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**Small Businesses and Individuals in Chapter 11**

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**By**

**Professor Jeffrey W. Morris  
Samuel A. McCray Chair in Law  
University of Dayton School of Law  
300 College Park  
Dayton, OH 45419  
(937) 229-3315  
[morris@udayton.edu](mailto:morris@udayton.edu)**

**and  
Of Counsel  
Porter, Wright, Morris & Arthur  
(937) 449-6708  
<jmorris@porterwright.com>**

This presentation addresses the treatment of small businesses and individuals under chapter 11 of the Bankruptcy Code. It includes a consideration of the relevant statutory definitions as well as the operative sections of chapter 11 that apply particularly to those debtors. Emphasis will be placed on the amendments to chapter 11 included in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”).

Individuals and small businesses have always been eligible for chapter 11 relief, Toibb v. Radloff, 501 U.S. 157 (1991), but BAPCPA has significantly changed the treatment of these entities for cases commenced on or after October 17, 2005. The changes include new provisions governing property of the estate, adjusted time periods for the filing and confirmation of plans, the use of form plans and disclosure statements and the possibility of plans operating as a disclosure statement, changes in the timing of the entry of a discharge in individual debtor cases, and the introduction of several provisions taken in large part from chapter 13 of the Bankruptcy Code.

These new provisions make chapter 11 resemble chapter 13 for individual debtors, and they arguably increase the burdens on small business debtors to reorganize under chapter 11. Additional reporting requirements and limits on the time of confirmation of plans could increase the cost for small businesses to successfully navigate chapter 11. Increased oversight by the United States trustee could improve the success rates of chapter 11 debtors, but it may drive others out of the process entirely.

## **I. What is a “Small Business Debtor” and a “Small Business Case”**

Sections 101(51C) and (51D) set out the definitions of a small business debtor and a small business case. A small business case is simply a chapter 11 case in which the debtor is a small business debtor. Thus, the real question is whether a particular debtor is a small business debtor. Prior to October 17, 2005, § 1121(e) of the Bankruptcy Code provided that the small business provisions of chapter 11 applied only if the debtor elected to be treated as a small business debtor. Since that time, the Code now provides that a small business debtors is any entity engaged in business that does not owe more than \$2,190,000 at the time of the commencement of the case. Individuals, partnerships, and corporations can be small business debtors. Excluded from the definition, however, are businesses engaged solely in the ownership or operation of real property. In 2005, Congress also amended the definition to exclude from “small business debtors” any such entity if there is an active and representative committee of unsecured creditors. The monetary limits should not present too many difficulties, although there could be disputes over whether the claims are contingent or unliquidated. Even there, however, there is guidance in the case law under chapters 12 and 13.

The potentially more difficult problem is the existence of an active and representative unsecured creditors’ committee. Under the Bankruptcy Code, the presence of such a committee operates to exclude the debtor from the definition of a small business. But,

the activity level of a creditors' committee can fluctuate over the course of a chapter 11 case. Creditors' committees, like middle aged joggers, get tired. When they do, the statute seems to anticipate that a particular debtor can become a small business debtor. Facing this potential for fluctuating status, the Advisory Committee on Bankruptcy Rules proposed a solution which the Supreme Court approved in April and which will become effective on December 1, 2008 (absent Congressional action to the contrary). Bankruptcy Rule 1020 requires a debtor filing a voluntary petition under chapter 11 to state on the petition whether it is a small business debtor. Under subdivision (b) of the rule, that initial designation is subject to challenge by any party in interest for 30 days from the time that the debtor makes the designation. Moreover, subdivision (c) of the rule provides that if an unsecured creditors' committee has been appointed, and the court thereafter determines that the committee is not sufficiently active and representative, then the debtor is a small business debtor only from that date forward. Making this determination operative on a prospective basis protects the debtor from a ruling that could easily make chapter 11 relief retroactively unavailable. If the determination is made after the time by which a small business debtor must file a plan, then no plan could be submitted and no real relief would be available.

## **II. First Matters – Meeting with the US Trustee and New Reporting Requirements**

Congress added § 1116 to the Code in 2005. It requires the trustee or debtor in possession in a small business case to file additional documents including a current balance sheet, statement of operations, cash-flow statement, and the latest Federal income tax return for the entity along with the voluntary petition, or within 7 days after the entry of the order for relief in an involuntary case. The section also requires the trustee or debtor in possession to time file all other required reports as well as tax returns. Finally, the trustee or debtor in possession must pay administrative priority taxes and maintain appropriate insurance for the business. These obligations were often established under local rules and practices prior to the adoption of § 1116, and the failure to meet some of these obligations constitute grounds for the dismissal or conversion of the case under § 1112 of the Code.

