

Nature of Bankruptcy and Insolvency Proceedings

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§ 1.1 OBJECTIVES

(a) Introduction

The income tax effect of certain transactions during the administration period and of tax assessments related to prebankruptcy periods can impose undue hardship on the bankrupt, who is already in a tenuous financial position. It is not uncommon for a bankrupt to realize substantial taxable income during the administration period from the sale of all or part of the assets or from taxable recoveries. Net operating loss (NOL) carryovers and other offsetting tax deductions often are unable to minimize the income tax effect. Therefore, in addition to ensuring that all statutory tax reporting and filing requirements are satisfied at the due dates, the accountant must be aware of those tax aspects that will permit the preservation and enlargement of the bankrupt's estate.

During the closing days of the 96th Congress, the Bankruptcy Tax Act of 1980 was passed as Public Law 96-589 and signed by President Carter on December 24, 1980. This bill eliminated a great deal of the uncertainty about handling debt forgiveness and other tax matters, as the Bankruptcy Code superseded the sections of the Bankruptcy Act that contained provisions for nonrecognition of gain from debt forgiveness along with other related tax items. The Bankruptcy Code contains state and local tax law but no federal tax provisions. The Bankruptcy Tax Act was passed after some last-minute compromises. Included was an amendment that delayed until January 1, 1982, the requirement that NOLs be reduced by the amount of debt that is forgiven. This was designed to allow one year for Congress to consider comments from the public regarding the handling of debt forgiveness. Sections of the Bankruptcy Tax Act and other sections of the Bankruptcy Code relating to the tax issues of troubled businesses were changed by several tax reform acts since it was passed.

On April 20, 2005, President George W. Bush signed the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005¹ (2005 Act). In many ways, the 2005 Act represents the most significant changes in the bankruptcy laws since the Bankruptcy Code replaced the Bankruptcy Act in 1978. One of the key reasons for the revisions to the Bankruptcy Code was to prevent perceived abuses in consumer bankruptcies. An important part of the basis for reducing consumer abuses was the establishment of means testing provisions. Under the means test, a debtor having income above the state median may, rather than receiving a discharge of all debts, be required to make payments to creditors from future earnings. Although the primary focus of the 2005 Act was on eliminating abuses of the law by consumers, there are provisions in the bill affecting almost all participants in the bankruptcy process—businesses, creditors, landlords, and professionals involved in this field.

There was a desire, driven to a large extent by credit card companies, to make it harder for consumers to walk away from their debts. The motive underlying the 2005 Act is clear from its title, "Bankruptcy Abuse Prevention." Some of the underlying objectives driving the changes in the law were to:

¹ Pub. L. No. 109-08, 119 Stat. 23.

- Use a means test as a method to reduce perceived abuses of the current system by requiring some individuals to either have their petition dismissed or agree to transfer to chapter 11 or 13 and make at least some debt payments with future income.
- Eliminate perceived abuses by consumers, in addition to limiting the extent to which individuals can walk away from their debts, by adjusting amounts available for homestead exemptions, for example, and increasing amounts that may be recovered from fraud.
- Reduce the time that a business is in bankruptcy as evidenced by, among other things, a limit on the time a debtor has to decide whether to assume or reject a lease and a limit on the amount of time a debtor has the exclusive right to develop a plan.
- Provide a source of tax revenue, especially for state and local governments, by changing the tax law to provide fewer tax benefits to individuals and businesses in bankruptcy. With a significant amount of influence from state attorneys general, the drafters of the law were convinced that state and local governments were at a disadvantage when it came to the collection of taxes.
- Provide additional opportunities for creditors of businesses under certain conditions to recover all or a large percentage of their prepetition claims by, for example, increasing the reclamation period and providing that goods shipped within 20 days of bankruptcy are administrative expenses.
- Reinstate chapter 12 on a permanent basis and make other changes perceived as necessary to the Bankruptcy Code.
- Provide protection to certain creditors including, for example, those owed amounts for domestic support obligations and secured creditors in chapter 13.

The 2005 Act consists of over 16 different titles.

The purpose of this book is to analyze in detail the tax ramifications of bankruptcy and insolvency proceedings and to provide a practical guide that will assist financial advisors, accountants, attorneys, and other related professionals in rendering tax services in the liquidation and rehabilitation of financially troubled debtors in and out of bankruptcy court. The book should be of interest to debtors, business turnaround professionals, trustees, appraisers, and other professionals who assist debtors or creditors of debtors that are experiencing financial difficulty. While these professionals may not be directly involved in rendering professional tax services, they must be aware of the tax consequences of many decisions they make or recommend in bankruptcy cases or out-of-court settlements.

(b) Scope of Coverage

This book describes the tax aspects of a separate estate created for individuals in a chapter 7 or 11 case. The tax ramifications of discharge of debt in and out of bankruptcy court are discussed for both debtor and creditors. A full chapter is devoted to a discussion of the use of NOLs by corporations. Tax priorities, assessments, discharges, and authority in bankruptcy are described in the last three chapters.

The Bankruptcy Tax Act significantly changed the ways in which a corporation can be reorganized in a bankruptcy proceeding. The new type G reorganization created

under this Act is analyzed, along with the other aspects of tax reorganization. Other special tax problems are described, such as impact of debt forgiveness on the earnings and profit account and tax issues related to partnerships and S corporations.

The balance of this chapter describes briefly the nature of out-of-court settlements and reorganization or liquidation in a title 11 bankruptcy case. This discussion is intended only to provide the reader with a basic introduction to out-of-court and bankruptcy proceedings. For a more detailed discussion of the legal aspects of and the accounting for out-of-court settlements and bankruptcy cases, see Newton's *Bankruptcy and Insolvency Accounting: Practice and Procedure*.²

§ 1.2 ALTERNATIVES AVAILABLE TO A FINANCIALLY TROUBLED BUSINESS

A debtor's first alternatives are to locate new financing, to merge with another company, or to find some other basic solution to its situation in order to avoid the necessity of discussing its problem with representatives of creditors. If none of these alternatives is possible, the debtor may be required to seek a remedy from creditors, either informally (out of court) or with the help of judicial proceedings.

(a) Out-of-Court Settlements

An out-of-court settlement is an informal agreement that usually consists of an extension of time (stretch-out), a pro rata cash payment for full settlement of claims (composition), an issue of stock for debt, or some combination of these methods. The debtor, through counsel or credit association, calls an informal meeting of the creditors for the purpose of discussing its financial problems. Counsel and/or financial advisors for the debtor may work with the individual creditors or may work with a group of creditors in an attempt to negotiate an arrangement with the creditors for the business to continue with all or part of the debt owed to creditors being paid over time or in some cases exchanged for stock.

(i) Creditors' Committee

To make it easier for the debtor to work with the creditors, a committee of creditors may be appointed during the initial meeting of the debtor and its creditors, providing, of course, the creditors judge the case to warrant some cooperation. The creditors are often as interested in working out a settlement as is the debtor.

There is no set procedure for the formation of a committee. Ideally, the committee should consist of four or five of the largest creditors and one or two representatives from the smaller creditors. A lot of time wasted on deciding the size and composition of the committee would be saved at creditors' meetings if the committees were organized routinely in this manner. However, there are no legal or rigid rules defining the manner in

² Grant W. Newton, *Bankruptcy and Insolvency Accounting: Practice and Procedure* (7th ed.), Vol. 1 (Hoboken, NJ: John Wiley & Sons, 2009).

which a committee may be formed. Although a smaller creditor often serves on a committee, there are committees on which only larger creditors serve, either because of lack of interest on the part of the smaller creditors or because the larger creditors override the wishes of others.

