

# Can a Business Reorganize under Chapter 13?

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Can a business debtor reorganize under chapter 13? Certainly! As long as the business debtor is eligible, he or she can easily use chapter 13 for his or her reorganization. What kind of “business debtor” is eligible to use chapter 13? An individual (a living and breathing human being) who operates his or her own business, is not a stockbroker or commodity broker, and has debts within certain limits. It is not the *kind* of business that matters (other than a stockbroker),<sup>1</sup> it is the *debts*—whether they are below certain thresholds and whether they represent trade debt associated with the production of income.<sup>2</sup>



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Under the current limits, secured debt must be less than \$1,010,650 and unsecured debt less than \$336,900.<sup>3</sup> Watch out: The unsecured debt includes all unsecured tax claims,<sup>4</sup> other unsecured priority claims and the undersecured portion (deficiency portion) of a secured claim.<sup>5</sup> Contrary to what most debtors believe, the debt limits include those debts that the debtor *disputes*, even though the limits do not include those debts that are unliquidated or contingent.<sup>6</sup> The debt limits are adjusted every three years; the next adjustment will be in 2010.<sup>7</sup>

How does a business debtor use chapter 13? The same as any other chapter 13 debtor—through the efficient, routine-driven practice used by chapter 13 debtors throughout the country. Is chapter 13 for the individual business debtor *really* just the same as the individual consumer debtor? No. The business case does vary

## About the Author

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from the consumer case because the business case requires some different preparation and additional attention to details. Initially, a critical determination is whether the self-employed business debtor is a “debtor engaged in business,” meaning that he or she incurs trade credit in the production of income.<sup>8</sup> The debtor who meets the “engaged in business” definition will have particular postpetition reporting requirements and responsibilities.<sup>9</sup> Before filing the chapter 13 petition for the business debtor, however, consider the following points.

## Feature

### The Codebtor Stay

The codebtor stay is found in §1301 and imposes a stay of collection action against nondebtor co-signers, generally. However, the codebtor stay protects co-obligors of *consumer* debts and does not apply to individuals who became liable on the debtor’s debts in the ordinary course of that individual’s business. Bankruptcy Code §101(8) defines a consumer debt as a “debt incurred by an individual primarily for a personal, family or household purpose.” The legislative history directs that the “consumer debt does not include a debt to any extent that the debt is secured by real property.”<sup>10</sup> The Code fails to exclude secured debts from the definition, and thus bankruptcy courts rarely recognize this history.<sup>11</sup> The “ordinary course of business” exception applies to the codebtor; that is, the stay will not apply if the debt was incurred in the ordinary course of the *codebtor’s* business.<sup>12</sup>

### Is the Non-Filing Spouse Protected?

Maybe. If the spouse is liable for the home mortgage, then in the majority of jurisdictions, yes, the spouse is protected.<sup>13</sup> If the spouse is liable for household debts such as medical bills, household furnishings and appliances, then yes, the spouse is protected. It is the personal loans and credit cards that can be troublesome and may require some research. Before filing the petition, examine the credit card statements or the loan applications. If the co-signed credit card or personal loan was not used for personal, family or household purposes, but instead was used for the business, the co-signer may not be protected.<sup>14</sup> Finally, the spouse will not be protected from collection of tax debts; generally tax obligations are not consumer debts for purposes of the codebtor stay of §1301.<sup>15</sup>

### Is the Business Partner Protected?

Probably not. If the business partner happened to co-sign a personal debt unrelated to his business (just to be a good friend), then yes, the partner is protected. If the partner co-signed debts for the operation of his business, then the codebtor stay of §1301 will not provide protection.

### The Means Test

Business debtors really do have to complete Form 22C (the means test). The only exception to this requirement for individual debtors is found in chapter 7.<sup>16</sup> Although some jurisdictions have initiated a local practice that exempts individual “business debtors” from this filing requirement, the rules do not contain such an exception.<sup>17</sup> All individuals filing chapter 13 or chapter 11 must complete and file a means test form.

### How Do I Report “Above the Line” Figures?

When filing Form 22C, keep in mind these tips. First, the gross average monthly income is reported on line 3a (gross

<sup>1</sup> See *In re Schave*, 91 B.R. 110 (Bankr. D. Colo. 1988).

