Involuntary Individual Chapter 11— Getting Paid or Involuntary Servitude?

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In re Schlehuber; 489 B.R. 570 (8th Cir. BAP 2013) involves a decision by the Bankruptcy Court to involuntarily convert Mr. Schlehuber's case from a no-asset Chapter 7 case to one under Chapter 11, where his wages would at least hypothetically be available to repay his creditors. The decision was appealed[1] to the U.S. Court of Appeals for the Eighth Circuit, which on March 19, 2014, affirmed the BAP in a one-page, unpublished, *per curiam* ruling.

The Eighth Circuit, which declined to grant oral argument, failed to reach the constitutional issues raised, and did not discuss the procedural standards to be applied. Nevertheless, the issues presented in *Schlehuber* are important ones, capable of arising in future cases, and the discussion below is a portion of the argument in Appellant's brief.

When Congress first added individual reorganization provisions to the old Bankruptcy Act in 1938 (Chapter XIII, now Chapter 13), it made their coverage elective, and the choice to utilize them solely the debtor's. A debtor must *voluntarily* proceed under Chapter 13; that chapter cannot be forced upon a debtor. Involuntary bankruptcies were and are limited to Chapters 7 and 11, *see* 11 U.S.C. § 303(a) and (b). There is no provision analagous to § 706(b) allowing the Court to involuntarily convert a debtor's case to one under Chapter 13.

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[1] Brett Weiss and Daniel Press represented the Debtor in the Circuit Court appeal.

There was—and is—a very specific reason for these restrictions. When the current Chapter 13 was enacted in 1978, it provided that only an individual (not a corporate entity) could be a Chapter 13 debtor,[2] imposed limitations on the amount of debt that a Chapter 13 debtor could have,[3] and, most important for the purposes of this discussion, required that post-petition wages, that is, money earned by the debtor *after* the case was filed, would be considered estate property[4] that would need to be contributed towards the payment of a Chapter 13 plan of reorganization.[5] *At that time, there was no Chapter 11 analogue to § 1306(a)(2), and an individual Chapter 11 debtor's post-petition wages were not considered to be property of the estate.*

For a Chapter 13 Plan to succeed, the Debtor must be a willing and active participant in the reorganization. Congress specifically recognized that, were a Chapter 13 to be *in*voluntary, there could be Thirteenth Amendment problems:

> As under current law [Chapter XIII], chapter 13 is completely voluntary. This Committee firmly rejected the idea of mandatory or involuntary chapter XIII in the 90th Congress. The thirteenth amendment prohibits involuntary servitude. Though it has never been tested in the wage earner plan context, it has been suggested that a mandatory chapter 13, by forcing an individual to work for creditors, would violate this prohibition. On policy grounds, it would be unwise to allow creditors to force a debtor into a repayment plan. An unwilling debtor is less likely to retain his job or to cooperate in the repayment plan; and more often than not, the plan would be preordained to fail.

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[2] 11 U.S.C. § 109(e).
[3] 11 U.S.C. § 109(e).
[4] 11 U.S.C. § 1306(a)(2).
[5] 11 U.S.C. § 1325(b)(1)(B).

House Report at 120, and Sen. Report at 32, U.S. Code Cong. & Admin. News 1978 at 6080.[6]

Similar reasoning applied to an involuntary bankruptcy under § 303 of the Code. The Official Notes to this section state:

> Involuntary chapter 13 cases are not permitted either. To do so would constitute bad policy, because chapter 13 only works when there is a willing debtor that wants to repay his creditors. Short of involuntary servitude, it is difficult to keep a debtor working for his creditors when he does not want to pay them back.

