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## On the Edge

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### No Discharge for Failure to Make Percentage Distributions to Unsecureds

The Ninth Circuit Bankruptcy Appellate Panel (BAP) recently addressed — for the first time — an issue arising in a case in which a chapter 13 debtor failed to make a percentage distribution to unsecured creditors, even though all required payments were made pursuant to the plan.<sup>1</sup> As a result of the debtor's failure to make the percentage distribution to unsecured creditors, the BAP concluded that the bankruptcy court did not err in denying the debtors a discharge in chapter 13 and dismissing their bankruptcy case.

#### Factual Background

The pre-petition factual background is not complicated, nor is it that uncommon. Prior to filing for bankruptcy, Steven and Joanne Schlegel owned a home that was encumbered by two mortgages. Due to market conditions, the value of the home had declined such that the home's value was less than the amount of the first-lien debt, and as a consequence, the second-lien lender was unsecured.<sup>2</sup> In addition to the mortgage debt, the Schlegels had some unsecured debt.

#### Bankruptcy Court Proceedings

On Dec. 31, 2008, the Schlegels filed a voluntary petition for relief under chapter 13 and later filed a motion (the "valuation motion") with the court seeking, *inter alia*, (1) an order from the court determining the value of their home to be \$266,500, which was less than the amount of the first-lien debt; (2) an order pursuant to § 506(a) of the Bankruptcy Code determining that the second-lien lender's claim was fully unsecured; and (3) an order avoiding the second-lien lender's lien pursuant to § 1322(b) of the Bankruptcy Code contingent upon the entry of an order confirming a chapter 13 plan in the case. After

a hearing, the court granted the Schlegels' valuation motion, resulting in the Schlegels' unsecured claim pool increasing from approximately \$64,350 to approximately \$219,596.<sup>3</sup>

The Schlegels further proposed and confirmed a chapter 13 plan that required monthly plan payments to the chapter 13 trustee of \$812 per month for 60 months and total distributions to unsecured creditors of 48 percent of their claims.<sup>4</sup> After the plan was confirmed, the Schlegels made plan payments in an amount that was \$77,780 short of the 48 percent distribution required by the plan. In order for the Schlegels to make the required distributions to unsecured creditors, an additional 96 months of payments were required.<sup>5</sup>

The discrepancy between the plan payments and the proposed distribution to unsecured creditors was apparently due to the debtors and their professionals failing to take into consideration the increase in the unsecured claims pool as a result of the court granting the valuation motion and determining that the second lien lender's claim was unsecured. While the Schlegels had knowledge (or at least constructive knowledge) of the increase in the unsecured claims pool, they never filed a motion to modify the plan to provide for increased plan payments or to decrease the percentage distribution to unsecured creditors. Rather, on the eve of the completion of the plan payments, the Schlegels filed a motion for hardship discharge (the "hardship motion"). In response to the hardship motion, the chapter 13 trustee filed an objection and a motion to dismiss. The bankruptcy court denied the Schlegel's hardship motion and in turn granted the trustee's dismissal motion.<sup>6</sup>



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1 *In re Schlegel*, 2015 WL 783710, 526 B.R. 333 (B.A.P. 9th Cir. Feb. 25, 2015).  
2 526 B.R. at 336.

3 *Id.* at 336-37.

4 *Id.* at 337. Pursuant to the plan, total payments to unsecured creditors were expected to be \$105,406 (*i.e.*, 48 percent of the total claim pool of \$219,596). However, the total plan payments were expected to total only \$48,720 (*i.e.*, 60 payments of \$812 per month).

5 *Id.*  
6 *Id.*

At the hearing on the hardship motion and motion to dismiss, the bankruptcy court expressed concern that the Schlegels waited until near the end of the plan's term to file the hardship motion. Rather, the court stated that the Schlegels should have filed a plan modification earlier to reduce the percentage dividend to creditors. As such, the bankruptcy court concluded that the hardship motion should be denied and granted the motion to dismiss due to the Schlegel's "failure to fully complete plan payments on or before five (5) years from the commencement of the case."<sup>7</sup>

## Proceedings Before the BAP

On appeal to the Ninth Circuit BAP, the Schlegels argued that the bankruptcy court erred in granting the dismissal motion under § 1307(c) of the Bankruptcy Code, which allows a bankruptcy court to dismiss a case for "cause," including a material default with respect to the terms of the plan. The bankruptcy court based its decision to dismiss the case based on the Schlegel's failure to make the required plan payments within five years of the commencement of the case. On appeal, the Schlegels contended that the bankruptcy court erred in dismissing the case because they completed all of the required plan payments, as required by § 1328(a) of the Bankruptcy Code, even though they failed to pay the required percentage dividends.<sup>8</sup>

The BAP affirmed the bankruptcy court's decision, holding that even though a chapter 13 debtor may have completed his/her monthly plan payments, the debtor's failure to pay the unsecured creditors the promised percentage dividend constitutes a material default with respect to the terms of a confirmed plan. Consequently, the BAP concluded that the bankruptcy court did not err in denying the Schlegels' hardship motion and dismissing the bankruptcy case. In reaching its conclusion, the Ninth Circuit BAP relied on the reasoning in similar cases in other jurisdictions.<sup>9</sup>

The BAP further noted that during the term of the plan, the debtors were aware (or became aware) of the potential material default under the plan that would be the result of the failure to make the percentage distribution to unsecured creditors. But, notwithstanding such notice, the Schlegels did not seek to amend the plan. As such, the court refused to consider whether the provisions of § 1322(d) limited the bankruptcy court's ability to modify a plan to allow for the debtor to continue making plan payments more than 60 months after the commencement of the case.<sup>10</sup>

## Conclusion

The *Schlegel* case is a reminder to chapter 13 debtors' lawyers that they must consider not only the amount of disposable income available for plan payments, but also the total claims pool when determining a proposed percentage distribution to creditors. Failure to consider both the total amount of claims and the total dollar distribution made through the plan payments may result in an inadvertent

default under the plan as it nears conclusion, resulting in a denial of the debtor's discharge and dismissal of the case. Such an inadvertent result will be a hardship on almost all chapter 13 debtors. **abi**

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<sup>7</sup> *Id.* at 338.

<sup>8</sup> *Id.* at 339.

<sup>9</sup> *In re Roberts v. Boyajian*, 279 B.R. 396 (B.A.P. 1st Cir. 2000), *aff'd*, 279 F.3d 91 (1st Cir. 2002); *In re Rivera*, 177 B.R. 332 (Bankr. C.D. Cal. 1995); and *In re Hill*, 374 B.R. 745 (Bankr. D. Cal. 2007). *Id.* at 340-41.

<sup>10</sup> *Id.* at 341.