

THE DISAPPEARING CORPORATE DEBTOR

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Enactment of BAPCPA, was, in large part, driven by a philosophical decision that prospective debtors with significant income should make a substantial effort to pay some portion of their debts. Proponents of the legislation preferred to push debtors into repayment plans. Chapter 13 received the most attention, but, some debtors, those with high incomes or large home mortgages, could not meet the debt limits of Chapter 13.

The greatest impediment to pre-BAPCPA individual Chapter 11 debtors was the rule of absolute priority. In order to confirm a plan of reorganization over rejection by a dissenting class, (cram down) the dissenting class had to be paid 100% of their allowed claims. For individuals, the rule of absolute priority has been abandoned for a best interest of creditors test. Bankruptcy Code §1129(b)(2)(B).

It has not been uncommon for incorporated “Mom and Pop” businesses to seek relief under Chapter 13 by formally (in some instances, informally) transferring business assets to themselves immediately before seeking relief. Do the individual debtor modifications to Chapter 11 open the door for business reorganizations that might not have been possible under pre-BAPCPA Chapter 11?

HYPOTHETICAL

Dan Debtor is 56 years old and divorced. He owns 50% of the outstanding stock in Insolvent Co., Inc. The remaining stock is owned by his 75 year-old brother who is disabled and owns no other assets. Insolvent Co., Inc.’s balance sheet (assets at FMV, not book):

INSOLVENT CO., Inc.
Balance Sheet
December 31, 2006

Assets:

Current Assets

Deposit Accounts	\$ 15,000
Accounts Receivable (net)	\$ 225,000

Fixed Assets

Equipment	\$ 650,000
Land and Improvements	<u>\$1,250,000</u>

Total Assets		<u>\$2,140,000</u>
Liabilities:		
Current Liabilities		
Trade Accts (unsecured)	\$ 375,000	
Operating Line (secured)	\$ 185,000	
Equipment Financing (secured)	\$ 675,000	
Other Liabilities		
First Mortgage	\$ 725,000	
Second Mortgage	<u>\$ 450,000</u>	
Total Liabilities		\$2,410,000
Equity		(\$ 270,000)
Total Liabilities and Equity		<u>\$2,140,000</u>

Dan Debtor is a personal guarantor of the Operating Line and the Equipment Financing. He believes it "might be possible" that the collateral supports both obligations. In discussions, Dan concludes that the trade creditors will be paid nothing if there is a liquidation. Stripped of its unsecured debt, the business could generate sufficient revenue to pay Dan a living wage with about \$8,000 per year that could serve pre-bankruptcy creditors. If necessary, Dan can draw on his exempt Pension/IRA assets to make it work.

Dan Debtor's Personal Financial Statement (assets at FMV, not book) looks like:

Assets:		
Deposit Accounts	\$ 15,000	
Insolvent Co., Inc. Stock	\$ 0	
Pension/IRA (net of loans)	\$ 650,000	
Vehicle (2002 Ford F-350)	\$ 12,150	
Home	<u>\$ 275,000</u>	
Total Assets		\$ 952,150
Personal Liabilities:		
MegaCredit Card	\$ 25,000	
Home Equity Line of Credit	\$ 75,000	
Home Mortgage	<u>\$ 200,000</u>	
Total Liabilities		<u>\$ 300,000</u>
Asset Value for Unsecured Creditors		\$ 25,000

Dan and his lawyer conclude that, if Dan files a personal bankruptcy, his personal creditors will be paid in full. His guarantees of corporate debt will be fully satisfied by the corporation's assets which secure the debt.

Dan wants to continue his business (the business of Insolvent Co., Inc.) for a multitude of economic and non-economic reasons. He has been working on a secret process. It is incomplete today, but will generate a competitive advantage beginning in about three years. He believes that in just five more years his secret process will be widely recognized. Until then, pickings will be slim. There will be almost no money to pay today's trade creditors. Some of those trade creditors have become hostile. Dan's lawyer concludes that Insolvent Co., Inc. cannot confirm a plan of reorganization because it cannot meet the absolute priority rule.