11 U.S.C. § 303 (Official Notes).

Prior to 2005, no such provisions applied to an individual Chapter 11 debtor. Post-petition wages and income were not included in estate property and did not need to be dedicated to a Chapter 11 Plan. An individual Chapter 11 debtor was entitled to a discharge immediately upon confirmation of a Chapter 11 Plan, and the case would thereupon close and the automatic stay terminate, as the Bankruptcy Court had concluded its involvement in the Debtor's case. It rarely would make sense to involuntarily convert an individual Chapter 7 case to a Chapter 11 case, since the only estate assets would be the same assets that could be liquidated in the Chapter 7.

Because of these differences, pre-BAPCPA, there were no direct constitutional issues in forcing an individual debtor into Chapter 11, either through an involuntary conversion or an involuntary filing; the debtor's post-petition wages were not property of the estate and did not have to be used to pay creditors under a Chapter 11 Plan. Such was

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[6] When Chapter 12, Adjustment of Debts of a Family Farmer or Fisherman with Regular Income, was passed in 1986, 706(a) and (c) were amended to add Chapter 12 references. In Chapter 12, like Chapter 13, the debtor's post-petition earnings are part of the bankruptcy estate, 11 U.S.C. § 1207(a)(2), and are submitted as part of the Chapter 12 reorganization plan to repay creditors, § 1222(a)(1), (a)(4).

expressly recognized by the Supreme Court in *Toibb v. Radloff,* 501 U.S. 157, 111 S. Ct. 2197, 115 L. Ed. 2d 145 (1991). As Justice Blackmun stated, "Because there is no comparable provision in Chapter 11 requiring a debtor to pay future wages to a creditor, Congress' concern about imposing involuntary servitude on a Chapter 13 debtor is not relevant to a Chapter 11 reorganization." *Id. at* 166.

This all changed in 2005, with the passage of the Bankruptcy Abuse Protection and Consumer Protection Act ("BAPCPA"). The 2005 amendments made a number of significant changes in the framework for individual Chapter 11 cases. These changes attempted to graft onto Chapter 11 many provisions previously applicable only in Chapter 13 cases. As Judge Bruce Markell noted in *In re Shat,* 424 B.R. 854 (Bankr. D.Nev. 2010):

> [W]hile not entirely free from doubt, it appears that Congress inserted the individual chapter 11 provisions to ensure no easy escape from means testing. The template for this effort was to adopt and adapt as much of chapter 13 as possible with respect to individual debtors in chapter 11.
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> What remains is a sort of hybrid chapter 13, in which many provisions of chapter 13 sit uneasily in chapter 11.

Shat, id., at 859-61.

These quasi-Chapter 13 provisions include:

- Including post-petition earnings as property of the estate;
- Requiring that a Chapter 11 plan for an individual debtor provide for the payment to creditors of such post-petition earnings or other future income of the debtor as is necessary for execution of the plan;

- Requiring that individual debtors pay their "disposable income" during a portion of the Chapter 11 plan in certain cases;
- Delaying discharge until the completion of payments unless otherwise ordered by the Court; and
- Allowing certain post-confirmation modifications.

These 2005 Amendment provisions appear to have been copied virtually verbatim from Chapter 13 and pasted into Chapter 11 with little thought of how they would integrate into the existing Chapter 11 framework or analysis as to how they would work in actual cases. One of the demonstrations of the lack of thought is the fact that neither section 706(b) nor 303 was changed to reflect the new reality that post-petition wages were now considered part of the Chapter 11 estate, and to address the specter of involuntary servitude.

"The fact is that Congress perceived the usual 13 case as emanating from a nonbusiness debtor and determined to make the relief of that chapter voluntary in order to avoid the spectre of involuntary peonage for a hapless debtor laboring for his creditors on their petition and their plan which could strip the debtor and his family of all that made their lives otherwise worth living." *In re Noonan*, 17 B.R. 793, 799 (Bankr. S.D.NY 1982). *See also, In re Markman,* 2 C.B.C.2d 653, 5 B.R. 196, 6 B.C.D. 632 (Bankr. E.D.N.Y.1980), where these same principles supported an order barring a trustee from seeking to extend the life of a debtor's plan in a Chapter 13 case beyond the period fixed by Congress.

