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Does the Bankruptcy Code Allow Tiered Chapter 13 Plans?

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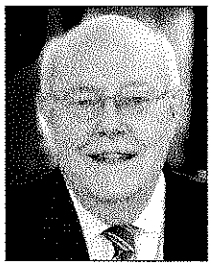

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Under 11 U.S.C. § 1325, a chapter 13 plan must pay secured creditors the value of their claims. If a plan proposes to pay those claims in periodic payments — as most do — § 1325(b)(iii)(I) requires that those payments be in equal monthly amounts. However, the Bankruptcy Code is silent on *when* those payments begin. Section 1326(b)(1) requires that debtors pay priority administrative claims (such as attorneys' fees to debtors' counsel) before or at the time that general creditors are paid. As a result, many debtors propose "tiered" plans. These plans pay small adequate-protection payments to secured creditors while debtor's counsel is paid in full, with larger equal monthly payments to secured creditors following later.[1]

This trend is significant. Only 38.8 percent of chapter 13 debtors complete repayment plans.[2] While the Code requires debtors to pay secured creditors equal monthly payments sufficient to pay off secured claims, it is more likely that a chapter 13 case will be dismissed or converted before those equal monthly payments begin or are satisfied.

So, does the Code permit tiered plans? Bankruptcy courts are divided,[3] and even courts within the same federal districts have reached different results.[4] Given this uncertainty and split of authority, there is an obvious problem in § 1325 that Congress must resolve.

Background of §§ 1325 and 1326

Before 2005, chapter 13 plans could propose creative payment structures to secured creditors, but this caused two perceived abuses.[5] First, chapter 13 had no express requirement that secured creditors receive adequate-protection payments.[6] This permitted debtors to propose plans with payment moratoriums, allowing debtors to use collateral for months without payment.[7] These debtors could then convert their cases to chapter 7 or modify their plans to surrender the now-devalued collateral before payments began.[8] Second, chapter 13 plans could propose small payments over the plan's life with large balloon payments at the end.[9] Debtors could even propose quarterly or semi-annual payments or reduce payments during certain months of the year.[10]

When Congress enacted the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), it amended two provisions of chapter 13 to solve these issues.[11] First, BAPCPA amended § 1325(a)(5)(B) to require that debtors pay secured creditors equal monthly payments.[12] Second, BAPCPA amended § 1326(a) to require debtors to pay adequate-protection payments to secured creditors holding liens on personal property, with those payments starting no later than 30 days after the petition date.[13] Congress intended these amendments to eliminate fluctuating payment schemes and protect secured creditors from the threat of devalued collateral and early plan termination.

However, these amendments created a new problem. While BAPCPA required equal monthly payments to secured creditors, Congress failed to identify *when* those payments begin. For example, may a plan pay a secured creditor in full over the course of 12 months, but provide that monthly payments begin in year two of the plan after debtor's counsel is paid, or does the Code require that payments begin right after confirmation? Some bankruptcy courts have confirmed tiered plans, holding that payments may begin at any time, but other courts have rejected tiered plans, holding that equal monthly payments must begin just after confirmation.

1 There are other uses of tiered plans, such as allowing a debtor to reduce payments to secured creditors to pay off multiple secured debts before the maturity of one or more of them. *In re Shelton*, 2018 Bankr. LEXIS 2815, at *38-42 (Bankr. N.D. Ill. Sept. 14, 2018). However, debtors often propose tiered plans to ensure prompt payment to debtor's counsel. *Id.*

2 *See* Ed Flynn, "Success Rates in Chapter 13," XXXVI *ABI Journal* 8, 38-39, 56-57, August 2017, *available at* abi.org/abi-journal.

