Section 1115: Because the phrase "in addition to the property specified in Section 541" is "not the direct object of the transitive verb, 'includes'" stated differently, the phrase "is not an answer to the question what is included as 'property of the estate' under §1115)." The phrase merely expands the property that will be deemed included among the property of the estate. In re Arnold, 471 B.R. 578, 602 (Bankr. C.D. Cal. 2012), overruled by Zachary v. California Bank & Trust, 811 F.3d 1191 (9th Cir. 2016). The statutory language and Congress' intent are ambiguous and do not provide a clear indication that Congress intended to change existing practices.

      (ii) BAPCPA was enacted to curb abusive bankruptcy practices.

   c. Representative cases: Zachary v. California Bank & Trust, 811 F.3d 1191 (9th Cir. 2016); In re Ice House America, LLC v. Cardin, 751 F.3d 734 (6th Cir. 2014); In re Lively, 717 F.3d 406 (5th Cir. 2013); In re Stephens, 704 F.3d 1279 (10th Cir. 2013); In re Maharaj, 681 F.3d 558 (4th Cir. 2012); Brown v. Ferroni (In re Brown), 505 B.R. 638 (E.D. Pa. 2014). The Narrow View has become the majority view among the Circuits. See In re Brown, 498 B.R. 486, 503-04 (Bankr. E.D. Pa. 2013).

   d. The consequences of the Absolute Priority Rule in those jurisdictions applying the "Narrow View" are harsh.

      The debtor must either pay unsecured creditors in full

      OR

Pay over all disposable income for the longer of 5 years or the period of payments under the plan.	+	Liquidate all prepetition property, other than exempt property

4. Does retention of property that the debtor claimed as exempt violate the Absolute Priority Rule? No. In re Maharaj, 681 F.3d 558 (4th Cir. 2012)

V. **There is no absolute right to convert an individual debtor's Chapter 11 case to a Chapter 7 case.**

VI. **Statutory Framework**

A. Section 1112 – Conversion or dismissal

1. The debtor may convert a case under this Chapter to a case under Chapter 7 of this title unless –

a. the debtor is not a debtor in possession;

b. the case originally was commenced as an involuntary case under this chapter; or

c. the case was converted to a case under this chapter other than on the debtor's request.

(i) (1) Except as provided in paragraph (2) and subsection (c), on request of a party in interest, and after notice and a hearing, the court shall convert a case under this chapter to a case under Chapter 7 or dismiss a case under this chapter, whichever is in the best interests of creditors and the estate, for cause unless the court determines that the appointment under Section 1104(a) of a trustee or an examiner is in the best interests of creditors and the estate.

(ii) The court may not convert a case under this chapter to a case under Chapter 7 or dismiss a case under this chapter if the court finds and specifically identifies unusual circumstances establishing that converting or dismissing the case is not in the best interests of creditors and the estate, and the debtor or any other party in interest establishes that--

(a) there is a reasonable likelihood that a plan will be confirmed within the timeframes established in Sections 1121(e) and 1129(e) of this title, or if such sections do not apply, within a reasonable period of time; and

(b) the grounds for converting or dismissing the case include an act or omission of the debtor other than under paragraph (4)(A)--

(1) for which there exists a reasonable justification for the act or omission; and

(2) that will be cured within a reasonable period of time fixed by the court.

2. The court shall commence the hearing on a motion under this subsection not later than 30 days after filing of the motion, and shall decide the motion not later than 15 days after commencement of such hearing, unless the movant expressly consents to a continuance for a specific period of time or compelling circumstances prevent the court from meeting the time limits established by this paragraph.

a. For purposes of this subsection, the term "cause" includes –

(i) substantial or continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation;

(ii) gross mismanagement of the estate;

(iii) failure to maintain appropriate insurance that poses a risk to the estate or to the public;

(iv) unauthorized use of cash collateral substantially harmful to 1 or more creditors;

(v) failure to comply with an order of the court;

(vi) unexcused failure to satisfy timely any filing or reporting requirement established by this title or by any rule applicable to a case under this chapter;