Dan and his lawyer decide to dissolve Insolvent Co., Inc. Dan will first acquire all of his brother's stock. Then he will assume all of the debt. Dan will, then, immediately file an Individual Chapter 11 proposing to pay all of his unsecured creditors (personal and formerly corporate) \$40,000 (10¢ on the dollar). Arithmetically, there would be no money for unsecured creditors if Dan filed a Chapter 7 case after dissolving the corporation. All secured creditors (personal and corporate) endorse this proposal. They will vote to confirm the plan. The corporate trade creditors will, by a slim margin, vote to confirm the plan because 10¢ is better than nothing. MegaCredit Card will object to the plan and vote against it. MegaCredit Card's objection is based on its claim that Dan has defrauded his personal creditors (MegaCredit Card) and would be denied a discharge in Chapter 7. It believes that the case is filed and the plan proposed in bad faith.

DISPOSING OF THE CORPORATION

A. Why Collapse the Corporation?

The basic plan is quite simple. Reorganization of Insolvent Co, Inc. is impractical. If it seeks to reorganize, Dan Debtor must also seek protection. Two bankruptcy cases. Two lawyers. Two retainers. Even without debt service to unsecured creditors, its cash flow during the next five years will be marginal. It has no hope of repaying a significant amount of unsecured debt. The proposal will not pass the absolute priority test described in 11 USC §1129(b)(2)(B). Dan's lawyer advises him that, a corporate reorganization is out of the question.

The lawyer has a flash of brilliance. Before BAPCPA, it was not uncommon for a "Mom and Pop" business to seek relief by dissolving the corporation, or other limited liability entity, and then file a case under Chapter 13, scheduling all of the business debts. There is only one bankruptcy case to support. The test of confirmation is the best interest of creditors, i.e., creditors will receive the greater of the value of assets retained by the debtor, or, the debtor's net disposable earnings for the life of the plan. The "rule of absolute priority" is inapplicable. But, saddled with assumption of Insolvent Co., Inc.'s debt, Dan would no longer be eligible for relief

under Chapter 13. In the hypothetical, Dan Debtor may have qualified for relief under Chapter 13 had he not assumed the corporation's assets and liabilities. (This would depend on the extent of his personal guarantee of unsecured debt.) By choosing to dissolve the corporation and assume its debt, Dan disqualifies himself from relief under Chapter 13.

Dan's lawyer focuses on revised §1129(b)(2)(B). Seemingly, the BAPCPA amendments eliminated the "rule of absolute priority" for individuals seeking relief under Chapter 11. As pertinent here, Section 1129(b)(2)(B) now provides,

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

(*Emphasis added.*)

B. How Does Dan Collapse the Corporation?

Dissolution. The state's corporation code describes a statutory process for dissolution. Action by the board of directors and/or the shareholders starts the process. *See*, for instance, ORS 60.624; ORS 60.627. Once authorized, the corporation must file articles of dissolution with the name of the corporation, date dissolution was authorized, and information about the voting. ORS 60.631. If the corporation is dissolved by the incorporators or initial directors, the articles of dissolution must indicate that no corporate debts remain unpaid. ORS 60.621. Dissolution does not end the corporate existence. The corporation may not carry on any business but actions may still be brought against it and property levied on. ORS 60.637. With respect to creditors, Oregon law provides that a dissolved corporation "*may*" dispose of known claims in the manner prescribed in ORS 60.641, which says in Section (2) that the dissolved corporation "*shall*" notify creditors of the dissolution.

Query: How would claims of Insolvent Co., Inc.'s creditors be treated in Dan Debtor's bankruptcy? What if those creditors sought return of specific corporate assets to satisfy claims of Insolvent Co., Inc.'s creditors.

If Dan Debtor dissolves the corporation in anticipation of filing an individual Chapter 11, he can't notify creditors and pay claims. That would thwart the entire bankruptcy process. What's more, the amounts available to Dan Debtor's corporate creditors will be different if those

debts are included in a personal Chapter 11 because creditors now will be paid from Dan Debtor's personal assets as well. Thus, practically speaking, how is "collapse" accomplished?

