

Steroidal Side Effects: Conundrums Inside the Individual Chapter 11

Taryn M. Darling Hill¹

Individual Chapter 11 bankruptcy filings are on the increase. While the individual Chapter 11 is still a small subset of Chapter 11 filings, its use is increasing as more individuals in financial distress possess income, equity, and debt exceeding the Chapter 13 limitations. Although the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) has sought to impose features of a Chapter 13 case into an individual Chapter 11 case, creating a “Chapter 13 on Steroids,” there are some considerable differences arising from the creation of the bankruptcy estate as an entity separate from the individual debtors, effectively creating a “no man’s land” where practitioners versed in both Chapter 13s and Chapter 11s fear to tread. Although there is limited case law interpreting the provisions as applied to individual Chapter 11 debtors, there are some interesting developments that require the careful practitioner to advise her client of the potential side-effects of the individual Chapter 11 so that he or she may best weigh the costs and benefits of a filing. Tax consequences and the effect of an individual filing on the attorney-client relationship are two areas in which a practitioner will want to take extra care to inform her clients.

Disclaimer: The Use of Steroids May Result In Increased Tax Liability.

Individuals filing a Chapter 11 must be advised of the consequences of a bankruptcy on taxation. Separate, albeit joint, estates are created for married individuals under both the Chapter 7 and the Chapter 11 context. In an individual Chapter 11, the bankruptcy estate is a separate taxpayer that is taxed at the rates established for married persons filing separately. 26 U.S.C. § 1398.² A debtor in possession (“DIP”) is required to file a return individually (Form 1040), in addition to a return for the estate (Form 1041). If the debtor-in-possession (“DIP”) is also married, the DIP must file two separate forms for the estate (requiring taxes to be paid as “married filing separately”). Conversely in a Chapter 13, there is no separate taxable estate created – and the tax attributes remain with the individual debtor. Within the individual Chapter 11 case, however, the tax attributes of an individual debtor enter the bankruptcy estate and, as adjusted, pass back to the debtor when the estate is terminated. As a result, a married couple in a Chapter 11 case will most likely pay more taxes per year than a married couple outside of bankruptcy or in a Chapter 13 case, in addition to incurring the costs of hiring an accountant to determine the withholding and to file the returns. For example, if all other things are equal and a married couple has taxable income of \$250,000, the married couple will pay about \$12,500 more in federal income tax in a Chapter 11 case than a married couple filing a Chapter 13 case.³ The

¹ Taryn M. Darling Hill is an associate at the bankruptcy boutique, Crocker Kuno PLLC in Seattle, Washington.

² For greater explanation, see IRS Publication 908, located at <http://www.irs.gov/publications/p908/index.html>, last visited May, 27, 2010.

³ SOME COMPARISONS BETWEEN INDIVIDUAL CHAPTER 11 AND CHAPTER 13 CASES, by Stephen T. Boyke, presented at the 23rd Annual Northwest Bankruptcy Institute on April 23-24, 2010.

Chapter 11 practitioner should inform the potential individual filers of the tax consequences in the individual Chapter 11 case so that they may better weigh the costs and benefits of an individual Chapter 11 filing.

Disclaimer: The Use of Steroids May Require Disclosure, and at Best, Discussion and Consideration of Potential Conflicts of the Representation.

Individual Chapter 11 cases create competing fiduciary obligations for debtors and counsel, which are not present in the Chapter 7 or 13 cases. In a Chapter 11 case, the debtor has a fiduciary duty to creditors and debtor's counsel is counsel for the bankruptcy estate and therefore owes fiduciary obligations to the estate. These obligations present potential conflicts when the debtor, as an individual, has interests that are contrary to those of the estate. *See, e.g., In re McClelland*, 418 B.R. 61, 67 (Bankr. S.D.N.Y. 2009) (noting the difficulty inherent in the concept that the attorney represents the debtor-in-possession and the debtor's estate, but not the debtor as an individual).⁴

Because counsel represents the estate and not the debtor individually, counsel has an independent responsibility to determine whether an action is likely to benefit the estate or will produce an advantage solely for the individual debtor. Although the individual may direct counsel to take certain actions, such action may cause counsel to doubt the value of such action to the estate, resulting in a potential conflict in her representation. Recent Chapter 11 case law further highlights this tension, as courts determine whether to permit employment of counsel and whether to allow fees of such counsel in Chapter 11 cases. The analysis turns upon how much value the representation is likely to net for the estate as compared to the individual debtor. *In re Miell*, 2009 U.S. Dist. LEXIS 73757 (N.D. Iowa, Aug. 19, 2009), is an example of a Chapter 11 case wherein, the district court affirmed the bankruptcy court in denying a motion to employ attorneys to represent the individual debtor in his pending criminal suits. In so holding, the court reasoned that in addition to failing to provide a statutory basis, the debtor could not establish that the attorneys he intended to compensate rendered services "in connection" with the bankruptcy or that such services would provide a benefit to the estate. *Id.* Similarly, in a decision in which the court did grant an individual Chapter 11 debtor's motion to employ two law firms to represent her as special counsel in post-divorce motions and an appeal of a divorce decree, the court based its decision to approve the employment on the basis that the efforts of outside counsel would be directed at maximizing the value of the estate. *In re Graves*, 2008 Bankr. LEXIS 3244 (Bankr. S.D. Tex. Step. 4, 2008). Transmitting to counsel the import of its role for the estate, however, the Court warned counsel that approval of a subsequent fee application

⁴ Quoting also the ABA's own: GHOSTS OF INDIVIDUAL CHAPTER 11 DEBTORS: ETHICAL ISSUES IN REPRESENTING DEBTORS IN INDIVIDUAL CHAPTER 11S UNDER BAPCPA: Part I, C.R. "Chip" Bowles Jr., American Bankruptcy Institute Journal, December 2006-January 2007: "[R]epresenting a debtor's bankruptcy estate in an individual chapter 11 is almost an out-of-body experience. . . . It stretches the bounds of legal fiction to comprehend the difference between the bankruptcy estate of an individual (your client) and the individual himself (not your client)."

would depend upon whether the services provided were reasonably likely to benefit the estate and to be deemed as necessary for the administration of the case. *Id.*⁵

The current economic environment has presented practitioners with ample opportunities to provide clients with solutions to their economic distress. The body of law with which to apply such solutions and the effects of its application are largely untested, particularly with regard to roles, expectations, and consequences to individual Chapter 11 debtors and counsel. It is a brave new world which may allow us to provide feasible and creative solutions, but one that requires the balancing of various competing interests and considerations. May you chart your course with as few side effects as possible.

⁵ See, INDIVIDUAL CHAPTER ELEVEN CASELAW CONSIDERATIONS by Gary W. Dyer – Office of the U.S. Trustee, and Cynthia Kuno and Tereza Simonyan – Crocker Kuno PLLC, presented at the 23rd Annual Northwest Bankruptcy Institute on April 23-24, 2010.