(vii) failure to attend the meeting of creditors convened under Section 341(a) or an examination ordered under rule 2004 of the Federal Rules of Bankruptcy Procedure without good cause shown by the debtor;

(viii) failure timely to provide information or attend meetings reasonably requested by the United States trustee (or the bankruptcy administrator, if any);

(ix) failure timely to pay taxes owed after the date of the order for relief or to file tax returns due after the date of the order for relief;

(x) failure to file a disclosure statement, or to file or confirm a plan, within the time fixed by this title or by order of the court;

(xi) failure to pay any fees or charges required under Chapter 123 of Title 28;

(xii) revocation of an order of confirmation under Section 1144;

(xiii) inability to effectuate substantial consummation of a confirmed plan;

(xiv) material default by the debtor with respect to a confirmed plan;

(xv) termination of a confirmed plan by reason of the occurrence of a condition specified in the plan; and

(xvi) failure of the debtor to pay any domestic support obligation that first becomes payable after the date of the filing of the petition.

B. Section 1109(b) – Right to be heard

1. A party in interest, including the debtor, the trustee, a creditors' committee, an equity security holders' committee, a creditor, an equity security holder, or any indenture trustee, may raise and may appear and be heard on any issue in a case under this chapter.

C. Section 706 – Conversion

1. The debtor may convert a case under this chapter to a case under Chapter 11, 12, or 13 of this title at any time, if the case has not been converted under Section 1112, 1208, or 1307 of this title. Any waiver of the right to convert a case under this subsection is unenforceable.

* * *

2. Notwithstanding any other provision of this section, a case may not be converted to a case under another chapter of this title unless the debtor may be a debtor under such chapter.

D. Section 1307 – Conversion or dismissal

1. The debtor may convert a case under this chapter to a case under Chapter 7 of this title at any time. Any waiver of the right to convert under this subsection is unenforceable.

2. On request of the debtor at any time, if the case has not been converted under Section 706, 1112, or 1208 of this title, the court shall dismiss a case under this chapter. Any waiver of the right to dismiss under this subsection is unenforceable.

a. Except as provided in subsection (f) of this section, on request of a party in interest or the United States trustee and after notice and a hearing, the court may convert a case under this chapter to a case under Chapter 7 of this title, or may dismiss a case under this chapter, whichever is in the best interests of creditors and the estate, for cause, including--

(i) unreasonable delay by the debtor that is prejudicial to creditors;

(ii) nonpayment of any fees and charges required under Chapter 123 of title 28;

(iii) failure to file a plan timely under Section 1321 of this title;

(iv) failure to commence making timely payments under section 1326 of this title;

(v) denial of confirmation of a plan under Section 1325 of this title and denial of a request made for additional time for filing another plan or a modification of a plan;

(vi) material default by the debtor with respect to a term of a confirmed plan;

(vii) revocation of the order of confirmation under Section 1330 of this title, and denial of confirmation of a modified plan under Section 1329 of this title;

(viii) termination of a confirmed plan by reason of the occurrence of a condition specified in the plan other than completion of payments under the plan;

(ix) only on request of the United States trustee, failure of the debtor to file, within fifteen days, or such additional time as the court may allow, after the filing of the petition commencing such case, the information required by paragraph (1) of Section 521(a);

(x) only on request of the United States trustee, failure to timely file the information required by paragraph (2) of Section 521(a); or

(xi) failure of the debtor to pay any domestic support obligation that first becomes payable after the date of the filing of the petition.

VII. **Does a Chapter 11 Debtor Have the Right to Convert to a Chapter 7?**

A. A Chapter 11 debtor's request to convert his case to Chapter 7 can be denied. Circumstances that would justify denial of the request to convert are generally extreme and include bad faith, but do not require a finding of bad faith.

B. In re Adler, 329 B.R. 406 (Bankr. S.D. N.Y. 2005) (Honorable Burton R. Lifland) (finding right to convert from Chapter 11 to Chapter 7 is not absolute and "cause" existed to dismiss case with prejudice for 180 days).