3 Confirming tiered plans: *In re Carr*, 583 B.R. 458 (Bankr. N.D. Ill. 2018); *In re Amaya*, 585 B.R. 403 (Bankr. S.D. Tex. 2018); *In re White*, 564 B.R. 883 (Bankr. W.D. La. 2017); *In re Brennan*, 455 B.R. 237 (Bankr. M.D. Fla. 2009); *In re Butler*, 403 B.R. 5 (Bankr. W.D. Ark. 2009); *In re Hernandez*, 2009 Bankr. LEXIS 982, 2009 WL 1024621 (Bankr. N.D. Ill. April 14, 2009); *In re Marks*, 394 B.R. 198 (Bankr. N.D. Ill. 2008); *In re Chavez*, 2008 Bankr. LEXIS 592, 2008 WL 624566 (Bankr. S.D. Tex. March 5, 2008); *In re Hill*, 397 B.R. 259 (Bankr. M.D.N.C. 2007); *In re Erwin*, 376 B.R. 897 (Bankr. C.D. Ill. 2007); *In re DeSardi*, 340 B.R. 790 (Bankr. S.D. Tex. 2006); *In re Blevins*, 2006 Bankr. LEXIS 2422, 2006 WL 2724153 (Bankr. E.D. Cal. 2006). Sustaining objections to tiered plans: *In re Shelton*, 2018 Bankr. LEXIS 2815 (Bankr. N.D. Ill. Sept. 14, 2018); *In re Miceli*, 2018 Bankr. LEXIS 2068 (Bankr. N.D. Ill. July 9, 2018); *In re Williams*, 583 B.R. 453 (Bankr. N.D. Ill. 2018); *In re Cochran*, 555 B.R. 892 (Bankr. M.D. Ga. 2016); *In re Romero*, 539 B.R. 557 (Bankr. E.D. Wis. 2015); *In re Kirk*, 465 B.R. 300 (Bankr. N.D. Ala. 2012); *In re Willis*, 460 B.R. 784 (Bankr. D. Kan. 2011); *In re Bollinger*, 2011 Bankr. LEXIS 3339, 2011 WL 388275 (Bankr. D. Ore. Sept. 2, 2011); *In re Espinosa*, 2008 Bankr. LEXIS 2121, 2008 WL 2954282 (Bankr. D. Utah Aug. 1, 2008); *In re Williams*, 385 B.R. 468 (Bankr. S.D. Ga. 2008); *In re Sanchez*, 384 B.R. 574 (Bankr. D. Ore. 2008); *In re Denton*, 370 B.R. 441 (Bankr. S.D. Ga. 2007).

4 *Compare In re Shelton*, 2018 Bankr. LEXIS 2815 (Bankr. N.D. Ill. Sept. 14, 2018), *with In re Carr*, 583 B.R. 458 (Bankr. N.D. Ill. 2018).

5 *In re Hill*, 397 B.R. 259, 270 (Bankr. M.D.N.C. 2007).

6 *Id.*

7 *Id.*

8 *Id.* (citing *In re DeSardi*, 340 B.R. 790, 809-811 (Bankr. S.D. Tex. 2006); Richardo I. Kilpatrick and Marla A. Zain, "Selected Creditor Issues Under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005," 79 *Am. Bankr. L.J.* 817, 836 (Summer 2005)); *In re Marks*, 394 B.R. 198, 202 (Bankr. N.D. Ill. 2008) (citing *In re Robson*, 369 B.R. 377, 379 (Bankr. N.D. Ill. 2007)).

9 *In re Butler*, 403 B.R. 5, 13 (Bankr. W.D. Ark. 2009) (citing *In re Erwin*, 376 B.R. 897, 901 (Bankr. C.D. Ill. 2007)).

10 *Id.* at 13.

11 *Id.* at 10.

12 *Id.*

13 *Id.*

Argument for Tiered Chapter 13 Plans

Bankruptcy courts that have confirmed tiered chapter 13 plans have generally done so for three reasons. First, the Bankruptcy Code contains no express requirement that equal monthly payments begin at confirmation.[14] Some courts reason that these payments may begin at any time, so long as the payments are in equal monthly amounts when they begin, and so long as these payments continue until secured claims are paid in full.[15]

Second, § 1325(b)(iii)(II) requires that debtors make adequate-protection payments to creditors with claims secured by personal property starting 30 days after the petition date, so any delay in paying equal monthly payments will not harm these creditors. Adequate-protection payments must equal the amount of depreciation to a creditor's collateral so that these creditors "will not be left holding the bag for any loss in value of [their] collateral if the plan should later fail or become converted to a chapter 7 case."[16]

Section 1325(b)(iii)(II) does not specifically require debtors to make adequate-protection payments to creditors with claims secured by real property.[17] This is likely because the BAPCPA amendments to §§ 1325 and 1326 were targeted at "perceived abuses of car lessors and purchase money secured creditors."[18] However, courts have noted that creditors with claims secured by real property might still protect themselves by seeking adequate protection under §§ 362 or 363.[19] At least one court has confirmed a tiered plan over a mortgagee's objection.[20]