This increase in obligations fittingly arises at the commencement of the case. Many of the changes to the Code were intended to expedite the process. Presumably, the debtor and debtor's counsel will have undertaken as careful as possible a study of the debtor's financial position and reorganization prospects prior to filing the case. The abbreviated deadlines for filing and confirming a plan for a small business debtor make the front end preparation of the case even more important that it has been over the years.

In addition to filing the required materials, the debtor in possession or trustee must also meet with the United States trustee. The meeting is intended to provide the US trustee with the information needed to evaluate the debtor's prospects and to ensure that the debtor is complying with all of the requirements of the Bankruptcy Code and Rules. Among the 2005 amendments was the addition of § 586(a)(7) to title 28 which

specifically directs the US trustee to conduct this initial meeting with small business debtors to determine their economic viability and to ask about their business plan. The provision also states that the US trustee must “explain the debtor’s obligation to file monthly operating reports,” among other things. The US trustee has a right to review the debtor’s books and records upon reasonable written notice. Additionally, there are guidelines that are published by the US trustee program setting out the obligations of the debtor in possession regarding reporting requirements and the like.

Once the case is underway, there are new periodic reporting requirements that the debtor in possession or trustee must meet. Section 308 was added to the Code in 2005, and it provides that a small business debtor must provide periodic financial and other reports that set out the debtor’s profitability and compares the debtor’s projected and actual cash flow during the prior period. While the Code requires the debtor to file a report as to “profitability,” the debtor cannot avoid this obligation by failing to be profitable. These periodic reports also must state whether the debtor is in compliance with any other obligations under the rules and with the filing and payment of taxes and other governmental filings.

This obligation is new, and it should become effective on January 30, 2009. Section 434(b) of BAPCPA provides that § 308 becomes effective “60 days after the date on which rules are prescribed under section 2075 of title 28, United States Code, to establish forms to be used to comply with section 308 of title 11....” An amendment to Bankruptcy Rule 2015(a) adds new subparagraph (6) which governs the reporting requirement for small business debtors. Absent Congressional action to the contrary, that rule amendment becomes effective on December 1, 2008. Sixty days thereafter is January 30, 2009. Even though § 308 would not seem to be effective until that date, I believe that small business debtors will have to file periodic monthly reports under the rule beginning on December 1, 2008. Of course, the US trustee has already been requiring debtors to file these reports, so the “new” obligation is not really that new after all. The new rule provides that the trustee or debtor in possession shall

(6) in a chapter 11 small business case, unless the court, for cause, sets another reporting interval, file and transmit to the United States trustee for each calendar month after the order for relief, on the appropriate Official Form, the report required by § 308. If the order for relief is within the first 15 days of a calendar month, a report shall be filed for the portion of the month that follows the order for relief. If the order for relief is after the 15<sup>th</sup> day of a calendar month, the period for the remainder of the month shall be included in the report for the next calendar month. Each report shall be filed no later than 20 days after the last day of the calendar month following the month covered by the report. The obligation to file reports under this subparagraph terminates on the effective date of the plan, or conversion or dismissal of the case.

The Committee Note explains the new provision as follows:

Subparagraph (a)(6) implements § 308 of the Code, added by the 2005 amendments. That section requires small business chapter 11 debtors to file periodic financial and operating reports, and the rule sets the time for filing those reports and requires the use of an Official Form for the report. The obligation to file reports under this rule does not relieve the trustee or debtor of any other obligations to provide information or documents to the United States trustee.

Note that the last sentence of the Committee Note reminds us that this reporting obligation does not otherwise limit the United States trustee's review of the debtor's books and records and operations. The US trustee's duty to supervise chapter 11 cases under 28 U.S.C. § 586(a)(3) provides authority for the continuing review of all matters relevant to the case. Section 308 is an additional duty placed on small business debtors by Congress under the 2005 amendments to the Bankruptcy Code.