Sell Assets for Assumption of Debt. Consider a bulk sale of all assets, which requires a board resolution (in a "Mom and Pop" business, often the type of formality overlooked). *See* ORS 60.534. The sale price would be assumption of all the debt - is that a fair price? Perhaps Dan Debtor does a Bill of Sale for the corporate assets and then files Articles of Dissolution with the Secretary of State but doesn't provide any noticing to creditors. A few weeks later when he files Chapter 11, of course, these creditors will get notice of the filing.

Query: Dan Debtor will "overpay" \$270,000. If Dan Debtor assumes all corporate debt as the price for its assets, has a transfer in fraud of creditors occurred? Bankruptcy Code §548 addresses transfers for less than equivalent consideration. How much value will be attributed to the secret process? Note that representation that the process has significant value may put the cost of reorganizing out of reach.

Ignore the Formalities. What if Dan Debtor just buys his brother's stock, becomes the sole shareholder, thereby assuming all of the corporate debt without a Bill of Sale? That is likely more problematic as is illustrated by a 1997 Chapter 13 case where a debtor "collapsed" her corporation without following state corporate dissolution law and tried to keep the corporate assets (vehicles). *In re Lane*, 215 B.R. 810 (Bankr. E.D. Va. 1997). The debtor even tried arguing that her own corporate veil should be pierced, noting that she treated the vehicles as hers personally. The court disagreed and noted that, upon dissolution, she was obligated to notify creditors and to return the collateral to them. She simply did not have an interest in them.

C. *Creditor Objections to Collapse & Implications for Debtor's Counsel.*

MegaCredit Card cries foul. Had Dan not attempted to salvage Insolvent Co., Inc., MegaCredit Card would be paid in full. After Dan's assumption of Insolvent Co., Inc.'s debt, it will be paid 10% of its claim. It argues that the Dan Debtor's Chapter 11 case is filed in bad faith. Dan's plan cannot be proposed in good faith. Bankruptcy Code §1129(a)(3). MegaCredit Card will not be paid the amount that it would have been paid had Dan not assumed Insolvent Co., Inc.'s debt and had filed under Chapter 7. MegaCredit Card asks its attorney to block Dan's effort to obtain a discharge. Bankruptcy Code §1141(d)(5).

D. *The Lawyers Ethical Obligations.*

Debtor's bankruptcy counsel is expected to structure his client's affairs to take maximum advantage of exemptions and other provisions of the law that will soften the impact of a client's crash. But, a creative attorney might expose his client to claims of actual or constructive fraud. For example, *see In re Woodfield*, 978 F.2d 516, 518 (9th Cir. 1992). In *Woodfield*, on the eve of bankruptcy, the debtors incorporated their business, transferring an equal amount of assets and liabilities to the new corporation which had no equity upon formation. The fortunate creditors of

the new corporation were assured full payment of their claims. The creditors whose debts were not assumed, were to receive a diminished share of their claims. The 9th Circuit reversed the bankruptcy court and the district court, holding that the plan, which was the inverse of Dan Debtor's situation, was sufficient to deny the debtors discharges. Under Section 727(a)(2).

The Oregon Supreme Court has held that an attorney who counsels a client to make a fraudulent transfer is subject to disciplinary sanctions. *In re Hockett*, 303 Or 150, 160-162, 734 P2d 877 (1987).

Query: Does Dan Debtor's lawyer risk disciplinary sanction for counseling a client to commit a fraudulent transfer? Consider that a lawyer who has a reasonable and good faith basis may not be subject to discipline. *In re Hockett* 303 Or at 162 n.3.

CONFIRMING A PLAN

In our hypothetical, the only dissenting creditor is Mega Card. As he drafts the proposed plan, Dan Debtor's lawyer must focus on the proposed treatment of Mega Card. In order to be confirmed, a Chapter 11 plan must meet the standards described in Bankruptcy Code §1129(a)(1)-(16). If each enumerated requirement is met, with the exception of item 8 (acceptance by all impaired classes), the plan may be confirmed by meeting the requirements of Bankruptcy Code §1129(b). BAPCPA has added provisions to accommodate individuals seeking relief under Chapter 11.