Finally, § 1326(b) requires that administrative-expense claims be paid "[b]efore or at the time of each payment to creditors under the plan," which administrative expenses include attorneys' fees to a debtor's counsel. If chapter 13 plans had to start equal monthly payments to secured creditors just after confirmation, some bankruptcy courts caution that debtors might be unable to pay both administrative claims and secured creditors at the same time.[21] In these cases, debtors could not propose a confirmable plan, which is — according to some courts — "an absurd result that Congress could not have intended."[22]

Argument Against Tiered Chapter 13 Plans

Interpreting the same statutory language, another line of cases has rejected tiered plans. These courts hold that tiered plans violate the Bankruptcy Code by impermissibly favoring payment to debtor's counsel and other administrative claims over secured creditors. In addition, at least one court has held that proposing a tiered plan can constitute bad faith.[23]

These courts first emphasize that when Congress enacted § 1325(a)(5)(B)(iii)(I), it intended to shift the risk of plan failure away from secured creditors.[24] However, a tiered plan shifts the risk the opposite way, favoring debtor's counsel and other administrative-expense claimants over the very creditors that Congress intended to protect.[25]

These courts continue that providing smaller adequate-protection payments during any delay under a tiered plan violates the plain language of § 1325(a)(5)(B)(iii)(I).[26] In reality, adequate-protection payments are "periodic payments."[27] Post-confirmation, all "periodic payments" must be in equal monthly amounts under § 1325(a)(5)(B)(iii)(I). Thus, allowing a chapter 13 plan to pay smaller adequate-protection payments in the first few months of a plan, with larger plan payments to follow, violates the plain language of § 1325(a)(5)(B)(iii)(I).[28]

Next, these courts have concluded that § 1326(b) does not require that administrative expenses be paid in full before plan payments to secured creditors begin.[29]

14 *Id.* (citing *In re DeSardi*, 340 B.R. at 805; *In re Marks*, 394 B.R. at 204; *In re Hill*, 397 B.R. at 268-69; 8 *Collier on Bankruptcy* ¶ 1325.06[3][b][ii][A] (15th ed. *rev'd* 2008)).
15 *In re Hill*, 397 B.R. at 268-69.
16 *In re Marks*, 394 B.R. at 204-05.
17 *In re Hill*, 397 B.R. at 264 ("If the creditor is secured by real property, then there is no requirement that the payments be in an amount sufficient to provide the creditor adequate protection under Section 1325(a)(5)(B).").
18 *In re Hernandez*, 2015 Bankr. LEXIS 3175, at *10-11 n.6, 2015 WL 5554126 (Bankr. S.D. Fla. Sept. 18, 2015).
19 *Id.*
20 *In re Amaya*, 585 B.R. 403 (Bankr. S.D. Tex. 2018).
21 *In re Hill*, 397 B.R. at 270.
22 *Id.*; *see also In re Hernandez*, 2009 Bankr. LEXIS 982, at *14, 2009 WL 1024621 (Bankr. N.D. Ill. April 14, 2009).
23 *In re Shelton*, 2018 Bankr. LEXIS 2815, at *38-42 (Bankr. N.D. Ill. Sept. 14, 2018).
24 *Id.*
25 *Id.*
26 *In re Miceli*, 587 B.R. 492, 498 (Bankr. N.D. Ill. 2018).
27 *Id.*
28 *Id.* (citing *In re Hamilton*, 401 B.R. 539, 543 (B.A.P. 1st Cir. 2009)).
29 *In re Miceli*, 587 B.R. at 497-98.

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Problems in the Code: Does the Code Allow Tiered Chapter 13 Plans?

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Instead, § 1326(b) expressly allows administrative-expense claims and plan payments to secured creditors to be paid concurrently:

> Section 1326(b) only requires payment of allowed administrative expenses "[b]efore or at the time of each payment to creditors under the plan." Clearly, that section permits creditors to be paid concurrently with administrative expenses.[30]

There is no language in § 1326(b)(1) allowing a debtor to favor administrative-expense claims over secured creditors entitled to equal monthly payments.[31] Consequently, "in instances where both §§ 1325(a)(5)(B) and 1326(b)(1) apply, debtors 'need to calculate plan payments sufficient to provide for these payments and for payment of attorney fees and other administrative expenses.'"[32]