Rule 2015(a)(6) requires that the filer use the appropriate Official Form for the reporting of the information. The Judicial Conference has approved Official Form 25C as the monthly operating report form for small business debtors. The form was proposed with the active participation of the United States trustee program so that the Official Form would include all of the information that the United States trustee reasonably needs to administer the case while also including all the information required by § 308. This avoids the need for filing separate forms and should limit the cost to the debtor and the estate. As you can see from the rule, these reports are generally due on the 20<sup>th</sup> of the month following the month for which the data is being reported. The rule also sets out the filing time for the initial report. For example, if a small business chapter 11 case is filed from September 1 through September 15, then the first report would be due on October 20<sup>th</sup>, and it would include the information for September. If the case was filed after September 15<sup>th</sup>, then the initial report would not be due until November 20<sup>th</sup>, and it would include the information from the date of the filing until October 31. The rule provides, however, that the court, for cause, can order that a different reporting schedule be followed. For example, if the debtor is already under an obligation to provide a periodic report of financial affairs in a form that would include all of the information called for in Official Form 25C, it may be appropriate to allow the other form to be used and filed at the intervals called for under that reporting regime. Presumably, the courts will be influenced to a large degree by the views of the creditors for whose benefit the reporting is being undertaken.

Official Form 25C is not the only new report that a small business debtor must file. All chapter 11 debtors, not just small business debtors, must file Official Form 26. This form requires all chapter 11 debtors to disclose the profitability of any entity in which the

bankruptcy estate holds a substantial or controlling interest. This reporting requirement is not set out in the Bankruptcy Code, but is instead in § 419 of BAPCPA, an uncodified provision. Rule 2015.3, effective on December 1, 2008, requires that the Official Form be filed initially not later than 5 days before the first date set for the § 341 meeting of creditors, and periodically every six months thereafter. The rule also provides that a 20% interest in another entity is presumed to be a substantial or controlling interest, and a lesser interest is presumed not to be a substantial or controlling interest. Parties in interest can challenge either presumption. The debtor must give 20 days notice to the entity whose profitability is to be disclosed that the form will be filed. This gives the entity an opportunity to seek a protective order or other relief. If the debtor cannot obtain the necessary information, the court can modify the debtor's obligation to report the data. The court can also dispense with the filing of the report if the information to be reported is already publicly available.

### **III. The Plan and Disclosure Statement – Format, Contents, and Timing**

For those small business debtors who make it through the various reporting obligations, there is still the matter of the case itself. Chapter 11 debtors seek to reorganize their financial affairs through the process of proposing and obtaining confirmation of a plan of reorganization. This is true whether the debtor is United Airlines, or United Dry Cleaners, Inc., a small business debtor. When the debtor is a small business as defined in § 101, however, the rules governing the proposal and confirmation of a chapter 11 plan are somewhat different.

Section 1121 of the Code governs the timing and the authorship of chapter 11 plans. In small business cases, the debtor has the exclusive right to file a plan for the first 180 days after the order for relief, unless the court, for cause, orders otherwise. Thereafter, any party in interest can file a plan, but the plan must be filed not later than 300 days after the entry of the order for relief. The court can extend these periods, but only if the debtor can demonstrate that it is more likely than not that the court will confirm a plan in a reasonable time and the court issues an order setting a new deadline prior to the original expiration date. The statute does not seem to anticipate that a creditor or other party in interest would seek an extension of these deadlines, but it would seem that they should be allowed to obtain an extension if they can prove that the court would confirm a plan in a reasonable time.

The 300 day deadline for filing any plan is also the deadline for filing a disclosure statement in the case. Presumably, the disclosure statement will not be filed at that late date, but will be filed either with the plan or immediately thereafter. In fact, in 2005, Congress amended § 1125 to authorize the dual use of a chapter 11 plan in a small business case as both the plan and the disclosure statement. Section 1125(f) now provides that the court may “determine that the plan itself provides adequate information and that a separate disclosure statement is not necessary.” If the plan is intended to operate both as the plan and the disclosure statement, the plan must

designate that it contains “adequate information” so that the court and parties in interest know that no separate disclosure statement will be forthcoming.

To facilitate the short deadlines in small business cases, § 1125(f)(3) provides that the court can approve disclosure statements on a conditional basis. This permits the distribution of the disclosure statements to creditors prior to final approval of the disclosure statement and the joinder of the hearing on approval of the disclosure statement with the confirmation hearing. This new procedure is especially important because § 1129(e) now provides that confirmation of the plan in a small business case must occur within 45 days after the plan is filed. This extremely short deadline can be extended under § 1121(a)(3). Extensions could well be granted given that Bankruptcy Rule 2002(b) requires that creditors be given 25 days notice of the confirmation hearing, and if any disputes arise concerning the plan, there would be very little time to resolve those conflicts. In the absence of an extension, an objecting creditor could wield enormous control over the plan confirmation process. Nevertheless, an extension is available only if the court grants the extension prior to the expiration of the 300 day period, and the court finds that confirmation of a plan is likely in a reasonable period of time.