The debtor's job of running the business while under the limited direction of the creditors' committee can be made easier if the creditors selected are those most friendly to the debtor.

(A) Duties of Committee The creditors' committee serves as the bargaining agent for the creditors, supervises the operation of the debtor during the development of a plan, and solicits acceptance of a plan once it has been approved by the committee. Generally, the creditors' committee will meet as soon as it has been appointed, for the purpose of electing a presiding officer and counsel. The committee will also engage a financial advisor to help the members understand the nature of the debtor's problems and evaluate the debtor's business plan.

At the completion of the valuation analysis, the creditors' committee will meet to discuss the results. If the valuation analysis reveals that the creditors are dealing with a dishonest debtor, the amount of settlement that will be acceptable to the creditors will be increased significantly. It becomes very difficult for a debtor to avoid a bankruptcy court proceeding under these conditions. However, if the debtor is honest and demonstrates the ability to reverse the unprofitable operations trend and reestablish the business, some type of plan may eventually be approved.

(ii) Plan of Settlement

It is often advisable, provided there is enough time, for the financial advisor and the attorney to assist the debtor in preparing a suggested plan of settlement so it can be presented and discussed at the first meeting with creditors. Typically, only the largest creditors and a few representatives of the smaller creditors are invited in order to avoid having a group so large that little can be accomplished.

There is no set form that a plan of settlement proposed by the debtor must take. It may call for 100 percent payment over an extended period of time, payments on a pro rata basis in cash for full settlement of creditors' claims, satisfaction of debt obligations with stock, or some combination. A carefully developed forecast of projected operations, based on realistic assumptions developed by the debtor with the aid of its financial advisor, can help creditors determine whether the debtor can perform under the terms of the plan and operate successfully in the future.

Generally, for creditors to accept a plan, the amount they will receive must be at least equal to the dividend they would receive if the estate were liquidated. This dividend, expressed as a percentage, is equal to the sum of a forced-sale value of assets, accounts receivable, cash, and prepaid items minus priority claims, secured claims, and expenses of administration divided by the total amount of unsecured claims.

The plan should provide that all costs of administration, secured claims, and priority claims, including wages and taxes, are adequately disposed of for the eventual protection of the unsecured creditors. If the debtor's plan includes a cash down payment

in full or partial settlement, the payment should at least equal the probable dividend the creditors would receive in bankruptcy.

(iii) Acceptance of Plan

After the creditors' committee approves a plan, it will notify all the other creditors and recommend to them that they accept the plan. Even if a few creditors do not agree, the debtor should continue with the plan. The dissenting creditors will eventually have to be paid in full. Some plans even provide for full payment to small creditors, thus destroying the nuisance value of small claims. In an informal agreement, there is no provision binding the minority of creditors to accept the will of the majority. Thus, it is necessary to obtain the approval of almost all of the creditors in order for an out-of-court settlement to be successful.

(iv) Advantages and Disadvantages

Summarized below are a few of the reasons why the informal settlement is used in today's environment:

- The out-of-court settlement is less disruptive to a business that continues operating.
- The debtor can receive considerable benefits from the advice of a committee, especially if some of the committee members have extensive business experience, preferably but not necessarily in the same line of business.
- The informal settlement avoids invoking the provisions of the Bankruptcy Code and, as a result, more businesslike solutions can be adopted.
- Frustrations and delays are minimized because problems can be resolved properly and informally without the need for court hearings.
- An agreement usually can be reached much faster informally than in court proceedings.
- The costs of administration are usually less in an out-of-court settlement than in a formal reorganization.

The weaknesses of informal composition settlements are:

- A successful plan of settlement requires the approval of substantially all creditors, and it may be difficult to persuade distant creditors to accept a settlement that calls for payment of less than 100 percent.
- The assets of the debtor are subject to attack while a settlement is pending. (The debtor can, of course, point out to the creditors that if legal action is taken, a petition in bankruptcy court will have to be filed.)
- The informal composition settlement does not provide a method to resolve individual disputes between the debtor and the creditors.
- Executory contracts, especially leases, may be difficult to avoid.
- Certain tax law provisions make it more advantageous to file a bankruptcy court petition.
- Priority debts owed to the United States under Revised Statutes section 3466 must be paid first.

(b) Assignment for Benefit of Creditors

A remedy available under state law to a corporation in serious financial difficulties is an *assignment for the benefit of creditors*. In this instance, the debtor voluntarily transfers title to its assets to an assignee, which then liquidates them and distributes the proceeds among the creditors. Assignment for the benefit of creditors is an extreme remedy because it results in the cessation of the business. This informal liquidation device (although court-supervised in many states) is like the out-of-court settlement devised to rehabilitate the debtor, in that it requires the consent of all creditors or at least their agreement to refrain from taking action. The appointment of a custodian over the assets of the debtor gives creditors the right to file an involuntary bankruptcy court petition.

Proceedings brought in the federal courts are governed by the Bankruptcy Code. Normally, it will be necessary to resort to such formality when suits have been filed against the debtor and its property is under garnishment or attachment or is threatened by foreclosure or eviction.

(c) Bankruptcy Court Proceedings

Bankruptcy court proceedings are generally the last resort for a debtor whose financial condition has deteriorated to the point where it is impossible to acquire additional funds. When the debtor finally agrees that bankruptcy court proceedings are necessary, the liquidation value of the assets often represents only a small fraction of the debtor's total liabilities. If the business is liquidated, the creditors get only a small percentage of their claims. The debtor is discharged of its debts and is free to start over; however, the business is lost and so are all the assets. Normally, liquidation proceedings result in large losses to the debtor, to the creditor, and to the business community in general. Chapter 7 of the Bankruptcy Code covers the proceedings related to liquidation. Another alternative under the Bankruptcy Code is to seek some type of relief so that the debtor will have enough time to work out agreements with creditors with the help of the bankruptcy court and be able to continue operations. Chapters 11, 12, and 13 of the Bankruptcy Code provide for this type of operation

Title 11³ of the U.S. Code contains the bankruptcy law. The code is divided into nine chapters:

Chapter 1: General Provisions

Chapter 3: Case Administration

Chapter 5: Creditors, the Debtor, and the Estate

Chapter 7: Liquidation

Chapter 9: Adjustment of Debts of a Municipality

Chapter 11: Reorganization

Chapter 12: Adjustment of Debts of a Family Farmer with Regular Income

Chapter 13: Adjustment of Debts of an Individual with Regular Income

Chapter 15: Ancillary and Other Cross-Border Cases

³ The Bankruptcy Code as originally passed consisted of only odd-numbered chapters. In 1986, Congress added chapter 12; in 2005, chapter 15 was added.

Chapters 1, 3, and 5 apply to all proceedings under the code, except in chapter 9, where only those sections of chapters 1, 3, and 5 specified apply. A case commenced under the Bankruptcy Code's chapters 7, 9, 11, 12, or 13 is referred to as a title 11 case.