A. Changes to Cogitate When Crafting the Plan.

Property of the Estate. Bankruptcy Code §1115 (a). In an individual case, property of the estate now includes, in addition to property described in Bankruptcy Code §541, post-petition personal service income and any other property acquired before the case is closed, dismissed, or converted. Both are significant changes. Three years after filing his case, Dan Debtor might discover that his process is all wrong. In a flash of recognition, he comes upon a patentable process worth millions. Four years after he files his Chapter 11 case, Dan Debtor's father might pass away, leaving him \$350,000. Before BAPCPA, neither would have been property of the estate. Today, both will be. The changes are significant because Bankruptcy Code §1127 permits the debtor, the trustee, the U.S. Trustee, or the holder of an unsecured claim to seek modification of a confirmed plan to provide for an extension of the time for payments or an increase in the amount of payments. Implicitly, but not explicitly, unplanned increases in property of the estate will be a cause for such modifications.

The Order of Discharge. Bankruptcy Code §1141(d)(5) now delays entry of an individual debtor's discharge until the court grants a discharge on completion of all payments under the plan.

Query: If the plan pays all unsecured claims within five years but restructures a real property mortgage over a normal amortization period, say, 15 years, is the discharge deferred for 15 years?

Involuntary Servitude. Bankruptcy Code §§1112, 1115, 1127, 1129(a)(15), 1141(d)(5)(A).

- ▶ A Chapter 11 case cannot be converted to a case under another Chapter if the debtor is ineligible for relief under that Chapter. Bankruptcy Code §1112.
- ▶ Virtually all income earned and property acquired after the petition and before closure of the estate is property of the estate. Bankruptcy Code §1115(a).
- ▶ At any time before completion of payments under the plan, the debtor, the trustee, the US Trustee or the holder of an unsecured claim may seek to modify the plan by, among other things, extending the payment plan. Bankruptcy Code §1127.
- ▶ Payments to the holder of an unsecured claim may extend beyond five years. Bankruptcy Code §1129(A)(15).
- ▶ A discharge is not entered until completion of all payments under the plan. Bankruptcy Code §111(d)(5).

Query: Dan Debtor's plan proposes to reamortize the mortgages secured by his commercial real estate. As is relatively common, he proposes a 15 year amortization. Dan's plan proposes payments for a period of ten years. Can the U.S. Trustee move, after 9 years to extend the plan because Dan's secret process has hit the front page of the Wall Street Journal? When does Dan ever get out of Chapter 11?

B. Classification of Claims.

Bankruptcy Code §1123(a)(1). A plan shall designate classes of claims. As a general proposition, general unsecured claims are classified in the same class. Mega Card rightfully believes that its potential 100% dividend has been watered down to a 10% dividend as a result of Dan Debtor's attempt to preserve Insolvent Co., Inc. Mega Card believes it should be classified separately and treated. It will demand better treatment than the corporate debts assumed by Dan Debtor.

C. Proposed Distribution to Unsecured Creditors.

Bankruptcy Code §§1129(a)(7), 1129(a)(15). Subparagraph requires that the plan provide that each member of an impaired class must either accept the plan, or receive an amount equal to or greater than what the member would receive in a liquidation under Chapter 7. **But**, subparagraph (15) provides different treatment for an unsecured creditor who objects to the plan. Such a creditor must either receive a 100% distribution or a dividend based on the disposable net income of the Debtor for five years.

Query: Assume that Dan Debtor's proposed plan provides for payment of a 10% dividend over five years. That amount is based on the value of Dan's non-exempt, unencumbered equity. Further assume that Dan's projected disposable net income would support only a 5% distribution. (The remainder will come from Dan's exempt pension fund.) Can Dan confirm a plan that proposes to pay Mega Card only 5% because it has objected to the proposed 10% distribution?

