

## **Business Chapter 13 Cases: The Self-Employed Debtor**

(Friday, March 23, 2012, 1:45pm - 2:25pm)

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This presentation will discuss:

1. What constitutes a "business case" under Chapter 13;
2. Factors to look for when determining if the trustee will deem case to be a business case;
3. Ensuring that debtor understands obligations related to the business during the case;
4. How to incur trade debt during the case;
5. What documents must debtor provide the trustee;
6. Necessary disclosures in statement of financial affairs and schedules;
7. Rights and powers of debtor engaged in business; and
8. The duties of debtor engaged in business.

### **1. What constitutes a "business case" under Chapter 13:**

- a. **Governing Law:** 11 U.S.C. § 1304(a).<sup>1</sup> “Debtor engaged in business. (a) A debtor that is self-employed and incurs trade credit in the production of income from such employment is engaged in business.”

- b. **Eligibility of Debtor Engaged in Business:**

The Code permits access to Chapter 13 by any individual (including a married couple) with regular income, including those engaged in business, self-employed debtors, farmers and entrepreneurs, so long as they have regular income and comply with the debt limitations of section 109.

To be a debtor engaged in business, for the purposes of section 1304, a debtor must be both self-employed and incur trade credit in the production of self-employment income.

The key determination centers on the requirement of incurring “trade credit” – a concept not defined in the Code and used commonly to mean that the business borrows money or charges on accounts in its ordinary business dealings.

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<sup>1</sup> All references to the “Bankruptcy Code” or the “Code” and to “sections” thereof are to title 11 of the United States Code, 11 U.S.C. §§ 101 *et seq.*, unless otherwise specified.

Thus, obtaining supplies or inventory on a 30-day credit basis is sufficient to be “engaged in business” for Chapter 13 purposes.

A self-employed individual with regular income who does not incur trade credit is eligible for Chapter 13 relief, but is not a debtor engaged in business under the Code. Therefore, such a debtor cannot utilize certain provisions of Chapter 13 and, with the exception of tax withholdings, that case will be conducted like that of an ordinary debtor.

The principal difference appears to be that the debtor who does not incur trade credit could not utilize the trustee's power to obtain credit.

c. **Business Case – advantages for the debtor:**

Chapter 13 provides an avenue to reorganize a debtor’s business obligations and deal with personal obligations in one simple process. It is significantly less expensive and less cumbersome than a Chapter 11. Among other things, there is no disclosure statement required and no creditor’s committee as in a Chapter 11. Additionally, only the debtor can file the plan.

Further, the debtor will have the exclusive use of estate property to sell or lease regardless of whether it is within the ordinary course of the debtor’s financial affairs. Simply put, the trustee won’t be in a position to interfere with the business so long as the debtor is conducting it in a normal manner.

**2. Factors to look for when determining if the trustee will deem case to be a business case:**

- a. **Governing law:** As noted above, section 1304(a) defines what constitutes a business debtor for these purposes: “...self-employer debtor and incurs trade credit...”

Don’t be misled by the definition of “small business debtor” in section 101(51D) – that only applies to Chapter 11 cases (which distinguish between those debtors and larger, more complicated cases).

b. **What the trustee will look for:**

- i. First, a great deal of weight is given, at least initially, to the debtor’s petition, which will specify if the majority of the debts are business or consumer. If business is checked, the trustee will immediately assume that the debtor is

conducting a business. Also, if the debtor is self-employed, the petition will usually reflect other names.

- ii. The trustee will then examine Form B22, where line 3 will designate if part of the debtor's income comes from a business.
- iii. Schedule I will do the same – the debtor must identify where he or she is getting their income and the type of business designated.

**c. Having made an initial assumption, the trustee will examine:**

- i. Whether or not the debts on Schedules “D”, “E”, and “F” were incurred by a business or are consumer in nature.

Specifically, without trade credit, the case doesn't qualify for a business Chapter 13. Although it is possible that there are no outstanding debts for trade credit, it is highly unusual that a self-employed debtor will be seeking protection in a bankruptcy if he or she is not behind in some of the business payments.

Additionally, the nature of the debtor's Schedule “D” will often include a secured debt against inventory or materials – enough to show a business bankruptcy.

Further, Schedule “E” will often show business taxes due. These can include payroll taxes, self-employment (social security) taxes, or sales taxes collected by the state.

- ii. After examining the debtor's schedules, the trustee will reach a conclusion as to whether the plan payments will need to be paid from the income produced by a business. If so, and that will necessitate continuing to incur trade credit, then the case will be administered as a business case. There is, unfortunately, no magic percentage as to when a case reaches the threshold to have it treated one way or the other. More often than not, the trustee will be reasonable and respect the debtor's opinion.