The 2005 Act codified significant changes with respect to the relief available to foreign debtors in the United States by creating a new chapter—Chapter 15: Ancillary and Other Cross-Border Cases. The purpose of chapter 15 is to incorporate the Model Law on Cross-Border Insolvency to provide effective mechanisms for dealing with cases of cross-border insolvency. See section 1501 of the Bankruptcy Code. Specifically, the new statute is intended to accomplish several objectives, including:

- Promoting cooperation between (a) courts, trustees, United States trustees, examiners, debtors, and debtors-in-possession in the United States and (b) courts and other competent authorities of foreign countries in cross-border cases;
- Fostering greater legal certainty for trade and investments;
- Providing guidance designed to encourage fair and efficient administration of cross-border insolvencies that protects the interests of all creditors and other interested entities, including the debtor;
- Protecting and maximizing the value of the debtor's assets; and
- Facilitating the rescue of financially troubled businesses, thereby protecting investment and preserving employment.⁴

(d) Provisions Common to All Bankruptcy Proceedings

A voluntary case is commenced by the filing of a bankruptcy petition under the appropriate chapter by the debtor. An involuntary petition can be filed by creditors with aggregate unsecured claims of at least \$14,425⁵ and can be initiated only under chapter 7 or 11. If there are 12 or more creditors with unsecured claims, at least 3 creditors must sign the petition; if the number of unsecured creditors is less than 12, a single creditor can force the debtor into bankruptcy. Only one of two requirements must be satisfied in order for the creditors to force the debtor into bankruptcy:

1. The debtor generally fails to pay its debts as they become due, or
2. Within 120 days prior to the petition, a custodian was appointed or a custodian took possession of substantially all of the debtor's property.

(i) Automatic Stay

A petition filed under the Bankruptcy Code results in an automatic stay of the actions of creditors. As a result of the stay, no party, with minor exceptions, having a security or adverse interest in the debtor's property can take any action that will interfere with

⁴ William H. Schrag and Wendy S. Walker, *2005 Bankruptcy Revisions: Implications for Businesses and Financial Advisors*, edited by Grant W. Newton (Medford, Oregon: Association of Insolvency and Restructuring Advisors and American Institute of Certified Public Accountants, 2005), pp. 75–85.

⁵ Many of the dollar amounts in the Bankruptcy Code are increased to reflect the change in the Consumer Price Index for all Urban Consumers for the most recent three-year period ending immediately before January 1 of the year that the three-year interval begins on April 1. The amounts are to be rounded to the nearest \$25 amount. Effective April 1, 2010, the minimum amount needed to file an involuntary petition was established at \$14,425; this value remains effective until April 1, 2013.

the debtor or its property, regardless of where the property is located, until the stay is modified or removed. The debtor or the trustee is permitted to use, sell, or lease property (other than cash collateral) in an ordinary course of business without a notice or hearing, provided the business has been authorized to operate in a chapter 7, 11, 12, or 13 proceeding and the court has not restricted the powers of the debtor or trustee in the order authorizing operation of the business.

In bankruptcy proceedings, the debtor or trustee also has the power to assume or reject any executory contract or any unexpired lease of the debtor.

(ii) Priorities

The 1978 Bankruptcy Code modified to a limited extent the order of payment of the expenses of administration and other unsecured claims. Section 507 of the Bankruptcy Code provides for the following priorities:

1. Allowed unsecured claim for domestic support obligations
2. Administrative expenses
3. In an involuntary case, unsecured claims arising after commencement of the proceedings but before an order of relief is granted
4. Wages earned within 180 days prior to filing the petition (or to the cessation of the business) to the extent of \$11,725 (for petitions filed after March 31, 2010) per individual
5. Unsecured claims to employee benefit plans arising within 180 days prior to filing the petition, but limited to \$11,725 (for petitions filed after March 31, 2010) times the number of employees less the amount paid in priority 4 above
6. Unsecured claims of grain producers against grain storage facilities and claims of fishermen against product storage or processing facilities to the extent of \$5,775 (for petitions filed after March 31, 2010) for each such individual
7. Unsecured claims of individuals to the extent of \$2,600 (for petitions filed after March 31, 2010) from deposits of money for purchase, lease, or rental of property or purchase of services not delivered or provided
8. Unsecured tax claims of governmental units (discussed in more detail in Chapter 11 of this book)
9. Allowed unsecured claims based on any commitment by the debtor to regulation agencies of the federal government to maintain the capital of an insured depository institution
10. Allowed claims for death or personal injury resulting from the operation of a motor vehicle or vessel under the influence of alcohol, drugs, or other substance

The 2005 Act moved the claim for domestic support obligations from seventh priority to first priority. Former priorities numbers 1 through 6 were changed to numbers 2 through 7. Also, the 2005 Act added the tenth priority above.

(iii) Discharge of Debts

The Bankruptcy Code contains provisions that allow an individual debtor in a chapter 7, 11, 12, or 13 proceeding to have its debts discharged. A corporation may also have

its debts discharged in chapter 11 or 12; however, these debts cannot be discharged in a chapter 7 or chapter 11 liquidation. Chapter 13 contained special provisions that dealt with the discharge of debt and allowed additional taxes to be discharged that could not be discharged in a chapter 7 or 11 proceeding. Included among debts that may not be discharged are certain types of taxes. However, the 2005 Act eliminated the special tax consideration, resulting in the same rules applying to all chapters. (These taxes are discussed in Chapter 11 of this book.)

The 2005 Act provided that a debtor may not receive a discharge on a second chapter petition that is filed within eight years of the first petition. Prior to the 2005 Act, the time period was six years. In a case filed prior to the effective date of the 2005 Act, a chapter 13 petition filed during the time period between the first and second chapter 7 petitions, which in this case exceeded seven years, does not toll the time period resulting in the tax being subject to discharge.⁶

(iv) Preferences

The Bankruptcy Reform Act of 1978 substantially modified the handling of preferential payments. Section 547 of the Bankruptcy Code provides that a trustee or debtor-in-possession can avoid transfers that are considered preferences. The trustee may avoid any transfer of property of the debtor:

- To or for the benefit of a creditor.
- For or on account of an antecedent debt owed by the debtor before such transfer was made.
- Made while the debtor was insolvent.
- Made:
 - On or within 90 days before the date of the filing of the petition, or
 - Between 90 days and one year before the date of the filing of the petition if such creditor, at the time of such transfer, was an insider.
- That enables such creditor to receive more than it would receive if:
 - The case were a case under chapter 7 of this title,
 - The transfer had not been made, or
 - Such creditor received payment of such debt to the extent provided by the provisions of this title.

Note that for an *insider*, the debtor can go back an entire year to void the transfer. However, the one year applies only to an insider and not to a third party. For example, if the president of the debtor company paid a bank loan 100 days prior to the filing of the petition, action to recover the preference could be taken against the president but not against the bank.

There was some uncertainty as to the extent to which the third party would be protected from the preference action. The 2005 Act contained a provision that specifically provided that action may be taken against the insider only and not against the third party to recover preferences.

⁶ In *Tidewater Finance Co. v. Deborah Williams*, 498 F.3d 249 (4th Cir. 2007).

Certain exemptions apply to preferential payments. One of these is a contemporaneous exchange: An exchange (payment) for new value, such as inventory not previously received, is given to the debtor. For example, the purchase of goods or services with payment by check or cash would not be a preferential payment. The second exemption protects payments of debts that are incurred in the ordinary course of business or financial affairs of both the debtor and the transferee, when the payment is made in the ordinary course of business or made according to ordinary business terms. For example, a 30-day open account for utility service would be sheltered provided payment is made according to the normal terms (such as 30 days) or according to ordinary business terms. Prior to the change made by the 2005 Act, the payment had to be made both in the ordinary course of business and according to ordinary business terms. Security interests granted in exchange for enabling loans, when the proceeds are used to finance the purchase of specific personal property, are also exempt. This exception would allow creditors to isolate from preference attack a transfer received, to the extent that the creditors replenish the estate with new value. For example, if a creditor received \$10,000 in preferential payments and subsequently sold goods with a value of \$6,000 to the debtor on unsecured credit, the preference would be only \$4,000.