<sup>2</sup> Bankruptcy Code §1304 assigns debtors who incur trade debt in the production of income with additional responsibilities.

<sup>3</sup> 72 Fed. Reg. No. 30 at 7082 (Feb. 14, 2007).

<sup>4</sup> The Second Circuit has found that even if the individual has not been assessed the liability as a responsible party for the unpaid withholding taxes of its corporation, the tax debt is counted in the debt limits and is not “contingent” or “unliquidated.” *In re Mazzeo*, 131 F.3d 295 (2d Cir. 1997).

<sup>5</sup> *In re Scavis*, 249 F.3d 975, 983 (9th Cir. 2001); *In re Balbus*, 933 F.2d 246, 247 (4th Cir. 1991); *In re Werts*, 410 B.R. 677, 686 (Bankr. D. Kan. 2009).

<sup>6</sup> *In re Nicholes*, 184 B.R. 82, 88-91 (9th Cir. B.A.P. 1995) (corporate debts are not contingent in chapter 13 for responsible party); *In re Williams*, 51 B.R. 249 (Bankr. S.D. Ind. 1984) (failure of SBA to provide accounting to guarantors after liquidation of collateral does not render debt unliquidated or contingent in guarantor’s chapter 13 case). See *In re Clark*, 91 B.R. 570 (Bankr. D. Colo. 1988) (claims requiring piercing of corporate veil may be contingent for purposes of debt limits).

<sup>7</sup> See 11 U.S.C. §§104 (change to occur April 1, 2010) and 109(e).

<sup>8</sup> 11 U.S.C. §1304.

<sup>9</sup> See Fed. R. Bankr. P. 2015(c).

<sup>10</sup> 124 Cong. Rec. H11, 909 (daily ed. Sept. 28, 1978).

<sup>11</sup> *In re Fenster*, No. 7-03-05002 (unpublished) (Bankr. W.D. Va. Oct. 7, 2006), citing *In re Goodson*, 130 B.R. 897 (Bankr. N.D. Okla. 1991); *In re Johnson*, 115 B.R. 159 (Bankr. S.D. Ill. 1990).

<sup>12</sup> *In re Patti*, 2001 WL 1188218 (Bankr. E.D. Pa. Sept. 14, 2001) (unpublished).

<sup>13</sup> Compare *In re Zersen*, 189 B.R. 732, 740 n.4 (Bankr. W.D. Wis. 1995) (loan incurred by debtor to purchase family home is consumer debt), with *In re Ikeda*, 37 B.R. 193 (Bankr. D. Haw. 1984) (consumer debts do not include home mortgages).

<sup>14</sup> *In re Lindamood*, 21 B.R. 473 (Bankr. W.D. Va. 1982).

<sup>15</sup> See Keith M. Lundin, *Chapter 13 Bankruptcy*, 3rd ed. 2007-1 (2000 & Supp. 2004), Vol. 1 §85.1, citing *IRS v. Westberry* (*In re Westberry*), 215 F.3d 589 (6th Cir. 2000); *In re Dye*, 190 B.R. 566 (Bankr. N.D. Ill. 1995).

<sup>16</sup> 11 U.S.C. §707(b)(2)(D).

<sup>17</sup> Fed. R. Bankr. P. 1017(b)(4), (5) and (6).

income is all cash received during that period). All debtors are cash basis when in bankruptcy, and all receipts are revealed, not just taxable receipts and certainly not just the net receipts. On line 3b, the form directs the debtor to report the average monthly business expenditures—that is, the actual true amounts paid out by the business during that six-month period, totaled and then averaged.

The result is a figure used to calculate “current monthly income” from which the debtor will determine his applicable commitment period, and from which he will deduct certain allowances and expenses. Most courts find that it is inappropriate to deduct expenses prior to calculating “current monthly income,” and therefore hold that the debtor should report all gross business income on line 3a but not deduct expenses on line 3b.<sup>18</sup>

When the debtor does report business expenses, whether on line 3b or Schedule J line 16, the debtor must report only actual out-of-pocket expenses. Most debtors will want to rely on the Schedule C from their 1040 tax return to determine business expenses. These debtors will take the total business expenses contained on line 28 of the Schedule C of the previous year’s 1040 tax return and divide such total by 12 to obtain an average monthly expense figure. This approach will likely result in an objection from a trustee or an unsecured creditor. Why? Because the tax return allows deductions that are permissible tax deductions but do not reflect out-of-pocket expenditures. The most common example is depreciation on business assets: The debtor should instead collect a record of his or her actual expenses.