Section 706(b) of the Bankruptcy Code governs conversion of Chapter 7 cases on request of a party other than the debtor. It provides, "On request of a party in interest and

after notice and a hearing, the court may convert a case under this chapter to a case under chapter 11 of this title at any time." Further restricting the power of the bankruptcy court to convert a case upon request of a party other than the Debtor are the provisions of 706(c) and (d), which state:

> (c) The court may not convert a case under this chapter to a case under chapter 12 or 13 of this title unless the debtor requests or consents to such conversion.
>
> (d) Notwithstanding any other provision of this section, a case may not be converted to a case under another chapter of this title unless the debtor may be a debtor under such chapter.

While § 706(c) might not at first blush appear to apply to an individual whose case is involuntarily converted to a Chapter 11, as discussed above, its provisions are quite relevant.

If a debtor's case is involuntarily converted to Chapter 11, there is no right to dismiss. § 1112(b). There is no right to convert. § 1112(a). The Debtor must dedicate not only his or her disposable income to a plan, the debtor must get creditors to vote for a plan. §§ 1129(a)(8) and (a)(10). If the unsecured creditors do not vote for the plan, the Debtor could be forced to lose all of his property under the absolute priority rule in order to confirm a plan. § 1129(b)(2)(B)(ii).[7] *See In re Maharaj*, 681 F.3d 558 (4th Cir. 2012); *In re Stephens*, 704 F.3d 1279 (10th Cir. 2013); *In re Friedman*, 466 B.R. 471 (9th Cir.BAP 2012); *SPCP Group, LLC v. Biggins*, 465 B.R. 316 (M.D.Fla.2011); *In re Shat*,

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[7] While most courts have held that exempt assets may be retained without implicating the absolute priority rule, *In re Henderson*, 321 B.R. 550 (Bankr.M.D.Fla., 2005); *In re Egan*, 142 B.R. 730 (Bankr.E.D.Pa. 1992); *In re Shin*, 306 B.R. 397 n.17 (Bankr. D.D.C. 2004); *In re Fross*, 220 B.R. 405 (D. Kan. 1998), some courts have held that retaining even exempt property violates the rule. *In re Gosman*, 282 B.R. 45 (Bankr. S.D. Fla. 2002); *Matter of Yasparro*, 100 B.R. 91 (Bankr.M.D.Fla., 1989).

424 B.R. 854 (Bankr.D.Nev.2010). Or a creditor could file a plan, explicitly forcing the Debtor to work for his or her creditors. § 1121(c). And if the Debtor does not cooperate in proposing and dedicating wages to this enforced plan, the bankruptcy court could appoint a Chapter 11 Trustee under § 1104 and force this upon him or her.

Once in an involuntarily converted Chapter 11, there is no way out. While the inability to dismiss or convert may not in and of itself constitute involuntary servitude, that fact combined with the fact that the Debtor's earnings *before confirmation* are property of the estate, and the Debtor is an involuntary fiduciary working not for him or herself but for the estate (and thus the creditors) *before confirmation*, makes the matter one of involuntary servitude.

The Thirteenth Amendment to the U.S. Constitution states:

> Neither slavery nor involuntary servitude, except as a punishment for crime whereof the party shall have been duly convicted, shall exist within the United States, or any place subject to their jurisdiction.

This amendment abolished both slavery and peonage. *See also* 42 U.S.C. § 1994 ("all acts...orders...by virtue of which any attempt shall be...made to establish, maintain, or enforce...the voluntary or involuntary service or labor of any persons as peons, in liquidation of any debt or obligation, or otherwise, are declared null and void.").