(e) Chapter 7: Liquidation

Chapter 7 is used only when the corporation sees no hope of being able to operate successfully or to obtain the necessary creditor agreement. Under this alternative, the corporation is liquidated and the remaining assets are distributed to creditors after administrative expenses are paid. An individual debtor may be discharged from liabilities and entitled to a fresh start.

The decision as to whether rehabilitation or liquidation is best also depends on the amount to be realized from each alternative. The method resulting in the greatest return to the creditors and stockholders should be chosen. The amount to be received from liquidation depends on the resale value of the firm's assets minus the costs of dismantling and legal expenses. The value of the firm after rehabilitation must be determined (net of the costs of achieving the remedy). The alternative leading to the highest value should be followed.

Financially troubled debtors often attempt an informal settlement or liquidation out of court, but if it is unsuccessful they will then initiate proceedings under the Bankruptcy Code. Other debtors, especially those with a large number of creditors, may file a petition for relief in the bankruptcy court as soon as they recognize that continuation of the business under existing conditions is impossible. As will be discussed later, the debtor may also liquidate by filing a plan of liquidation under chapter 11.

If a case involving primarily the consumer debts of an individual debtor is determined to be an abuse of Bankruptcy Code provisions, chapter 7 may not be an available alternative. Section 707(b) provides that the court, on its own motion or on a motion by the U.S. trustee, or any party in interest, may dismiss a case filed by an individual debtor under this chapter whose debts are primarily consumer debts or, with the debtor's consent, may convert such a case to a case under chapter 11 or 13, if it finds that the granting of relief would be a substantial abuse of the provisions of chapter 7. This assessment is referred to as the *means test* and is made by completing Form 22A,

Statement of Current Monthly Income and Means Test Calculations. Form 22A is available at www.ilnb.uscourts.gov/forms/Official_Bankruptcy_Forms/B22A.pdf.

(i) Income

Section 707(b)(7) precludes any party, including the bankruptcy judge or U.S. trustee, from bringing action for substantial abuse if the annual income of the debtor and the debtor's spouse (determined by multiplying the average monthly income for the last six months times 12) does not exceed the median state income. Thus, if the annual income as calculated above does not exceed the median state income, the debtor may use the provisions of chapter 7. In section 101(39A) of the Bankruptcy Code, "median family income" for any year means the median income both calculated and reported by the Bureau of the Census in the most recent year and, if not calculated in the current year, then adjusted annually for each year since the income was reported by using the percent change in the Consumer Price Index for All Urban Consumers. For example, an individual chapter 7 debtor residing in Oregon would compare the annual income to the median income from the state of Oregon for one person. If the debtor has a household of two, three, or four, the comparison would be made with the applicable income for Oregon for the appropriate number in the household. If the debtor is a household of more than four, then an allowance of \$7,500 per year would be added to the appropriate state income for each household member in excess of four in the median household.

For example, in Mississippi, Oregon, and New York, the median family income estimated for 2011 for various family sizes is listed as:

Household Size	Mississippi	Oregon	New York
1 person	\$32,658	\$44,707	\$46,295
2 persons	\$41,579	\$55,553	\$57,777
3 persons	\$47,058	\$60,523	\$68,396
4 persons	\$55,711	\$72,767	\$83,942

In some states, the spread between the lowest and highest median incomes for one-person households was over \$26,000; for a four-person household, it was almost twice that amount. In Mississippi, the 2011 estimated median income for a one-person household was only \$32,658; in New Jersey, it was over \$59,060. For a four-person household, one of the largest income levels was Maryland, at \$103,361; the lowest was Arkansas, at \$54,401.

Current monthly income is income from all sources that the debtor receives without regard to whether such income is taxable. It includes amounts received on a regular basis for the debtor's household expenses, including expenses of the debtor's dependents, but excludes Social Security payments and selected payments to victims of war crimes or terrorism.

In considering whether the granting of relief would be an abuse of the provisions of this chapter in situations where the average income is greater than the median state income, the court shall presume abuse exists if the debtor's current monthly income (average of the previous six months) reduced by the average monthly deduction listed below and multiplied by 60 is not less than the lesser of:

- a. 25 percent of the debtor’s nonpriority unsecured claims in the case, or \$7,025 (for petitions filed before April 1, 2013), whichever is greater; or
- b. \$11,725 (for petitions filed before April 1, 2013).

Thus, if the debtor’s current monthly income (average of the previous six months) reduced by the average monthly deduction listed in subsection (ii) below (monthly net income) exceeds \$195.42 (\$11,725 divided by 60), it will be presumed that abuse exists. If the monthly net income is less than \$117.08 (\$7,025 divided by 60), the presumption of abuse does not exist. If the net income is between \$117.08 and \$195.42, abuse exists if the net income is greater than 25 percent of the debtor’s nonpriority unsecured claims. Under these conditions, abuse is presumed if the monthly net income is large enough to pay at least 25 percent of the nonpriority unsecured claims. For example, if the monthly net income is \$117.08, abuse would not exist if the unsecured debt is greater than \$28,099 (60 times 117.08, or \$7,025, is less than 25 percent of \$28,099). If the debtor’s debt is \$27,099, incurring additional debt in an amount in excess of \$1,000 prior to filing the petition for a valid need and use may avoid the presumption of abuse. If the monthly net income is \$195.42, the presumption of abuse does not exist if the nonpriority unsecured debt exceeds \$46,901 (\$195.42 times 60 divided by 25 percent).

(ii) Deductions

The following deductions as described in Code section 707(b)(2)(A) and indicated on Form 22A are allowed in determining if an abuse exists.

1. *IRS guidelines.* The monthly expenses as defined in Code section 707(b)(2)(A)(ii), including deductions allowed as living expenses specified under standards of the Internal Revenue Service (IRS), are allowed to be used by the debtor. The IRS guidelines include:
 - *National Standards*—These are nationwide allowances for food, clothing, and other items, effective March 1, 2011. The standards are the same regardless of the income levels of debtors. The National Standards apply, regardless of the amount actually spent. The standards are:

Expense	One Person	Two Persons	Three Persons	Four Persons
Food	\$300	\$537	\$639	\$757
Housekeeping supplies	29	66	65	74
Apparel & services	86	162	209	244
Personal care products & services	32	55	61	67
Miscellaneous	87	165	197	235
Total	\$534	\$985	\$1,171	\$1,377

For each additional person beyond four persons, an additional allowance of \$262 per person is allowed. The guidelines allow a qualifying debtor to claim an additional food and clothing (“Apparel & Services”) expense if the debtor’s average monthly food and clothing expense exceeds the combined allowances for those two subcategories. The allowance cannot exceed 5 percent of the food and clothing allowance. For purposes of these bankruptcy forms, the “Food” and “Apparel & Services” subcategories have been combined and are provided as a separate line item, which is displayed together with the 5 percent calculation of those two subcategories combined as shown below.