**d. Eligibility of Debtor Who Has Partnership Interests:**

An interesting problem arises with a debtor engaged in a partnership. The partnership cannot file a Chapter 13, although the individual owners can. This is often the case with a husband and wife; and under those circumstances, the

trustee will ignore the “partnership” formality and treat the case as a typical business case.

The problem occurs when one partner seeks relief in Chapter 13. Since the debt is often partnership debt, some courts have held that such a case cannot be filed because it would require administration of partnership assets. The better rule is probably to let the case continue and let it be administered, leaving the partnership assets out of the case altogether. Of course, if the only trade credit was incurred by the partnership, then the debtor would not qualify to have the case administered as a business Chapter 13.

**3. Ensuring that debtor understands obligations related to the business during the case:**

**a. Governing law:** The Code imposes severe obligations on a debtor in a business Chapter 13. *See, e.g.*, Federal Rule of Bankruptcy Procedure (“FRBP” or “Rule”) 2015(c). Rule 2015(c) requires the debtor to perform the obligations of Rule 2015(a) (2) – (4), which requires the debtor to:

“(2) keep a record of receipts and the disposition of money and property received;  
(3) file the reports and summaries required by § 704(8) of the Code, which shall include a statement, if payments are made to employees, of the amounts of deductions for all taxes required to be withheld or paid for and in behalf of employees and the place where these amounts are deposited;  
(4) as soon as possible after the commencement of the case, give notice of the case to every entity known to be holding money or property subject to withdrawal or order of the debtor, including every bank, savings or building and loan association, public utility company, and landlord with whom the debtor has a deposit, and to every insurance company which has issued a policy having a cash surrender value payable to the debtor, except that notice need not be given to any entity who has knowledge or has previously been notified of the case....”

**b. Getting the Debtor to pay attention:**

i. Legal approach: It is always a good idea to give the debtor a breakdown of the requirements of staying in a Chapter 13. In a consumer case, this often amounts to little more than reminding them to make their payments on time and to file their tax returns. But in a business case, a lot more is involved.

They must file periodic reports with the court, with the trustee, with the United States trustee, and with appropriate taxing agencies.

- ii. As a general rule, setting up quarterly or monthly reminders will help get the necessary forms and notices prepared. That amounts to a lot more work for the debtor's attorney since it becomes "baby-sitting" to some extent. If the debtor normally has a bookkeeper (even if it is the spouse of the business owner), set up regular phone appointments with him or her to remind them of these necessities. And have them calendar the appropriate report due dates. Once a regular pattern is set in, the filings become routine.

#### **4. How to incur trade debt during the case:**

- a. **Governing law:** **Section 1304(b)** specifies that a debtor engaged in business "...may operate the business of the debtor and, subject to any limitations on a trustee under sections 363(c) and 364 of this title and to such limitations or conditions as the court prescribes, shall have, exclusive of the trustee, the rights and powers of the trustee under such sections."

Section 363(c) gives a trustee – and therefore a Chapter 13 business debtor – the right "... to enter into transactions, including the sale or lease of property of the estate, in the ordinary course of business, without notice or a hearing..."

Section 364 gives the trustee – and therefore a Chapter 13 business debtor – the right to incur credit. There are, however, certain limitations on obtaining credit depending on whether the debtor wishes to incur unsecured or secured credit and the type of obligation attendant thereto.

Primarily, the Code allows obtaining trade credit, *if in the ordinary course of business*, without the necessity of notice and a hearing. Other kinds of credit require such notice and hearing. *See* Rule 4001(c), (d).

- b. **How to incur debt:** As noted above, trade credit (or debt) does not require notice or hearing if such is in the ordinary course of a debtor's business. Note that the debtor still has an obligation to keep the trustee informed of amounts incurred and expenditures made during the plan (*See* # 3 above and #8 below).

Whether a particular transaction is in the ordinary course of business, however, depends on the course of conduct by the parties involved, the nature of the business,

and the facts of each case. The Code does not contain a definition for the term “ordinary course of business.”

Certainly, if debt or credit is incurred in the ordinary course of business, it must also pass the tests of being an actual and necessary cost or expense of preserving the estate in order to receive priority in repayment. Section 503(b)(1)(A) lists wages, salaries, or commissions for services rendered as examples. Other expenses, such as utility bills, rent, supplies, purchases of raw materials, manufacturing expenses, and shipping of finished product are all probably “ordinary.”