The United States Supreme Court has long recognized that the Thirteenth Amendment prohibits peonage. *Pollock v. Williams,* 322 U.S. 4, 64 S. Ct. 792, 88 L. Ed. 1095 (1944); *Baily v. Alabama,* 219 U.S. 219, 31 S. Ct. 145, 55 L. Ed. 191 (1911); *Clyatt* v. *United Stales,* 197 U.S. 207, 25 S. Ct. 429, 49 L. Ed. 726 (1905). The Supreme Court has explained peonage as follows: "Peonage is a term descriptive of a condition which

has existed in Spanish America, and especially in Mexico. The essence of the thing is compulsory service in payment of a debt. A peon is one who is compelled to work for his creditor until his debt is paid." *Baily v. Alabama,* 219 U.S. at 242. The fact that a debt was voluntarily entered into does not exclude peonage from the Thirteenth Amendment's prohibition. *Pollock v. Williams,* 322 U.S at 24 (a state may not "directly or indirectly command involuntary servitude, even if it was voluntarily contracted for.").

This principle's relevance to bankruptcy has long been recognized. The United States Supreme Court explained the deleterious impact of peonage at length in *Local Loan Co. v. Hunt,* 292 U.S. 234, 245, 54 S. Ct. 695, 78 L. Ed. 1230 (1934):

> When a person assigns future wages, he, in effect, pledges his future earning power. The power of the individual to earn a living for himself and those dependent upon him is in the nature of a personal liberty quite as much if not more than it is a property right. To preserve its free exercise is of the utmost importance, not only because it is a fundamental private necessity, but because it is a matter of great public concern. From the viewpoint of the wage-earner there is little difference between not earning at all and earning wholly for a creditor. Pauperism may be the necessary result of either. The amount of the indebtedness, or the proportion of wages assigned, may here be small, but the principle, once established, will equally apply where both are very great. The new opportunity in life and the clear field for future effort, which it is the purpose of the Bankruptcy Act to afford the emancipated debtor, would be of little value to the wage-earner if he were obliged to face the necessity of devoting the whole or a considerable portion of his earnings for an indefinite time in the future to the payment of indebtedness incurred prior to his bankruptcy.

The underlying purpose of the Bankruptcy Act—and of the modern Bankruptcy Code—is consistent with the purpose of the Thirteenth Amendment: to prevent the imposition of penal consequences on debtors who act honorably and in good faith, but cannot pay their debts. Its function is to allow such persons to start fresh and contribute

fully to all of society with a fresh start. Chapter 7 discharge relieves honest but unfortunate debtors of their debts and allows them a fresh start through discharge of prepetition debts. 11 U.S.C. § 727. *In re Babb,* 358 B.R. 343 (Bankr. E.D.Tenn. 2006). Bankruptcy cannot be used as a tool by creditors to force debtors to choose between work and wage slavery. Bankruptcy is not an unbecoming harbor in which involuntary servitude or peonage are permissible. The Thirteenth Amendment contains no exemptions from its prohibitions for debtors in bankruptcy to be forced into servitude.

It is the application of § 706(b) in light of the 2005 bankruptcy amendments to § 1115, making post-petition earnings property of the Chapter 11 estate, and § 1129(a)(15), requiring that disposable income be paid into the Chapter 11 plan that violates these long-established constitutional principles where an individual's voluntary Chapter 7 bankruptcy is involuntarily converted to a Chapter 11 proceeding. Section 1115(a) of the Code brings an individual debtor's post-petition income into the bankruptcy estate. Section 1129(a)(15) actually requires that the value of the property to be distributed under the Plan be not less than the projected disposable income of the debtor for a five year period commencing on the date on which the first Plan payment is due if a holder of an impaired unsecured claim objects to the confirmation of the Plan. Finally, § 1127(e) allows any holder of an allowed unsecured claim to seek modification an individual debtor's confirmed Plan to increase the amount of payments. Section 1127(f)(1) makes the requirements of 11 U.S.C. § 1129(a)(15), regarding post-petition income, applicable to Plan modifications under § 1127.