Expenses	One Person	Two Persons	Three Persons	Four Persons
Food and Clothing	\$362	\$683	\$835	\$996
5% of Food and Clothing	\$18	\$34	\$42	\$50
Additional Persons Amount				
More than 4 persons				
Food and Clothing			\$190	
5% of Food and Clothing			\$10	

- *National Standards: Out-of-Pocket Health Care Expenses*—These standards are now published by the IRS and are available for the debtor to use in a bankruptcy filing. The allowance has been increased and is added to Form 22A as a separate line item. The allowance is based on the age of each member of the household of the debtor. If under the age of 65, the allowance is \$60 per member; if 65 or older, the allowance is \$144 per member.
- *Local Standards*—Allowances for housing and utilities and transportation, known as Local Standards, vary by location. The allowances for housing and utilities are based on counties within the state and are divided into three levels: families of two or less, families of three, and families of four or more. Living allowance for housing and utilities is separated from nonmortgage expenses and mortgage and rent expense. Payments that are secured with a home are deducted from the mortgage and rent allowance and reported as a secured monthly cash outlay. Unlike the National Standards for federal tax purposes, under Local Standards the taxpayer is allowed the amount actually spent if greater than the standard. Based on section 707(b)(2), “debtor’s monthly expenses shall be the debtor’s applicable monthly expense amounts specified under the National Standards and Local Standards.” Furthermore, section 707(b)(2)(A)(ii)(V) notes that, “[i]n addition, the debtor’s monthly expenses may include an allowance for housing and utilities, in excess of the allowance specified by the Local Standards for housing and utilities issued by the Internal Revenue Service, based on the

actual expenses for home energy costs, if the debtor provides documentation of such actual expenses and demonstrates that such actual expenses are reasonable and necessary.” Line 21 of Form 22A is provided for the debtor to include cost of the allowed amount.

- *Transportation Costs*—Transportation schedules are based on both national and regional standards. The national rate for 2011 is an allowance of \$496 per month for ownership costs for the first vehicle and \$496 for the second. The allowance for the first vehicle is reduced by the monthly secured debt payment related to that vehicle and listed as a secured debt payment. A similar reduction applies to a second vehicle as shown on lines 23 and 24 of Form 22A. Operating and public transportation costs are for no car and one or two cars and are based on census regions and metropolitan statistical areas. If the taxpayer lives within one of the areas defined by city and county, the rate for that area would apply; if the taxpayer does not reside in one of these areas, the regional standard is used. For example, one of the metropolitan areas is Portland, consisting of the city of Portland, seven counties in Oregon, and one county in Washington. All other counties in Oregon would use the regional rates.
2. *Expenses not specified by IRS.* Section 702(b)(2)(A)(ii), paragraph (I), of the 2005 Act provides that certain categories of expenses not specified by the IRS may also be allowed:
 - Reasonably necessary health insurance, disability insurance, and health savings account expenses for the debtor, the spouse of the debtor, or the dependents of the debtor.
 - Debtor’s reasonably necessary expenses incurred to maintain the safety of the debtor and the family of the debtor from family violence.
 - An additional allowance for food and clothing of up to 5 percent of the food and clothing categories as specified by the National Standards issued by the IRS, provided it is shown that such costs are reasonable and necessary.
 - However, notwithstanding any other provision, the monthly expenses of the debtor shall not include payments for debts.
 3. *Expenses for care of family member.* These include expenses paid by the debtor that are reasonable and necessary for care and support of an elderly, chronically ill, or disabled household member or member of the debtor’s immediate family who is unable to pay for such reasonable and necessary expenses.
 4. *Chapter 13 monthly expenses.* These include expenses of the debtor to administer a chapter 13 plan for the district in which the debtor resides, up to 10 percent of the projected plan payments, as determined by the Executive Office of the U.S. trustee.
 5. *Special educational expenses.* These include the actual expenses for each dependent child less than 18 years of age (not to exceed \$1,500 per year per child) to attend a private or public elementary or secondary school.
 6. *Excess housing and utilities.* This is an allowance for housing and utilities expense in excess of the allowance for these expenses in the Local Standards issued by the IRS; it is to be based on the actual expenses for home energy costs, provided the debtor submits documentation of the actual expenses and demonstrates that the expenses are reasonable and necessary.

7. *Secured debt payments.* These are total secured debt due over the five years of the chapter 13 plan divided by 60 months; past-due secured payments included in the plan that are necessary for the debtor's possession of the primary residence, motor vehicle, or other property necessary for the support of the debtor and the debtor's dependents are also considered.
8. *Priority claims.* Debtor's expenses for payment of all priority claims (including priority child support and alimony claims) shall be calculated as the total amount of debts entitled to priority, divided by 60.
9. *Contributions: Furthermore.* Code section 707(b)(1) implies that the chapter 13 practice of allowing plan contributions to a tax-exempt charity is to be continued under the 2005 Act.

(iii) Rebuttal of Presumption of Abuse

The presumption of abuse may be rebutted only by demonstrating special circumstances, such as a serious medical condition or a call or order to active duty in the armed forces. To the extent such special circumstances justify additional expenses or adjustments of current monthly income for which there is no reasonable alternative, the additional expenses will be allowed as provided in Code section 707(b)(2)(B) as a deduction in a recalculation of the extent to which abuse may exist. Thus, the special circumstances do not eliminate the need for means testing but only reduce the likelihood of an abuse.

Code section 707(b)(6) provides that only the bankruptcy judge or U.S. trustee can also assert abuse if it is determined that the petition was filed in bad faith or the totality of the circumstances of the debtor's financial situation demonstrates abuse as stipulated in Code section 707(b)(3).

(iv) Appointment of Trustee

As soon as the order for relief has been entered, the U.S. trustee will appoint a disinterested party from a panel of private trustees to serve as the interim trustee. The functions and powers of the interim trustee are the same as those of an elected trustee. Once an interim trustee has been appointed, the creditors have the right to elect, at a meeting of creditors, a trustee that will be responsible for liquidating the business. If a trustee is not elected by the creditors, the interim trustee may continue to serve in the capacity of the trustee and carry through with an orderly liquidation of the business. Rarely is a trustee elected by the creditors.

The duties of the trustee are defined in section 704 of the Bankruptcy Code. They include:

- Collect and reduce to money the property of the estate for which such trustee serves and close up such estate as expeditiously as is compatible with the best interests of parties in interest.
- Be accountable for all property received.
- Investigate the financial affairs of the debtor.
- If a purpose would be served, examine proofs of claims and object to the allowance of any claim that is improper.

- If advisable, oppose the discharge of the debtor.
- Unless the court orders otherwise, furnish such information concerning the estate and the estate's administration as is requested by a party in interest.
- If the business of the debtor is authorized to be operated, file with the court and with any governmental unit charged with responsibility for collection or determination of any tax arising out of such operation, periodic reports and summaries of the operation of such business, including a statement of receipts and disbursements, and such other information as the court requires.
- Make a final report and file a final account of the administration of the estate with the court.

The objective of the trustee will be to liquidate the assets of the estate in an orderly manner. Once the property of the estate has been reduced to money and the security claims to the extent allowed have been satisfied, then the property of the estate shall be distributed to the holders of the claims in an order as specified by the Bankruptcy Code. The first order, of course, would be priority claims. Once those claims have been satisfied, the balance will go to unsecured creditors. After all the funds have been distributed, the remaining debts of an individual will be discharged. As mentioned earlier, if the debtor is a corporation, the debts will not be discharged. Thus, it will be necessary for the corporation to cease existence. Any funds subsequently coming into the corporate shell would be subject to attachment.

(f) Chapter 11: Reorganization

The purpose of chapter 11 is to provide the debtor with court protection, allow the debtor (or trustee) to continue the operations of the business while a plan is being developed, and minimize the substantial economic losses associated with liquidations. Chapter 11 as provided for in the Bankruptcy Code was designed to provide the flexibility of Chapter XI under prior law, yet it contains several of the protective provisions of the old Chapter X. It is designed to allow the debtor to use different procedures depending on the nature of the debtor's problem and the needs of the creditors. Agreements under this chapter can affect unsecured creditors, secured creditors, and stockholders. A voluntary or involuntary petition can be filed under chapter 11. Upon the filing of the involuntary petition, the court may, on request of an interested party, authorize the appointment of a trustee. The appointment is not mandatory and the debtor may, in fact, continue to operate the business as if a bankruptcy petition had not been filed, except that certain transactions may be avoided under the Bankruptcy Code. If the creditors prove the allegations set forth in the involuntary petition, an order for relief is entered, and the case will proceed in a manner identical to that of a voluntary case.