More recently, one bankruptcy court held that a debtor's attorney had filed a chapter 13 plan in bad faith by proposing tiered payments to secured creditors.[33] The court held that the tiered plan was not in the debtor's best interests because it not only shifted risk to secured creditors (in violation of congressional intent), it also shifted risk to the debtor.[34] During the delay period, secured debt would be left unpaid. If the plan failed during that period or shortly afterward, the debtor might be left "in a worse position that had [he/she] not filed for bankruptcy" in the first place.[35] This could be true even if the plan had provided adequate protection during the delay. Adequate-protection payments are often less than the contractual payments due, so if the case were dismissed before equal monthly payments began, "the debtor [would] automatically [be] in default under the terms of the contract ... even if the debtor had been current with the terms of the bankruptcy plan."[36]

Conclusion

When it amended §§ 1325 and 1326, Congress intended to eliminate perceived abuses of chapter 13, these amendments have instead created more confusion. Not only are bankruptcy courts within the same district interpreting these amendments differently, but at least one court has determined that proposing a tiered plan constitutes bad faith, leaving debtors and their counsel with no clear guidance on how to balance payments to administrative-expense claimants and secured creditors. No matter what policy decision is ultimately made, Congress must step in and resolve the issue way or the other. An amendment as simple as setting forth *when* equal monthly payments to secured creditors must begin under § 1325(a)(5)(B)(iii)(I) is likely all that is needed to do so. abi

30 *Id.* (quoting 11 U.S.C. § 1326(b)).
31 *In re Williams*, 583 B.R. 453, 458 (Bankr. N.D. Ill. 2018).
32 *Id.* at 458 (quoting *In re Williams*, 385 B.R. 468, 475 (Bankr. S.D. Ga. 2008)).
33 *In re Shelton*, 2018 Bankr. LEXIS 2815, at *38-42.
34 *Id.* at *41.
35 *Id.*
36 *Id.* at n.11.

Insurance Issues: Maximizing Recoveries from Post-Confirmation Litigation

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With litigation funding, a litigation funder invests in the litigation controlled by the litigation trust on a non-recourse basis and provides capital to the litigation trust to pay litigation costs. If the litigation is resolved successfully, the proceeds received by the litigation trust are shared with the litigation trust beneficiaries and the litigation funder. If the litigation is unsuccessful, the litigation funder is not owed anything from the litigation trust. There are several ways for litigation trust beneficiaries to best position themselves in a chapter 11 process to benefit from litigation finance.

Receive the Debtors' Most Valuable Litigation and Use Litigation Finance to Pursue Causes of Action

In many chapter 11 cases, creditors that will receive litigation interests are forced to make tough choices when negotiating for their recovery. If the litigation is meritorious, the creditors could benefit from focusing on receiving as much plaintiff-side litigation as possible. However, litigation is a contingent asset that can only be monetized with a significant investment, and it might take years to receive a recovery. For the litigation interests to be converted to distributable cash by the litigation trust, the litigation trust beneficiaries need a considerable amount of money and patience.

Complex litigation pursued by litigation trusts is very expensive, and securing money from the litigation trust beneficiaries to fund the litigation is generally either impossible or impractical. Litigation trusts sometimes can retain attorneys using a contingency arrangement, but that significantly limits the attorneys who are willing to represent the litigation trust. It still does not address expert witnesses, document production, travel, depositions and other litigation expenses.

As a result, litigation trust beneficiaries usually believe that they must also negotiate for cash from the debtor to fund the litigation. This dynamic cedes leverage to more senior creditor constituencies who would otherwise receive the cash that is used to fund the litigation trust for the benefit of the litigation trust beneficiaries.

In addition, if the litigation trust can secure sufficient litigation funding to allow the trust to retain its ideal lawyers and experts to pursue the most appropriate litigation strategy, litigation trust beneficiaries will not be forced to accept a quick settlement that undervalues potential recoveries or to abandon the litigation without any recovery. If the litigation is sufficiently valuable, a litigation funder might be willing

Tax Cuts and Jobs Act: Bankruptcy Estate Tax Considerations

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removal of AMT on corporations, effective for taxable years beginning after Dec. 31, 2017.

No filing requirement changes have been made for domestic corporations, which (unless they are a charitable organization with less than $1,000 of unrelated business taxable income) must file tax returns until they cease business, dissolve and retain no assets (including litigation claims), regardless of the amount of income or loss.[4] Trustees, receivers or assignees of corporations that have not dissolved but retain no assets and have ceased business operations may continue to request an exemption from filing in writing to the local insolvency office, which must respond within 90 days.