The constitutional issues arising from application of these provisions can be examined by comparing Chapter 13 to Chapter 11. Direct support for the unconstitutionality of forcing an individual to remain in Chapter 11, and thereby treating his or her income as estate assets, appears in *In re Fitzsimmon,* 725 F.2d 1208 (9th Cir. 1984). The *Fitzsimmon* court faced the issue of whether a Chapter 11 debtor's post-petition income was property of the estate. It noted that the comparable provisions of 11 U.S.C. § 1306(a)(2), which makes a Chapter 13 debtor's income property of the estate, are constitutional because Chapter 13's are voluntary, and a debtor cannot be forced into Chapter 13. The court concluded:

> The consistency of the foregoing provisions of the Bankruptcy Code demonstrate implementation of a policy designed to prevent involuntary submission to the bankruptcy estate of post-petition earnings from services of an individual. This is consonant with the spirit, if not the letter, of the Thirteenth Amendment to the United States Constitution prohibiting involuntary servitude.

Forcing an individual Chapter 11 debtor to remain in Chapter 11 involuntarily would appear to be unconstitutional, because an involuntary Chapter 11 petition may be filed and because the provisions of § 1112(a) and (b) do not confer an absolute right upon an individual Chapter 11 debtor to dismiss his or her case or convert it to one under Chapter 7.[8] These problems are present and of constitutional magnitude based on facial statutory language.

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[8] In *In re Molina y Vedia*, 150 B.R. 393, 399 (Bankr. S.D.Tex. 1992), the Court analyzed whether an individual Chapter 11 debtor's income was property of the estate. It compared Chapter 11 to Chapter 12 and 13 and it noted that constitutional concerns were addressed by the debtor's absolute right to covert: "Similar Congressional concern for the Thirteenth Amendment is evidenced by the fact that debtors under Chapter 12 and Chapter 13 have an absolute right to convert or dismiss their cases. See 11 U.S.C. § 1307 and 11 U.S.C. § 1208." To be constitutional,

One author, Daniel McCarthy, *The Shackles of an Individual Chapter 11 Debtor's Servitude,* 30 Cal. Bankr. J. 159, 166-67 (2009) wrote:

> There are at least six reasons why courts have held that the Chapter 13 provisions governing post-petition earnings are constitutional:
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> (1) involuntary cases may not be filed under Chapter 13, which means that an individual debtor cannot be forced to subject his or her income to the requirement of paying creditors to receive a discharge in Chapter 13;
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> (2) a Chapter 13 debtor has the right to dismiss his or her Chapter 13 case or to convert it to Chapter 7, if the case has not been previously converted, thereby enabling the debtor to avoid the post-petition earnings restrictions in Chapter 13;
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> (3) only a Chapter 13 debtor can file a Plan;
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> (4) only a Chapter 13 debtor may modify a Chapter 13 Plan prior to confirmation, whereas creditors only may object to confirmation; (5) a Chapter 13 Plan may not last longer than 5 years; and
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> (6) at one time, a creditor or a trustee could not force a Chapter 13 debtor to extend Plan payments, although that is no longer the case.
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> ***These six aspects of Chapter 13 that saved (or at least previously saved) the provisions applicable to post-petition earnings from constitutional challenge under the Thirteenth Amendment cannot be found under the post-BAPCPA provisions of Chapter 11.***

(Emphasis added.)

Similarly, "an order directed to a debtor who lacks sufficient current assets but who has ample earning capacity to find work or to continue working, and to make payments to creditors out of that income stream, runs head-on into the Thirteenth Amendment." Margaret Howard, *Bankruptcy Bondage*, 2009 U. Ill. L. Rev. 191, citing

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individual Chapter 11 debtors should have an absolute right to convert or dismiss, or involuntary conversions to Chapter 11 for individuals should be prohibited, but that is not the case.