(i) Creditors' Committee

The Bankruptcy Code provides that a creditors' committee will be appointed. Ordinarily the committee consists of the seven largest unsecured creditors willing to serve or, if a committee was organized before the order for relief, such a committee may continue provided it was chosen fairly and is representative of the different kinds of claims. It is not unusual to see committees larger than seven; in K-Mart, the U.S. trustee appointed

a committee of unsecured creditors of 15 members. The purpose of the creditors' committee is very similar to that of a creditors' committee appointed in an out-of-court settlement. The U.S. trustee appoints the committee. The creditors' committee normally acts as the bargaining agent for the larger creditor body and continues to see that the assets of the debtor are protected.

The 2005 Bankruptcy Amendments provided these provisions that impact the nature of the creditors' committees and their operations:

- Under revised section 1102(a)(4), the court has a much more direct role in the process by having the authority to order the U.S. trustee to change the membership to ensure adequate representation. It may also order the U.S. trustee to appoint a small business concern to the committee if the court determines that the creditor holds claims (of the kind represented by the committee) where the aggregate amount of which, in comparison to the annual gross revenue of that creditor, is disproportionately large.
- Under revised section 1102(b)(3), the committee of creditors is required to provide access to information for creditors that hold claims similar to those represented by the committees. The second major change relates to the communication with and the type of information required to be provided to unsecured creditors that are not on the committee but are represented by the committee. Additionally, the creditors' committee is required to solicit and receive comments from the creditors. The committee often uses a special Web site to provide information to the creditors about issues related to the debtor's operations and the committee's activities and to receive comments from the creditors.

(ii) Operation of Business

The debtor will continue to operate the business unless a party in interest requests that the court authorize the appointment of a trustee. The U.S. trustee will make the appointment, if authorized by the court. Once the appointment has been authorized, the creditors also have the right to elect a trustee rather than have one appointed by the U.S. trustee. It is not necessary for an order to be granted to allow the debtor to continue to operate the business.

(iii) Disclosure Statement

A party cannot solicit the acceptance or rejection of a plan from creditors and stockholders affected by the plan unless they are given a written disclosure statement containing adequate information, as approved by the court. Section 1125(b) of the Bankruptcy Code requires that this disclosure statement must be provided prior to or at the time of the solicitation. The disclosure statement must be approved by the court, after notice and a hearing, as containing adequate information.

Section 1125(a) states that "adequate information" means information of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and the condition of the debtor's books and records, that would enable a hypothetical reasonable investor, typical of holders of claims or interests of the relevant class, to make an informed judgment about the plan. This definition contains

two parts. First it defines “adequate information,” and then it sets a standard against which the information is measured. It must be the kind of information that a typical investor of the relevant class, not one that has special information, would need to make an informed judgment about the plan.

Section 1125(a) of the Bankruptcy Code dealing with the disclosure requirements is expanded by requiring the proponent of the plan to include full discussion of the potential material federal and state tax consequences of the plan to the debtor, any successor to the debtor, and a hypothetical investor typical of the holders of claims or interests in the case. Thus, the disclosure statement should include the impact to the debtor, to various classes of creditors, and to shareholders.

In general, the disclosure requirements for the income tax impact of the plan have not generated the desired results. Often interested parties have been told to talk with their tax specialists to find out the income tax impact of the plan. Time will tell if this requirement will result in the plan’s tax impact being explained in such a manner that readers of the disclosure statement will understand tax consequences. The purpose of the amendment is not to change existing law but to make plan proponents adhere to the original intent of the law: to effectively disclose the tax ramifications of the plan on the debtor.

(iv) Developing the Plan

In cases where the debtor is allowed to operate the business as debtor in possession, the debtor has 120 days after the order for relief to file a plan and 180 days after the order for relief to obtain acceptance before others can file a plan. These time periods may be extended or reduced by the court; however, the 2005 Act limited a debtor’s ability to obtain extensions of the exclusive period to file a plan and solicit acceptance to a maximum of 18 months and 20 months respectively.

The Bankruptcy Code allows the debtor to file a liquidation rather than a reorganization plan where liquidation for various reasons may be more appropriate for the debtor. For example, during 2001 and 2002, over one-third of all public company plans confirmed were liquidation plans. Many of them were plans where the assets were sold in a section 363 sale under the provisions of the bankruptcy court and the proceeds were distributed to the creditors in a liquidation plan.

Section 1123 of the Bankruptcy Code lists the factors that are required to be included in the plan. They are:

1. Designate classes of claims and interests.
2. Specify any class of claims or interests that is not impaired under the plan.
3. Specify the treatment of any class of claims or interests that is impaired under the plan.
4. Provide the same treatment for each claim or interest in a particular class unless the holders agree to less favorable treatment.
5. Provide adequate means for the plan’s execution, such as:
 - (a) Retention by the debtor of all or any part of the property of the estate
 - (b) Transfer of all or any part of the property of the estate to one or more entities
 - (c) Merger or consolidation of the debtor with one or more persons (individuals, partnerships, and corporations)

- (d) Sale of all or any part of the property of the estate, either subject to or free of any lien, or the distribution of all or any part of the property of the estate among those having an interest in such property of the estate
 - (e) Satisfaction or modification of any lien
 - (f) Cancellation or modification of any indenture or similar instrument
 - (g) Curing or waiving of any default
 - (h) Extension of a maturity date or a change in an interest rate or other term of outstanding securities
 - (i) Amendment of the debtor's charter
 - (j) Insurance of securities of the debtor, or of any entity involved in a merger or transfer of the debtor's business for cash, for property, for existing securities, or in exchange for claims or interests, or for any other appropriate purpose
6. Provide for the inclusion in the charter of the debtor, if the debtor is a corporation, or of any corporation referred to in 5(a) or (b) above, of a provision prohibiting the issuance of nonvoting equity securities, and provide, as to the several classes of securities possessing voting power, an appropriate distribution of such power among such classes, including, in the case of any class of equity securities having a preference over another class of equity securities with respect to dividends, adequate provisions for the election of directors representing such preferred class in the event of default in the payment of such dividends.

In addition to the mandatory requirements just listed, the plan may provide for certain permissible provisions. They include:

- Impair or leave unimpaired any class of unsecured or secured claims or interests.
- Provide for the assumption or rejection of executory contracts or leases.
- Provide for settlement or adjustment of any claim or interest of the debtor or provide for the retention and enforcement by the debtor of any claim or interest.
- Provide for the sale of all of the property of the debtor and the distribution of the proceeds to the creditors and stockholders.
- Include any other provision not inconsistent with the provisions of the Bankruptcy Code.

(v) *Confirmation of the Plan*

Section 1129(a) of the Bankruptcy Code contains the requirements that must be satisfied before a plan can be confirmed. The provisions are summarized below.

1. *The plan complies with the applicable provisions of title 11.* Bankruptcy Code section 1122, concerning classification of claims, and section 1123, on the content of the plan, are two of the significant sections that must be followed.
2. *The proponents of the plan comply with the applicable provisions of title 11.* Section 1125 of the Bankruptcy Code, on disclosure, is an example of a section that is referred to by this requirement.