1. A Chapter 11 debtor's right to convert to Chapter 7 is not absolute.

Rationale:

a. The language of §1112(a) clearly states that a debtor "may" convert her case, but does not state that the court "shall" honor the request. Thus, the statute's use of the verb "may," rather than "shall," supports the view that the right to convert is not absolute.

b. Bankruptcy Rule 2002(a)(4) provides that a motion to convert a Chapter 11 case on at least 20 days' notice. "If the debtor had an automatic right to conversion, notice of the pending conversion would not be needed, creditors would only need to receive notice of the new chapter after the conversion of the case." Adler, 329 B.R. at 409.

c. In considering conversion, many courts have either (1) recognized that conversion may not be proper in situations involving "extreme circumstances" or (2) engaged in some type of equitable analysis of the facts, and whether a debtor can propose or has proposed a confirmable plan.

C. In re Johnson, 546 B.R. 83 (Bankr. S.D. Ohio 2016).

1. "When a debtor originally commences a chapter 11 case and then seeks to convert it to chapter 7, courts analyze the factors demonstrating bad faith – including a lack of candor, an ability to pay, and unwillingness to reduce excessive spending and take other steps necessary to provide creditors a meaningful recovery – through the lens of chapter 11's purpose. And that purpose is to provide debtors an opportunity to reorganize and repay creditors more than they would receive in liquidation. Thus, when an individual debtor begins in chapter 11, in addition to examining his prepetition conduct, courts also consider whether the debtor has conducted his chapter 11 case in a manner suggestive of an intent to reorganize and repay his debts." See id. at 160 *citing* In re Adle*r*, 329 B.R. 406, 410 (Bankr. S.D.N.Y. 2005).

2. In In re Johnson, the bankruptcy court listed five factors that led it to the conclusion that the debtor had not conducted himself in good faith, and as such, the debtor's request to convert from a Chapter 11 case to a Chapter 7 case would be denied. The factors listed by the Bankruptcy Court are:

   a. Whether the debtor made a good-faith attempt to repay his debts prior to bankruptcy by reducing his excessive expenditures;

   b. Whether the debtor has conducted his Chapter 11 case in a manner consistent with the purpose of reorganizing and repaying his debts;

   c. Whether the debtor has exhibited candor during the bankruptcy case;

   d. Whether the debtor has made a good-faith attempt to repay his debts by eliminating his excessive expenditures while in bankruptcy; and

   e. Whether the debtor, if he reduced his expenditures, would have sufficient income to repay creditors a dividend that would exceed what they would receive in a Chapter 7 liquidation of his non-exempt assets. *Johnson*, at 160-61.

D. Mahanna v. Bynum, 465 B.R. 436 (W.D. Tex. 2011) (affirming bankruptcy court's decision dismissing chapter 11 case).

   1. The language of §1112(a) is permissive, not mandatory.

E. Monroe Bank & Trust v. Pinnock, 349 B.R. 493 (E.D. Mich. 2006) (in a decision of first impression holding that Bankruptcy Code does not confer an absolute right to convert from Chapter 11 to Chapter 7).

   1. The plain language of §1112(a) does not grant the debtor an absolute right to convert.

F. Marrama v. Citizens Bank of Massachusetts, 549 U.S. 365 (2007).

   1. In the Adler decision (referenced above), Bankruptcy Judge Lifland in the Southern District of New York drew analogies from and referenced the Marrama opinion rendered by the U.S. Court of Appeals for the First Circuit. In re Marrama, 313 B.R. 525 (1st Cir. BAP 2004). In Adler, Judge Lifland determined that there is no absolute right to convert a Chapter 11 case to a Chapter 7 case.