Because of the ambiguity inherent in this determination, it might be prudent to file a noticed motion to obtain court approval of the contemplated credit. It is also an excellent idea, local rules permitting, to have the order confirming a Chapter 13 plan authorize the debtor to incur trade credit, at least in the ordinary course of business, without prior court approval. (Sometimes the court will limit this to a specific dollar amount, and sometimes it will be limited to obtaining the prior consent of the trustee).

## **5. What documents must debtor provide the trustee;**

- a. **Governing Law: Section 1304(c)** specifies as follows: “(c) A debtor engaged in business shall perform the duties of the trustee specified in section 704(a)(8) of this title.”

Section 704(a)(8) in turn states that the debtor must “(8) if the business of the debtor is authorized to be operated, file with the court, with the United States trustee, 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 United States trustee or the court requires....”

In addition, Rule **2015(c)** requires the debtor to perform the obligations of Rule 2015(a)(2) – (4):

“(2) keep a record of receipts and the disposition of money and property received;

(3) file the reports and summaries required by § 704(8) of the Code which shall include a statement, if payments are made to employees, of the amounts of deductions for all taxes required to be withheld or paid for and in behalf of employees and the

place where these amounts are deposited;

(4) as soon as possible after the commencement of the case, give notice of the case to every entity known to be holding money or property subject to withdrawal or order of the debtor, including every bank, savings or building and loan association, public utility company, and landlord with whom the debtor has a deposit, and to every insurance company which has issued a policy having a cash surrender value payable to the debtor, except that notice need not be given to any entity who has knowledge or has previously been notified of the case....”

- b. Thus, a debtor engaged in business is required to file with the court, with the United States trustee and with any taxing authority:
  - i. periodic reports and summaries, and
  - ii. a statement of receipts and disbursements, concerning the operation of the business.

The court may prescribe the form and frequency of such reports and summaries, in the event that local rules do not do so, and the court may require such other information as it deems appropriate.

Many courts and United States Trustees have adopted local rules and forms for this purpose. Typically, such forms must be filed at least monthly.

Check your local rules!

## **6. Necessary disclosures in statement of financial affairs and schedules:**

- a. **Governing Law:** The Bankruptcy Code requires truthful and complete preparation of all papers associated with the filing of the Petition. These include Form B22, the schedules, and the statement of financial affairs. In addition, Rule 1007 specifies the documents that must be filed in the case. Rule 1007(b)(1) provides as follows:

(b) Schedules, statements, and other documents required.

(1) Except in a chapter 9 municipality case, the debtor, unless the court orders otherwise, shall file the following schedules, statements, and other documents, prepared as prescribed by the appropriate Official Forms, if any:

- (A) schedules of assets and liabilities;
- (B) a schedule of current income and expenditures;
- (C) a schedule of executory contracts and unexpired leases;

(D) a statement of financial affairs;

(E) copies of all payment advices or other evidence of payment, if any, received by the debtor from an employer within 60 days before the filing of the petition, with redaction of all but the last four digits of the debtor's social-security number or individual taxpayer-identification number; and

(F) a record of any interest that the debtor has in an account or program of the type specified in § 521(c) of the Code.”

b. **Specifics for Business Chapter 13:** As noted above, FRBP 1007 requires the filing of the schedules and the statement of financial affairs. Form B22 is also required.

- i. For a Business 13, Form B22 requires the debtor to properly fill out line 3 – “Income from operation of business, profession or farm.” This seems to include the income and the expenses. However, in some jurisdictions (notably the 9<sup>th</sup> Circuit), line 3b is to be left blank, and business expenses are left to be put on the bottom of the form – line 60.

It can also be a good idea to add an attachment or schedule to Form B22 that itemizes the expenses that are being claimed.

- ii. Schedules. These should be prepared as normal, being careful to list all business property on Schedules A (real property) and B (personal property).

On Schedule “B” list all of the equipment, tools, inventory, bank accounts, pension or retirement accounts, office equipment and furnishings, receivables, leases, patents, licenses and any other tangible or intangible asset.

On Schedule “C” list anything under local law that would be exempt. This can include “tools of the trade” or a vehicle. The so-called “wild card” of the federal exemptions can also be used for anything not otherwise covered.

On Schedule “D” list all secured debts. This can include a mortgage on land, a lien on a vehicle or a general blanket security interest on equipment, inventory, tools, etc. General blanket security interests are often used by banks that lend money to a business.



Schedule “E” requires the disclosure of any priority debts. These include state, local and federal taxes and any money owed to employees.

Schedule “F” allows the listing of any general unsecured debts. This can include pretty much any payables unless they fall within Schedule “D” due to a security interest.