3. *The plan has been proposed in good faith and not by any means forbidden by law.*
4. *Payments are disclosed.* Any payment made or promised for services, costs, and expenses in connection with the case or plan has been disclosed to the court; payments made before confirmation are reasonable; and those to be made after confirmation must be subject to the court's approval.
5. *Officers are disclosed.* The proponents of the plan must disclose those who are proposed to serve after confirmation as director, officer, or voting trustee of the reorganized debtor. Such employment must be consistent with the interests of creditors and equity security holders and with public policy. Names of insiders to be employed and the nature of their compensation must also be disclosed.
6. *Regulation rate approval has been obtained.* Any regulatory commission that will have jurisdiction over the debtor after confirmation of the plan must approve any rate changes provided for in the plan.
7. *The best-interest-of-creditors test has been satisfied.* It is necessary for the creditors or stockholders who do not vote or who, if they voted, did not vote in favor of the plan, to receive as much as they would if the business were liquidated under chapter 7.
8. *Each class has accepted the plan.* Each class of creditors that is impaired under the plan must accept the plan. Section 1129(b) provides an exception to this requirement.
9. *Claims are treated in their order of priority.* This requirement provides the manner in which priority claims must be satisfied unless the holders agree to a different treatment.
10. *Acceptance by at least one class has been obtained.* At least one class that is impaired, other than a class of claims held by insiders, must accept the plan.
11. *The plan is feasible.* Confirmation of the plan is not likely to be followed by liquidation or the need for further financial reorganization unless such liquidation or reorganization is provided for in the plan. This requirement means that the court must ascertain that the debtor has a reasonable chance of surviving once the plan is confirmed and the debtor is out from under the protection of the court. A well-prepared forecast of future operations based on reasonable assumptions, taking into consideration the changes expected as a result of the confirmation of the plan, is an example of the kind of information that can be very helpful to the court in reaching a decision on this requirement.
12. *Payment of fees has been arranged.* All quarterly and filing fees must have been paid or the plan must provide that payment will be made on the effective date.
13. *Retiree benefits will continue.* The plan must provide for the continuation of payments of retiree benefits as required under section 1114 of the Bankruptcy Code.

As noted in requirement 8, for a plan to be confirmed, a class of claims or interests must either accept the plan or not be impaired. However, subsection (b) of Bankruptcy Code section 1129 allows the court, under certain conditions, to confirm a plan even though an impaired class has not accepted the plan. The plan must not discriminate unfairly and must be fair and equitable with respect to each class of claims or interest impaired under the plan that has not accepted it. The Bankruptcy Code states conditions

for secured claims, unsecured claims, and stockholder interests that would be included in the *fair and equitable* requirement.

(vi) Discharge of Debts

Once the plan has been confirmed, the Bankruptcy Code provides for discharge of the debts. This would include both individual and corporate debts. However, section 523 of the Bankruptcy Code provides that some debts of individuals may not be discharged. Among the debts that will not be discharged under section 523 are tax claims that have a priority under section 507 of the Bankruptcy Code and taxes for years in which a return was not filed, was filed late and within two years before the petition was filed, or was filed fraudulently.

(vii) Advantages of Chapter 11

Chapter 11 proceedings may be more appropriate under certain conditions than informal settlements made out of court. Some of chapter 11's advantages are:

- Rather than near-unanimous approval, majority approval in number or two-thirds in amount of allowed claims of creditors' voting is sufficient to accept a plan of reorganization and bind dissenters.
- Creditors bargain collectively with the debtor, which may result in more equitable treatment of the members of each class of claims or interests.
- The debtor's assets are in the custody of the court and safe from attack when the petition is filed.
- Executory contracts and leases can be canceled when such action benefits the debtor.
- Financing during the reorganization may be easier to obtain.
- The creditors have an opportunity to investigate the debtor and its business affairs.
- Certain preferential and fraudulent transfers can be avoided by the debtor in possession or trustee.
- Proper protection can be provided to holders of public securities.
- Certain tax advantages are available under the Bankruptcy Code.
- Creditors are additionally protected by the requirement that, to be confirmed by the court, the plan must be in the best interests of creditors; be feasible; be fair and equitable to any impaired, dissenting classes; and provide for priority claims.

(viii) Prepackaged or Prenegotiated Chapter 11 Plans

Before filing a chapter 11 plan, some debtors develop and obtain approval of the plan by all impaired claims and interests. The court may accept the voting that was done pre-petition provided that the solicitation of the acceptance (or rejection) was in compliance with applicable nonbankruptcy law governing the adequacy of disclosure in connection with the solicitation. If no nonbankruptcy law is applicable, then the solicitation must have occurred after or at the time the holder received adequate information as required under section 1125 of the Bankruptcy Code.

It is necessary for a chapter 11 plan to be filed for several reasons, including:

- Income from debt discharge is taxed in an out-of-court workout to the extent that the debtor is or becomes solvent. Some tax attributes may be reduced in a bankruptcy case, but the gain from debt discharged is not taxed.
- The provisions of section 382(1)(5) and section 382(1)(6) of the Internal Revenue Code (I.R.C.) apply only to bankruptcy cases (see § 6.24(g)).
- Some bond indenture agreements provide that amendments cannot be made unless all holders of debt approve the modifications. Because it is difficult, if not impossible, to obtain 100 percent approval, it is necessary to file a bankruptcy plan to reduce interest or modify the principal of the bonds.

Recently, “prenegotiated bankruptcies” have been used in certain conditions rather than prepackaged bankruptcies. Under a renegotiated plan, an agreement is reached with creditors before the petition is filed. Often the plan and disclosure statement are filed with the court at the time the petition is filed or shortly thereafter. Once the court has approved the disclosure statement, the plan and disclosure statement are issued and votes are solicited. Under the renegotiated plan, the disclosure for public companies is in the form of a disclosure statement rather than Securities and Exchange Commission filing requirements.

(g) Chapter 12: Adjustment of Debts of a Family Farmer with Regular Annual Income

To help farmers resolve some of their financial problems, Congress passed chapter 12 of the Bankruptcy Code. It became effective November 26, 1986, and lasted until October 1, 1993. Because chapter 12 was new and related to a specific class of debtors, Congress wanted to evaluate whether the chapter was serving its purpose and whether there was a need to continue this special chapter for the family farmer. Congress extended the life of chapter 12 to July 1, 2005. The 2005 Act reinstated chapter 12 on a permanent basis.

Most family farmers could not file under chapter 13 because they had too much debt to qualify; they were limited to chapter 11. However, the distinction between the dollar amounts of the debt was much greater than it is today. Many farmers had found chapter 11 needlessly complicated, unduly time consuming, inordinately expensive, and, in too many cases, unworkable.⁷ Chapter 12 was designed to give family farmers an opportunity to reorganize their debts and keep their land. According to legislative history, chapter 12 provides debtors with the protection from creditors that bankruptcy provides while at the same time preventing abuse of the system and ensuring that farm lenders receive a fair repayment.⁸

Section 1204 of the Bankruptcy Code allows the debtor to operate the farm unless the bankruptcy court orders otherwise. Only the debtor can file a plan in a chapter 12 case. The requirements for a plan in chapter 12 are more flexible and lenient than those in chapter 11. Chapter 12 applies to fishermen as well as farmers.

⁷ H.R. Rep. No. 958, 99th Cong., 2d Sess. 48 (1986).