D. Cram-Down and Absolute Priority.

The court may confirm a plan that meets all requirements of Bankruptcy Code §1129(a) except subparagraph (8.) (acceptance by each impaired class) if the plan meets certain other standards. With respect to an unsecured class of claims, the former version of Bankruptcy Code §1129(b)(2)(B) imposed the "rule of absolute priority." Members of a dissenting class of unsecured claims must either be paid an amount equal to their claims, or the holders of junior claims and interests must receive nothing. BAPCPA seems to eliminate the rule of absolute priority for individuals progressing through Chapter 11.

The statutory basis for the rule of absolute priority has been amended by adding two key provisions for confirmation of a plan.

- ▶ A plan may allow an individual to propose to pay dissenting unsecured creditors on the basis of "projected disposable income" of the debtor for five years. §1129(a)(15).
- ▶ In cram down, a debtor who is an individual "may retain property included in the estate under Section 1115, subject to the requirements of subsection (a)(14) of this section." §1129(b)(2)(B)(ii).

Query: Can Dan Debtor "cram down" confirmation of a Chapter 11 plan in which he pays unsecured creditors the greater of what they would receive in a hypothetical case filed under Chapter 7, or the amount of his projected disposable earnings for five years?

The U.S. Supreme Court held that "no Chapter 11 reorganization plan can be confirmed over the creditors' legitimate objections (absent certain conditions not relevant here) if it fails to

comply with the absolute priority rule.” *Norwest Bank Worthington, et. al. v. Ahlers*, 485 U.S. 197, 108 S.Ct. 963, 99 L.Ed. 2d 169 (1988). A debtor’s contribution of future labor, experience, and expertise (“sweat equity”) were not sufficient to allow debtor family farm to retain its equity interest in the farm. *Norwest*, 485 U.S. at 204-205. The court expressly declined to comment on the continuing vitality of its earlier decision in *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939) that recognized a possible “new value” exception to the absolute priority rule for contributions of “money or money’s worth.” *Norwest*, 485 U.S. at 203 n. 3. The “rule of absolute priority” now permits a debtor to retain “property of the estate under Section 1115. . . .” But, it is unclear what that reference might mean. Bankruptcy Code §1115 describes property of the estate (as defined in Bankruptcy Code §341) plus earnings from services performed after commencement of the case and before the case is closed, dismissed or converted. May the debtor retain any property of the estate or just post-petition personal service income? When read together Bankruptcy Code §§ 1129(a)(15) and (b)(2)(B) create a new value exception that allows an individual debtor to use post-petition personal service income to retain property by contributing the value of the property. The debate is not over. Consider the following excerpts:

Senate Report on Senate Bill 256, the BAPCPA, “Section 321(c) also amends Section 1129(b)(2)(B)(ii) of the Bankruptcy Code to provide that an individual Chapter 11 debtor may retain property included in the estate under Section 1115 (as added by the Act), subject to Section 1129(a)(14).” This really tells us nothing and as the Honorable Bruce Markell notes (see below), there is nothing to help us in the legislative history.

7-1129 Collier on Bankruptcy, P 1129.LH (15th ed. Rev. 2006): “Section 1129(b)(2)(B)(ii) was amended to indicate that an individual debtor may keep postpetition service income--made estate property by the concurrent adopting of Section 1115--and still confirm a plan over the dissent of a class of unsecured creditors.”

4 Norton Bankr. L. & Prac. 2d § 84A:1: “The absolute priority requirements imposed by Code 1129(b)(2)(B)(ii) were waived by permitting a debtor to retain property included in the estate under 1115. Although 1115 was added by the 2005 Amendments to include post-petition property and earnings, it also incorporates property of the estate under 541, and accordingly it is assumed that the debtor shall be entitled to retain property under 541 as well. A more narrow interpretation would cause this amendment to have little effect.”

Ordin on Contesting Confirmation, 3rd ed., ALERT-6 (Supplement) noting that, in cram down scenario, “debtor may retain estate property subject to the requirements in Section 1129(a)(14), which provides that, at a minimum, the debtor’s disposable income over five years must be dedicated to plan payments if an unsecured creditor objects to confirmation.”