The debtor’s bank statements will provide some support for the debtor’s actual business expenditures, yet the best support is a general ledger (reporting all receipts and all expenditures). If the debtor is not using a ledger, it is never too late to start. Debtors will need to report income and expenses during a chapter 13 case,<sup>19</sup> and should start ledgers (even handwritten ones will do) before they leave their initial bankruptcy consultations.

### How Do I Report “Below the Line” Figures?

If the difference on line 21 of Form 22C results in a figure once annualized that is greater than the state median income, the debtor will need to complete the entire Form 22C. When completing the rest of the form, the potential traps

are in lines 30 and 47: the deductions for taxes and for secured-debt payments.

On line 30, the debtor needs to report his or her average monthly tax liability, even if it has not been realized yet. This may not be obvious. Hopefully, a tax preparer can give an estimate or help provide a worksheet to determine liability using the debtor’s gross income and permissible deductions.

If a debtor has secured debts, he or she may claim debt deductions on line 47, but watch out: If the debt is for a loan secured on equipment or a mortgage secured on business property, and the debt deductions were included in the business expenditures reported on line 3b (“above the line”), the debtor should not claim the same monthly debt payment here. To do so will likely trigger an objection from a trustee or unsecured creditor on the grounds of “double dipping.”<sup>20</sup>

Can the debtor deduct business expenses on either line 60 or 57 of the form? For the business debtor who does not deduct business expenses on line 3b, the only other option for out-of-pocket expenditures for such items as supplies, inventory, equipment rental, office space, insurances or wages may be line 60 or 57. Yet the line 60 deductions are limited to actual out-of-pocket expenses for the health, welfare and safety of the debtor and his or her family<sup>21</sup> and the line 57 deductions only for special circumstances “that justify additional expenses or adjustments of current monthly income for which there is no reasonable alternative.”<sup>22</sup>

Fortunately, this conundrum may have little material impact. For the business debtor, Form 22C does *not* result in the calculation of disposable income.<sup>23</sup> Form 22C determines the amounts reasonably necessary for the maintenance and support of the debtor and his or her dependents; disposable income, however, is determined after considering such expenses and, in addition, necessary business expenditures.<sup>24</sup> The business debtor must be sure to claim his or her business expenses on Schedule J, line 16.

### Secured Debts

The business debtor may cram down most of his or her business secured debts.

The business debtor who has debts secured by business collateral (not personal-use property) may use §506 to deal with those secured debts. The debtor can value the collateral and can treat the creditor who has a lien on that collateral as secured to the extent of the value of the collateral, and as unsecured to the extent of any deficiency. The “hanging paragraph” limitation on motor vehicles purchased within 910 days of the petition does not apply to nonpersonal-use motor vehicles.

However, does the “any other thing of value purchased within one year of the petition” limitation apply to nonpersonal-use property, including a motor vehicle used in the debtor’s business? The business debtor needs to be careful about the “any other thing of value” limitation in the hanging paragraph of §1325. Courts are split on whether a business debtor may cram down a motor vehicle that was purchased for the debtor’s business within one year of the petition.<sup>25</sup> Courts are uniform, however, on the conclusion that a business debtor may not cram down business property other than possibly a motor vehicle purchased within a year of the petition.<sup>26</sup>

### The Unsecured Debts

The business debtor may have good reason to separately classify his or her unsecured debts. He or she may want to specially treat co-signed debts with a spouse, or co-signed debts with a business partner, or those particular debts that are absolutely vital to his or her ongoing operations. The business chapter 13 debtor can successfully separately classify his or her unsecured debts.