⁸ *Id.*

(h) Chapter 13: Adjustment of Debts of an Individual with Regular Income

The Bankruptcy Reform Act of 1978 changed Chapter XIII of the Bankruptcy Act to make it extremely attractive for individual owners of small businesses. Prior to the new law, only employees (wage earners) were allowed to file according to the provisions of the Bankruptcy Act. In addition, some courts allowed pension fund or Social Security recipients, and some self-employed individuals, such as carpenters, to seek relief under Chapter XIII; other courts interpreted the Act very narrowly, allowing only employees to file a petition. The objective of chapter 13 is to provide individuals with some alternative other than liquidation when in financial trouble. Chapter 13 allows the individual, with court supervision, to work out a plan that can provide for full or partial payment of debts over an extended period of time. The plan is similar in concept to a chapter 11 reorganization but on a less formal and more practical scale.

Individuals with secured or unsecured claims over certain dollar amounts are not allowed to file under chapter 13. The Bankruptcy Reform Act of 1994 increased the debt limits of chapter 13 cases for both secured and unsecured debt and provided for an increase in the debt limit every three years based on the Consumer Price Index for All Urban Consumers. The dollar amount as of April 1, 2010, was \$360,475 for unsecured debt and \$1,081,400 for secured debt. These dollar values are effective through March 31, 2013.

The definition of “regular income” requires that individuals filing the petition must have sufficient stable and reliable income to enable them to make payments under the chapter 13 plan. The limit on amount of indebtedness will prevent some wage earners from filing a petition. The purpose, however, of this limitation was to allow some small sole proprietors to file under this chapter (the filing of a chapter 11 petition might be too cumbersome for them) and require the larger individually owned businesses to use chapter 11.

In *In re Maxfield*,⁹ the bankruptcy court held that a section 6672 penalty assessed against the debtor for failure to pay the withholding taxes of Meridian Glass did count toward the debt limit.

The bankruptcy court held that the IRS’s disputed claim is includable in calculating the chapter 13 debt limits under section 109(e) of the Bankruptcy Code. The taxpayers claimed that a proof of claim filed by the IRS for \$338,500 was discharged in an earlier chapter 7 case. The bankruptcy court held that the objection to the proof of claim was irrelevant. The court noted that section 109(e) requires only that the debt be noncontingent and liquidated. In this case, the tax debt clearly was noncontingent, because it arose from the taxpayers’ failure to pay by the due dates. The court hypothesized that excluding disputed debts from the section 109(e) debt limits would encourage debtors to dispute every unsecured claim to satisfy the chapter 13 eligibility requirements. The court also noted that the tax obligation was not discharged in the prior chapter 7 cases because the taxpayers never sought to have it discharged.¹⁰ The bankruptcy court rejected the argument advanced by the debtor that the claim was secured because it

⁹ 4.1 159 B.R. 587 (Bankr. D. Idaho 1993).

¹⁰ *In re Ekeke*, 198 B.R. 315 (Bankr. E.D. Mo. 1996).

was secured with the assets of Meridian. The court ruled that the IRS claim was unsecured with regard to the bankruptcy estate. The bankruptcy court also rejected the argument that the claim was contingent by noting that the IRS was not required to collect from Meridian before collecting the penalty from the responsible person, which is the debtor in bankruptcy.

(i) Operation of Business

Section 1304 of the Bankruptcy Code provides that the debtor in a chapter 13 case will be allowed to continue to operate the business unless the court orders otherwise. In addition, the debtor has the responsibility of an operating trustee to file the necessary reports and other required information with the appropriate taxing authorities. To operate the business, it is necessary for the debtor to have control over its property. Section 1306(b) of the Bankruptcy Code provides that the debtor will remain in possession of all the property of the estate. The code also provides that the property of the estate includes, in addition to the property as of the date the petition was filed, all property acquired after the commencement of the case and earnings from services rendered before the case is closed.

(ii) Chapter 13 Plan

Only the debtor can file a plan in a chapter 13 case. The requirements for a plan in chapter 13 are much more flexible and lenient than those in chapter 11. In fact, only four requirements set forth in the Bankruptcy Code must be met:¹¹

1. The debtor must submit to the supervision and control of the trustee all or such part of the debtor's future earnings as is necessary for the execution of the plan.
2. The plan must provide for full payment, in deferred cash payments, of all priority claims unless the creditors agree to a different treatment.
3. Where creditors are divided into classes, the same treatment must apply to all claims in a particular class.
4. Notwithstanding the above provisions, a plan may provide for less than full payment of domestic support obligations under section 507(a)(1) provided all of the debtor's projected disposable income will be applied to a five-year plan period.¹²

Once the plan has been approved and confirmed by the court, the debts will be discharged. The extent to which debts can be discharged under chapter 13 is much greater than it is in chapter 11 procedures.

Individuals owning businesses that can file in either chapter 13 or chapter 11 may find some advantages in using chapter 13: Chapter 13 has much less creditor involve-

¹¹ 11 U.S.C. § 1322(a).

¹² Section 1325(b)(2) defines "disposable income" to mean current monthly income (other than child support payments, foster care payments, or disability payments for a dependent child) less amounts reasonable and necessary for (1) the maintenance or support of the debtor or a dependent of the debtor or for a domestic support obligation that first becomes payable after the date of the filing of the petition; and selected charitable contributions and (2) for the payment of expenditures necessary for the continuation, preservation, and operation of the debtor's business.

ment. In a chapter 11 proceeding, the debtor runs a risk of a trustee being appointed, but in chapter 13, the debtor will operate the business even though there is a standing trustee. Less creditor approval is also required in a chapter 13 case than in a chapter 11 proceeding.

(i) U.S. Trustee

In October 1986, Congress passed the Bankruptcy Judges, United States Trustees and Family Farmer Bankruptcy Act of 1986, which expanded the 10 pilot programs to 21 regions comprising all federal districts except districts in the states of Alabama and North Carolina. A U.S. trustee, serving a term of five years, is appointed in each of the regions. The U.S. trustee appoints creditors' committees, chapter 7 trustees, and chapter 11 trustees or examiners when authorized by the court when such appointments are needed. Section 586(a) of title 28 of the U.S. Code lists these additional functions of the U.S. trustee:

- Monitor applications for compensation and reimbursement for officers filed under section 330 of title 11 and, whenever the U.S. trustee deems it to be appropriate, file with the court comments with respect to any of such applications.
- Monitor plans and disclosure statements filed in cases under chapter 11 and file with the court comments with respect to such plans and disclosure statements.
- Monitor plans filed under chapters 12 and 13 of title 11 and file with the court comments with respect to such plans.
- Take such action as the U.S. trustee deems to be appropriate to ensure that all reports, schedules, and fees required to be filed under title 11 and [title 28] by the debtor are filed properly and in a timely manner.
- Monitor creditors' committees appointed under title 11.
- Notify the appropriate U.S. attorney of matters related to the occurrence of any action that may constitute a crime under the laws of the United States and, on the request of the U.S. attorney, assist the U.S. attorney in carrying out prosecutions based on such action.
- Monitor the progress of cases under title 11 and take such actions as the U.S. trustee deems to be appropriate to prevent undue delay in such progress.
- Monitor applications filed under section 327 of title 11 for the retention of accountants and other professionals and, whenever the U.S. trustee deems it to be appropriate, file with the court comments with respect to the approval of such applications.
- To move for the appointment of a trustee if there are reasonable grounds to suspect that current members of the governing body of the debtor, the debtor's chief executive or chief financial officer, or members of the governing body that selected the debtor's chief executive or chief financial officer participated in actual fraud, dishonesty, or criminal conduct in the management of the debtor or the debtor's public financial reporting.
- Perform other duties that the Attorney General may prescribe.