One way in which the plan process can be streamlined in small business cases is through the use of form plans and disclosure statements. Section 433 of BAPCPA required that form plans and disclosure statements be created for use in small business chapter 11 cases. Rule 3016(d), which becomes effective on December 1, 2008, provides that

(d) STANDARD FORM SMALL BUSINESS DISCLOSURE STATEMENT AND PLAN. In a small business case, the court may approve a disclosure statement and may confirm a plan that conform substantially to the appropriate Official Forms or other standard forms approved by the court.

The Committee Note accompanying this new provision states that while § 1125(f)(2) authorizes the courts to approve these plans, the rule takes no position on whether courts could require the use of other local standard form plans in these cases. The BAPCPA provision governing the matter is unclear on the issue, so Bankruptcy Rule 9009 is also being amended, effective on December 1, 2008, to clarify that the general obligation to use Official Forms is relaxed as to the use of form plans. So, a form plan (Official Form 25A) and a form disclosure statement (Official Form 25B) for small business debtors are now available for use in these cases. Given the range of entities, both as to form and business operations, the forms are necessarily somewhat skeletal. Nonetheless, they are intended to provide a framework that should result in the plans and disclosure statements meeting the statutory standards for those

documents. Of course, how you “fill in the blanks” makes all the difference.

#### **IV. Individual Debtors in Chapter 11 Under BAPCPA**

As initially noted, individuals have always been eligible for chapter 11 relief under the Bankruptcy Code. Given the costs of these proceedings (higher filing fees, more complexity causing higher attorney fees, quarterly fees to the US trustee, etc.), individuals are more likely to proceed under chapters 7 or 13. The housing market value boom followed by its bust, may leave more individual debtors unable to proceed under chapter 13 with its debt limits. For these individuals, and for those individuals engaged in businesses as sole proprietors, chapter 11 may be their only realistic opportunity for bankruptcy relief. Some of these debtors may be classified as “small business debtors,” and the provisions governing those entities will apply to those cases. This portion of the paper will address the other provisions of the Bankruptcy Code that apply only to individual debtors in chapter 11 cases.

Among the 2005 changes made by BAPCPA was the introduction of the requirement that individual debtors obtain a prepetition credit counseling briefing. This requirement presented the first set of problems under the amendments, and the assumption most make is that this is a provision that is limited to consumer debtors. That would make sense, but it is not the law. Section 109(h)(1) requires all individual debtors seeking relief under title 11 to complete the prepetition credit counseling obligation. If you fail to get the counseling, and no statutory excuse applies, you cannot be a debtor under the Bankruptcy Code. See, e.g., In re Giles, 361 B.R. 212 (Bankr. D. Utah 2007 (failure to obtain prepetition credit counseling within the 180 day period renders debtor ineligible for relief, and case is dismissed); but cf. In re Enloe, 373 B.R. 123 (Bankr. D. Colo. 2007) (debtor took credit counseling more than 180 days prior to the commencement of the case, but the case need not be dismissed).

#### **V. Property of the Estate for the Individual Chapter 11 Debtor**

Until 2005, property of the estate in a chapter 11 case was governed entirely by § 541 of the Bankruptcy Code. Significantly, under that section, postpetition earnings from personal services are excluded from the bankruptcy estate. This created a need for courts to determine in individual debtor chapter 11 cases whether the funds generated after the commencement of the case were the result of the debtor’s personal services and thus excluded from the estate. This was particularly the case when the debtor was a professional (lawyer, doctor, etc.) who employed others in the operation of his or her business. See, e.g., In re Fitzsimmons, 725 F.2d 1208 (9<sup>th</sup> Cir. 1984); In re Cooley, 87 B.R. 432 (Bankr. S.D. Tx. 1988).

This exclusion of postpetition earnings from the estate distinguished chapter 11 cases from chapter 13 cases. Under § 1306, a chapter 13 debtor's postpetition earnings from personal services are property of the estate, unlike their treatment in chapter 7. Until 2005, the postpetition earnings of chapter 13 and chapter 11 debtors were treated differently. Congress apparently concluded that this should no longer be the case, and § 1115 was added to the Code in 2005. It provides that the debtor's earnings from postpetition personal services are property of the estate. This change is consistent with other changes made to the provisions governing individual debtors in chapter 11 cases.

## **VI Plan Confirmation**

The standards for confirmation of a chapter 11 plan apply in an individual debtor case to the same extent that they apply to other chapter 11 debtors. Individuals, however, face other limitations on the ability to confirm a chapter 11 plan. For example, Congress had previously amended chapter 11 to limit the ability of an individual debtor to modify a home mortgage. Section 1123(b)(5) was amended in 1994 to prohibit the modification of a claim secured only by a security interest in real property that is the debtor's principal residence. This brought the treatment of these claims in chapter 11 into line with the treatment and protection of those claims in chapter 13 cases. The 2005 amendments expand the consistency of the treatment of individual debtors in chapter 11 and chapter 13 cases.