   2. In Marrama, where Judge Lifland looked for support for his Adler decision, the BAP for the First Circuit affirmed that the bankruptcy court has authority to deny a debtor's request for conversion from Chapter 7 to Chapter 13 because of the existence of "unusual circumstances"

constituting bad faith. The existence of extreme circumstances is a factual determination of "bad faith, abuse of process, or other gross inequity, and such cases usually involve egregious conduct on the part of the debtor, who is seeking to use the bankruptcy process abusively and selfishly rather than for its intended purpose." See Marrama, 313 B.R. at 531.

3. The U.S. Supreme Court granted certiorari to resolve a conflict among circuits as to whether or not a bad-faith debtor has an absolute right to convert a Chapter 7 case into a Chapter 13 case. The Supreme Court held that a Chapter 7 debtor forfeited his right to convert to a Chapter 13 case under §706(a) when the request was made in bad faith and would be considered an abuse of process. Marrama v. Citizens Bank of Massachusetts, et al., 549 U.S. 365 (2007).

4. §706(d) conditions a debtor's right to convert from a Chapter 7 case to a Chapter 11, 12 or 13 case on the debtor's ability to qualify as a debtor under the particular chapter to which the debtor wishes to convert. In the case of a Chapter 7 debtor that wishes to convert to a Chapter 13 case, there are two possible reasons that would render a Chapter 7 debtor ineligible to proceed under Chapter 13. One reason may be failure to stay within the debt limits arising under §109(e). Another reason may be found in §1307(c), which contains a non-exhaustive list of ten (10) instances that are examples of "cause."

5. The Supreme Court noted that none of the enumerated instances of "cause" under §1307(c) mention pre-petition bad faith conduct. The Supreme Court noted that "[b]ankruptcy courts nonetheless routinely treat dismissal for pre-petition bad-faith conduct as implicitly authorized by the words 'for cause.'" See id. at 373.

6. Thus, even in the context of conversion "up" from a Chapter 7 case to a case under a Chapter 11, 12 or 13, conversion is not absolute for everyone. The right to convert is only absolute for the majority of debtors who are the class of honest, but unfortunate debtors who wish to legitimately use the Bankruptcy Code in order to gain a fresh start.

VIII. Can a Chapter 11 Case be Dismissed (Rather than Converted to a Chapter 7) If it Appears Evident that a Plan Cannot be Confirmed? Yes.

A. Inability to propose a feasible reorganization or liquidation plan provides "cause" for dismissal or conversion of a Chapter 11 case on request of a disinterested party. In re Brown, 498 B.R. 486, 503-04 (Bankr. E.D. Pa. 2013). See also In re Santiago, 2015 Bankr. LEXIS 3438 (Bankr. D. P.r. 2015); In re MDM Gold of Gillette Ridge, LLC, 2014 Bankr. LEXIS 5126 (Bankr. D. Conn. 2014); In re Shap, LLC, 457 B.R. 625, 629 (Bankr. E.D. Mich. 2011).

IX. **What is an Individual Chapter 11 Debtor to do?**

A. Consider the asset rich, high income Chapter 11 debtor who files a motion to convert his case to a Chapter 7 case on the eve of a hearing on the U.S. Trustee's motion to appoint a Chapter 11 trustee under §1104.

1. Does the bankruptcy court proceed with the hearing on the trustee motion? Or should the motions be combined and heard on the same day? Consider §1112(a)(1), which divests a debtor from seeking conversion after it is no longer a debtor-in-possession.

2. Does §1112(b) have bearing on the scenario? Section §1112(b)(1) states that "on request of a party in interest …the court shall convert a case under this chapter to a case under Chapter 7 or dismiss . . , whichever is in the best interests of creditors and the estate, unless the court determines that the appointment under § 11104(a) of a trustee or an examiner is in the best interests of creditors and the estate. Is a debtor a "party in interest"? *See* § 1109 (Right to be heard).

B. What if an individual Chapter 11 debtor is defending against an effort by a creditor or other party who seeks conversion or dismissal of the case? Consider §1112(b)(2) which sets forth circumstances in which the court "may not" convert or dismiss a chapter 11 case.

C. Consider a comparison analysis of what creditors would receive in a Chapter 7 liquidation versus the alternative of pursuing collection outside of bankruptcy.