Bruce A. Markell, *The Sub Rosa Subchapter: Individual Debtors in Chapter 11 After BAPCPA*: Wondering does Section 1115’s language “bring all of the property snagged by Section 541 into the Chapter 11 estate, such that a person could say that Section 1115, by incorporation, specifies all property of the estate in Chapter 11 cases? If so, then the exception

in Section 1129 (b)(2)(B)(ii) just got a lot more interesting. Given the paucity of legislative history on this point, it is unclear what the intended scope of the section is.”

E. *Use of Exempt Property to Fund a Plan.*

Dan Debtor’s projected disposable income marginally meets the requirements for confirmation. Can he bridge the gap using exempt assets? Prior to enactment of BAPCPA, there was a split of authority regarding whether a Chapter 11 debtor could retain exempt property. One view held that debtor’s interest in exempt property was junior to a dissenting class of unsecured creditors and that a debtor could not retain it because of the phrase “any property” in Section 1129(b)(2)(B)(ii). See *In re Fross*, 233 B.R. 176 (BAP 10th Cir. 1999) and *In re Gosman*, 282 B.R. 45 (Bankr. S.D. Fla. 2002). The other view held that debtor’s interest was not junior because debtor retained exempt property as of right once the exemptions are allowed and exempt property could never be reached outside of bankruptcy nor liquidated in bankruptcy. See *In re Henderson*, 321 B.R. 550 (Bankr. M.D. Fla. 2005), *aff’d*, 341 B.R. 783 (M.D. Fla. 2006); *In re Bullard*, 2007 Bankr. LEXIS 100 (Bankr. D. Conn. 2007) (citing cases).

CONCLUSION

The jury is still out on whether Chapter 11 relief for individuals provides an opportunity to reorganize and operating business. A careful comparison of Chapter 13 to the new provisions of Chapter 11 suggest an intent that individual Chapter 11 cases be treated in much the same way as Chapter 13 cases. But, if that is true, why didn’t Congress simply increase the debt ceilings for individuals seeking relief under Chapter 13.

SUGGESTED READING

Hon. Paul W. Bonapfel, *Individual Chapter 11 Cases under BAPCPA*, ABI Journal, July/Aug 2006.

American Bankruptcy Institute Journal, 25-6 ABIJ 10, July 2006, Article:, *Individual Chapter 11 Cases after BAPCPA: Can You Still Close the Case Early?*, Written by: Robert J. Landry III, U.S. Bankruptcy Administrator's Office, Anniston, Ala., robert_landry@alnb.uscourts.gov.

The University of Illinois, *University of Illinois Law Review*, 2007, 2007 U. Ill. L. Rev. 67, 13697 words, *Symposium: Consumer Bankruptcy and Credit in the Wake of the 2005 Act: the Sub Rosa Subchapter: Individual Debtors in Chapter 11 after BAPCPA*, Bruce A. Markell. Copyright (c) 2007.

American Bankruptcy Institute Journal, 25-6 ABIJ 1, July 2006, Feature:, Written by: Hon. Paul W. Bonapfel, U.S. Bankruptcy Court; Atlanta, paul_bonapfel@ganb.uscourts.gov

American Bankruptcy Institute, *American Bankruptcy Institute Law Review*, Winter, 2005, 13 Am. Bankr. Inst. L. Rev. 483, 10089 words, *Article: Dead Man Filing Redux: Is the New Individual Chapter Eleven Unconstitutional?*, Robert J. Keach. Copyright (c) 2005.

American Bankruptcy Institute Journal, 25-10 ABIJ 46, December 2006, Column:, Ghosts of Individual Chapter 11 Debtors: Ethical Issues in Representing Debtors in Individual Chapter 11s under BAPCPA: Part I, Contributing Editor: C.R. "Chip" Bowles Jr., Greenebaum Doll & McDonald PLLC, Louisville, Ky., crb@gdm.com.

National Conference of Bankruptcy Judges, *The American Bankruptcy Law Journal*, Summer, 2005, 79 Am. Bankr. L.J. 571, 16884 words, *Article: Constitutional Issues Posed in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, by Erwin Chemerinsky. Copyright (c) 2005.

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