Schedule “G” should be used to list any executory contracts, such as a lease for a building or for office equipment.

Schedule “I” should include all of the income received during the previous month. List the income only, without any deductions for business expenses. And be sure that the amount of the income is roughly consistent with Form B22.

Schedule “J” should include all regular monthly expenses for the business. Usually a total is put on the form with an appropriate attachment itemizing the expenses. Local courts have their own forms for this, but always attach appropriate pages to break down and show the normal costs.

- iii. Statement of Financial Affairs. In a non-business case, usually only the information in response to questions 1 to 17 is supplied. In a business case, supply responses to questions 18 to 25. These are fairly simple, requiring information on who has knowledge of the books and financial affairs of the business, whether there are other owners of the business, and information on financial accounts.

Remember that the bankruptcy petition can be amended with addenda, schedules or explanations whenever necessary. Putting as much information in the documents that are part of the initial filing will save having to dig up the information later. It makes the trustee’s job easier, and therefore will make the process smoother.

## **7. Rights and powers of debtor engage in business:**

- a. **Governing Law: 11 U.S.C. § 1304(b):** “ Unless the court orders otherwise, a debtor engaged in business may operate the business of the debtor and, subject to any limitations on a trustee under sections 363(c) and 364 of this title [11 U.S.C. §§

363(c) 364] and to such limitations or conditions as the court prescribes, shall have, exclusive of the trustee, the rights and powers of the trustee under such sections.”

**b. Rights of a business debtor in a Chapter 13:** The debtor in a business Chapter 13 gets to continue to run his or her business. That includes:

- i. The *exclusive* right to exercise the powers conferred upon a trustee by section 363(c) and section 364. These sections largely deal with the ability to incur debt – to borrow money. *See* discussion above under Section 4;
- ii. the assumption or rejection of unexpired leases and executory contracts (11 U.S.C. § 1322(b)(7));
- iii. And most importantly, the right to continue to operate the business.

For all intents and purposes, the business continues as it did before the filing except that the debtor is protected by the automatic stay from legal processes, collection attempts, harassment, etc. Certainly, such protection may be only temporary and creditors do maintain a right to set-off under certain circumstances; but for a struggling business needing to buy some time to “right the ship,” a business 13 can be a most welcome reprieve.

Note however, that the debtor, without the consent of the secured creditor or a court order, cannot use cash collateral and must segregate it from other monies received in the ordinary course of business.

## **8. Duties of debtor engaged in business:**

- a. **Governing Law: 11 U.S.C. § 1304(c):** “A debtor engaged in business shall perform the duties of the trustee specified in section 704(a)(8) of this title.”

In addition, Rule **2015(c)** requires the debtor to perform the obligations of Rule 2015(a)(2) – (4) as follows:

“(2) keep a record of receipts and the disposition of money and property received;

(3) file the reports and summaries required by § 704(8) of the Code which shall include a statement, if payments are made to employees, of the amounts of deductions for all taxes required to be withheld or paid for and in behalf of employees and the place where these amounts are deposited;

(4) as soon as possible after the commencement of the case, give notice of the case to every entity known to be holding money or property subject to withdrawal or order of

the debtor, including every bank, savings or building and loan association, public utility company, and landlord with whom the debtor has a deposit, and to every insurance company which has issued a policy having a cash surrender value payable to the debtor, except that notice need not be given to any entity who has knowledge or has previously been notified of the case....”

**b. Debtor’s Requirements:**

- i. A debtor engaged in business is required to file with the court, with the United States Trustee and with any taxing authority affected thereby periodic reports and summaries, including a statement of receipts and disbursements, concerning the operation of the business. The court may prescribe the form and frequency of such reports and summaries, in the event that local rules do not do so, and the court may require such other information as it deems appropriate.
- ii. Additionally, the court will often order the debtor to file a complete inventory of all property and assets of the business along with periodic updates.
- iii. The debtor must also make the payments required under the Chapter 13 plan. Generally, a Chapter 13 debtor engaged in business will be allowed to continue the operation of the business for the duration of the Chapter 13 case, as disruption of the business will normally result in either a conversion to Chapter 7 or a dismissal of the case.
- iv. However, the debtor may not use cash collateral, even in the ordinary course of business, without the secured creditor's agreement or an order from the court. A motion to do so can be brought. *See* Rule 4001(b) , (d).
- v. Note also that the court is permitted to limit or condition (even terminate) the right of the debtor to operate the business. Hence, the trustee has the obligation to investigate thoroughly the business and the financial affairs of the debtor.