Most significantly, § 1129(a)(15) was added to the statute to bring individual debtor chapter 11 cases into line with chapter 13 cases. Under this section, if the holder of an unsecured claim objects to confirmation of a plan, then the claim either must be paid in full or all of the debtor's disposable income must be paid into the plan for the greater of five years or the period during which there will be plan payments. One can imagine a chapter 11 plan that modifies a commercial real estate loan and provides for the repayment of that loan over a thirty year period. Under § 1129(a)(15),(B), the debtor would be paying all of his or her disposable income for that thirty years or until the present value of those payments would satisfy the unsecured claims. It is hard to imagine that any debtor would accept such a fate. If confirmation is to occur in that kind of case, I would expect the debtor to move to dismiss or convert the case rather than to make payments for thirty years.

Section 1129(a)(15) does not actually require the payment of the debtor's disposable income in the same way as in chapter 13. Rather, it requires the debtor to pay "the value" of the debtor's "projected disposable income" for the relevant period. Consequently, the debtor could liquidate property or use other assets that are not earnings from personal services to make the payments that will meet the minimum distribution standard. In measuring the debtor's "projected disposable income," the section also directly incorporates § 1325(b)(2) into the individual chapter 11 debtor case. It also may require the application of the means test living expense calculations because § 1325(b)(3) states that the means test calculations define the debtor's reasonable living expenses if the debtor's current monthly income when multiplied by 12 exceeds the highest median

family income for a family of the same number of people as the debtor's in the state in which the debtor resides. Section 1129(a)(15) refers only to § 1325(b)(2), so an argument exists that Congress did not intend to bring the means test living expense calculations into chapter 11. If so, then the debtor's actual living expenses would determine the total projected disposable income.

In 2005, Congress also added § 1129(a)(14) to the Code. This provision establishes as a prerequisite to confirmation of a plan that the debtor must have paid all domestic support obligations that first became due after the date of the filing of the petition. If the debtor has paid these amounts, or if no such amounts are due, the debtor should so inform the court so that confirmation of the plan is possible.

Since all of the other aspects of plan confirmation apply in an individual debtor chapter 11 case, the plan must be accepted by all classes of impaired claims. If fewer than all of the impaired classes accepts the plan, then confirmation is still possible under the cram down provisions of § 1129(b). That section sets out the infamous "fair and equitable" rule which allows confirmation over the objections of a dissenting class of unsecured creditors as long as any junior class of claims does not receive or retain anything under the plan. This would be a problem in most individual debtor cases in chapter 11 because the debtor would normally retain possession of his or her exempt property. Section 1129(b)(2)(B)(ii) was amended in 2005 to overcome this problem. It provides that the debtor's retention of property does not violate the fair and equitable test. In re Tegeuder, 369 B.R. 477 (D. Neb. 2007).

## **VII Effect of Confirmation of the Plan**

For most chapter 11 debtors, confirmation of the plan discharges the debtor and leaves the debtor obligated only on those claims that survive or are created under the plan. Discharge is immediate, even if the payment of the amounts due under the plan does not take place for quite some time, or even at all. Chapter 13 has always delayed the entry of the discharge until the completion of payments under the plan. In 2005, Congress changed the timing of the chapter 11 discharge for individual debtors to coincide with the practice in chapter 13 cases. Section 1141(d)(5) now provides that the discharge for an individual chapter 11 debtor is not granted until all of the payments under the plan have been made. As in chapter 13, there is also a provision for a hardship discharge in chapter 11. If, the debtor has not completed the plan payments, a hardship discharge is available as long as modification of the plan under § 1127 is not practicable, and the present value of the payments already made under the plan meets the best interest of creditors test. This "hardship discharge" is easier to obtain than a chapter 13 hardship discharge which is only available if the debtor's failure to make the payments under the plan is "due to circumstances for which the debtor should not justly be held accountable." In chapter 11, it would appear that the "hardship" discharge is not really that hard to get. The flexibility in the provision is in the court's determination of whether modification of the plan is practicable.

The debtor's discharge might also be delayed for reasons unrelated to the payments due under the plan. Section 522(q) of the Code sets a limit on homestead exemptions and exemptions for a burial plot if the debtor has committed certain felonies, securities fraud, or intentionally or recklessly caused serious physical harm or death to another in the past 5 years.