Corporations that have made a valid S-election that has been accepted by the IRS must file on Form 1120S, passing items of income, gain and loss through to shareholders. Issues can arise when former officers of S-corporation bankruptcy estates are unsure whether S-elections had been made and/or accepted by the IRS. Verification with the IRS is advisable to avoid late-filing penalties. Such penalties, applicable to both partnerships filing on Form 1065 and S-corporations filing on Form 1120S, have increased from $190 to $200 per partner/shareholder per month (up to a maximum of 12 months per tax year) for the 2018 tax year.

A domestic partnership or multi-member LLC must generally file Form 1065 unless it neither receives income nor incurs any expenditures treated as deductions or credits for federal income tax purposes.[5] Previously, the sale or exchange of 50 percent or more of a partnership's capital and profits within a 12-month period (for example, as part of a chapter 11 reorganization plan) would trigger a "technical termination" of the partnership, whereby two separate tax returns were required for the termination year. However, the TCJA has eliminated the technical termination provision for tax years beginning after Dec. 31, 2017, removing the need to file two separate returns in such tax years. However, an accounting must still be performed to allocate members' distributive share of income and loss for the full tax year, including a complete or partial sale/exchange of membership interests.

Qualified settlement funds (QSFs) are trusts used to administer litigation claims, and one of their benefits is to secure current tax deductions for defendants contributing monies to the trust, even though plaintiffs might not actually receive the funds until much later. QSFs can potentially be established by bankruptcy estates to more closely match taxable income and tax-deductible expense.

QSFs must file tax returns on Form 1120SF, and late-filing penalties have increased to the smaller of the tax due, or $210. Amounts transferred to the fund by or on behalf of the transferor are not included in the QSF's income, and likewise payments of claims are not deducted by the QSF. Reportable items include interest, capital gains, other income and administrative expenses.

Conclusion

Many aspects of the TCJA will benefit bankruptcy estates, including the headline-grabbing tax-rate reductions, the simplification of partnership technical terminations, larger NOL carry-forward tax attributes available from pre-petition returns and a higher filing-requirement threshold for individual bankruptcy estates. However, the removal of the NOL carryback provision has complicated the process of matching taxable income and tax-deductible expenses, and created an urgency to assess NOL carryback potential from prior-year losses. Trustees, DIPs and their professionals should carefully consider the changes brought on by the TCJA as they work to maximize tax efficiency and compliance for their asset bankruptcy estates. abi

4 26 C.F.R. 1.6012-2 (corporations required to make returns of income).
5 2017 IRS Form 1065 Instructions, p. 3.

Straight & Narrow: A Statutory Rule of Legal Ethics in Bankruptcy Practice

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the parties did not act as though there were any benefit-to-the-estate checks on their scorched-earth tactics. The issue was not whether there were good-faith or nonfrivolous bases to pursue or defend claims under Rule 9011, but whether the actions taken and defended could be said to be reasonably related to "benefit to the estate." Although the debtor's president claimed justification in pursuing litigation as a negotiating tactic, where the high costs of the litigation far outweighed the potential benefits, especially when viewed in light of the confirmation hearing testimony, those claims were of little substantive merit. Although committee counsel argued that a fraudulent-transfer complaint needed to be researched and drafted in order to evaluate those claims, it was duplicative of the same substantive work that was being done by an examiner who concluded that there were statute-of-limitations issues that were material.

The authors believe that had the proposed estate-benefits analysis been applied at the outset, and the costs of pursuing litigation against numerous law firms as a "negotiating tactic" had been appropriately evaluated, the debtor and counsel (and the committee and its counsel) could have come to different conclusions. This test could have served the parties well had they employed it before engaging in scorched-earth tactics. Had such an analysis been done (and presented to the court in connection with the fee applications), the *Keene* court might also have had a more lenient approach to the fee applications.

In *Haimil Realty Corp.*,[34] the bankruptcy court held that the chapter 11 debtor owed more than $2.6 million[35] to its secured lender and entered an order allowing the lender's

34 *In re Haimil Realty Corp.*, 579 B.R. 19 (Bankr. S.D.N.Y. 2017).
35 Representing a principal balance of $1,225,427.21 and accrued interest of $1,383,098.84.