United States v Kozminski, 487 U S 931, 952, 108 S. Ct. 2751, 101 L. Ed. 2d 788 (1988). Under *Kozminski*, there must be actual coercion for a Thirteenth Amendment violation; psychological pressure is not enough. But the legal suasion need not be criminal. In *In re Nine Applications for Appointment of Counsel in Title VII Proceedings,* 475 F. Supp. 87, 88 (N.D. Ala. 1979), the Court stated, "Since earnings are within the estate, the debtor is an involuntary fiduciary as to those earnings; he cannot just abandon them without consequence." *See also* Keach, Robert, "*Dead Man Filing Redux: Is the New Individual Chapter Eleven Unconstitutional.*" 13 Am. Bankr. Inst. L. Rev. 483, 502 (2005).

In short, if an individual is involuntarily forced to dedicate post-petition wages to the payment of creditors, the lack of a right to dismiss or convert the Chapter 11 case, the ability of creditors to file a Chapter 11 plan, and the ability of creditors to modify a Chapter 11 plan, the application of § 706(b) and/or § 1115(a)(2) to an individual case involuntarily converted to Chapter 11 violates the Thirteenth Amendment and is unconstitutional.

United States Court of Appeals
for the Eighth Circuit

No. 13-2070

In re: James C. Schlehuber, also known as Jim Schlehuber, Formerly doing business as J.R.G., L.L.C., Formerly doing business as The Radar & Riley Limited Partnership, Formerly doing business as March Plan Investments, L.L.C., Formerly doing business as Rockford Omaha, L.L.C., Formerly doing business as January Real Group, L.L.C.

Debtor

James C. Schlehuber

Appellant

v.

Fremont National Bank & Trust Company; Nancy J. Gargula, U.S. Trustee

Appellees

Appeal from the United States Bankruptcy Appellate Panel for the Eighth Circuit

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Submitted: March 6, 2014
Filed: March 19, 2014 [Unpublished]

Before WOLLMAN, MURPHY, and SMITH, Circuit Judges.

PER CURIAM.

After James Schlehuber filed a voluntary Chapter 7 bankruptcy petition, one of his creditors moved under 11 U.S.C. § 706(b) to convert the petition to one under Chapter 11. After a hearing, the bankruptcy court[1] granted the motion, and the Bankruptcy Appellate Panel (BAP) affirmed. Schlehuber now appeals to this court, arguing that the bankruptcy court applied an improper legal standard, and abused its discretion, in granting the motion to convert. He also renews his constitutional challenge to certain bankruptcy statutes.

We decline to address the constitutional challenges, because Schlehuber abandoned them in his appeal to the BAP. See In re Trism, Inc., 328 F.3d 1003, 1008 (8th Cir. 2003) (declining to consider arguments on appeal not advanced before BAP). As to the arguments that are properly before us, we review for abuse of discretion an order granting a motion under section 706(b). See In re Tex. Extrusion Corp., 844 F.2d 1142, 1161 (5th Cir. 1988). Having carefully reviewed the record as a whole, including the memoranda and evidence that the parties submitted, as well as their varied arguments before the bankruptcy court, we find no basis to conclude that the court applied an improper legal standard or abused its discretion in granting the motion to convert. See In re Wolk, 686 F.3d 938, 940 (8th Cir. 2012) (court abuses discretion when it fails to apply proper legal standard or bases its order on clearly erroneous findings of fact); In re Danduran, 657 F.3d 749, 752 (8th Cir. 2011) (finding of fact is clearly erroneous when, although there is evidence to support it, reviewing court is left with definite and firm conviction that mistake was committed); see also Toibb v. Radloff, 501 U.S. 157, 163 (1991) (Chapter 11 embodies general Bankruptcy Code policy of maximizing value of bankruptcy estate). Accordingly, we affirm. See 8th Cir. R 47B.

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[1]The Honorable Thomas L. Saladino, Chief Judge, United States Bankruptcy Court for the District of Nebraska.