Like chapter 11, chapter 13 offers the opportunity to separately classify debts. Unlike chapter 11, the debtor does not need to solicit or tally ballots in order to determine if the plan has sufficient acceptances to permit confirmation under §1129. For the chapter 13 debtor, it is notice that is key to plan confirmation; after notice and opportunity for a hearing, a creditor’s silence or lack of opposition is deemed to be acceptance of its payment terms under the plan. In addition, the chapter 13 trustee will review the plan and may object to its terms, triggering a hearing on confirmation and placing the burden on the debtor to prove that the plan meets all requirements of confirmation.<sup>27</sup> The debtor

<sup>18</sup> *In re Wiegand*, 386 B.R. 238 (9th Cir. B.A.P. 2008); *In re Arnold*, 376 B.R. 652 (Bankr. M.D. Tenn. 2007).

<sup>19</sup> See Fed. R. Bankr. P. 2015(c).

<sup>20</sup> See, e.g., *In re Jackson*, 353 B.R. 849 (Bankr. E.D.N.C. 2006) (discussing concept of “double dipping”).

<sup>21</sup> 11 U.S.C. §707(b)(2)(A)(ii)(I).

<sup>22</sup> 11 U.S.C. §707(b)(2)(B). See, e.g., *In re Parulan*, 387 B.R. 168, 172-73 (Bankr. E.D. Va. 2008), for a discussion of “special circumstances” deductions in chapter 13 cases.

<sup>23</sup> The form does determine the applicable commitment period for the business debtor. *Wiegand*, 386 B.R. at 241.

<sup>24</sup> 11 U.S.C. §1325(b)(2)(B).

<sup>25</sup> See *In re Littlefield*, 388 B.R. 1, 4 (Bankr. D. Maine 2008), and review of case law therein.

<sup>26</sup> *In re Hickey*, 370 B.R. 219 (Bankr. D. Neb. 2007).

<sup>27</sup> *In re Fickel*, 2008 WL 1710102 (Bankr. M.D. Pa. April 10, 2008); *In re Brown*, 244 B.R. 603 (Bankr. W.D. Va. 2000).

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then will be required to show that the plan terms are permissible and appropriate.

The key to permissible separate classification in chapter 13 is if it does not result in “unfair discrimination.” Some courts will permit separate classification of co-signed debts without requiring a condition that the separate classification is “not unfair” or prejudicial to creditors, but many courts impose the unfair-discrimination test to all separate classification. Proving that the discrimination is fair is as simple as “running the numbers,” in some cases.

The commonly-used test for determining whether it is “fair” or “unfair” is found in *In re Husted*.<sup>28</sup> This test sets forth five factors to determine whether the discrimination is permissible (“fair”): (1) whether there is a rational basis for the classification; (2) whether the classification is necessary to the debtor’s rehabilitation under chapter 13; (3) whether the discriminatory classification is proposed in good faith; (4) whether

there is meaningful payment to the class discriminated against; and (5) whether there is a reasonable [not exorbitant] difference between what the creditors discriminated against will receive if the plan as proposed is confirmed and the amount they would receive without the separate classification.

## Bank Accounts

The chapter 13 business debtor does not need to open debtor-in-possession accounts, nor provide collateralization for bank accounts. However, the chapter 13 debtor does need to maintain a bank account. The debtor should expect to share copies of his or her bank statement with the trustee, and the bank statements, along with a general ledger, will help the debtor complete his or her business-debtor reports.<sup>29</sup>

## Postpetition Credit and Operating “COD”

Confirmation of the plan “re-vests” property of the estate in the debtor,

<sup>29</sup> Jurisdictions vary regarding the extent of the reporting required to comply with Rule 2015.

unless the confirmation order provides otherwise. Generally, this will not have much practical impact on the business debtor. Like the chapter 11 debtor, he or she will likely need to operate with cash (COD), unless he or she qualifies as a “debtor engaged in business.” If so, he or she may obtain unsecured credit or unsecured debt in the ordinary course of his or her business, subject to court approval and consistent with Bankruptcy Code §§364 and 1304.

## Conclusion

Chapter 13 can be the best choice for business debtors and practitioners who may: (1) be intimidated by the cost of, and the paperwork required in, a chapter 11 case; (2) need the extra hand-holding of a trustee to make conduit payments; or (3) want the flexibility to modify plans throughout their case or to voluntarily dismiss. It is always a good idea for the individual business debtor to consider chapter 13 when weighing other filing options. ■

<sup>28</sup> 142 B.R. 72 (Bankr. W.D.N.Y. 1992).

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