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Feature

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Hardship Discharge: A Case Study and Analysis of § 1228(b)(2)

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"[F]arming is a tough business. Farmers are at the mercy of nature and uncontrollable events. Hurricanes, drought, extreme heat waves, crop blight, international trade wars, and global pandemics relentlessly attack the farming economy. If these risks are combined with a random act of senseless violence resulting in severe bodily injuries on a farmer, the struggle becomes insurmountable."[1]

No truer words could have been spoken about the life and times of one chapter 12 debtor. Despite debilitating bodily injuries, David W. Rouse was denied a hardship discharge because he had not paid his unsecured creditors the amount required by the confirmed plan to be paid pursuant to the "liquidation test."[2] While this article addresses why the authors believe the decision to be erroneous, the primary purpose of this article is to suggest an appropriate framework for the analysis of hardship-discharge motions. Since the hardship-discharge requirements are identical in chapters 11, 12 and 13, the importance of this analysis goes far beyond chapter 12.

June 27, 2020, was a typical evening in Orrum, N.C. The day's work had ended, but like most farmers in the coastal plain region of the state, Rouse still faced more work once the day's chores were complete. As farmers know all too well, there are always three or four more tasks to complete in order to do what you planned to get done on any given day. Around 7 p.m. in the cool of the evening, Rouse, a farmer in Robeson County, was completing some tasks when a deranged man appeared and shot him multiple times. The man went on to shoot and kill two other people, and ultimately took his own life that day.[3]

The shotgun blasts left Rouse seriously debilitated, with significant wounds to his upper body. He lost a finger and suffered other lingering injuries, including nerve damage, muscle damage and vascular damage, all resulting in limited use of his arms and the loss of fine dexterity in his hands. He underwent numerous surgeries and extensive physical therapy. This event effectively ended Rouse's ability to farm and complete his chapter 12 plan.

Random acts of violence in our society are unfortunately all too familiar. Each one takes its toll on the survivors. When the survivor is also a farmer in an active chapter 12 case, the toll can be overwhelming to his career and his case.

Rouse's chapter 12 reorganization plan was confirmed on May 23, 2017,[4] after significant negotiation of terms between the debtor and the largest unsecured creditor over the course of a few months. The creditor, Nutrien Ag Solutions Inc., had an allowed claim of nearly $950,000.

As a result of these negotiations between the debtor, Nutrien and the chapter 12 trustee, the parties agreed to modify the liquidation-test calculation, resulting in a roughly $9,000 increase in required payments to the trustee to satisfy the "best interests" test found in 11 U.S.C. § 1225(a)(4). In at least partial consideration of this increase, Nutrien withdrew its opposition to confirmation, and the U.S. Bankruptcy Court for the Eastern District of North Carolina confirmed the plan by consent. Section 1225(b)(4) requires that

1 *In re Rouse*, Order Denying Hardship Discharge, 2020 Bankr. LEXIS 2737, 2020 WL 5884514 (hereinafter, the "Order"), *2-3 (Bankr. E.D.N.C. Oct. 2, 2020).
2 11 U.S.C. § 1225(a)(4).
3 "Shootings in Orrum Leave Three People Dead, One Man Wounded," *The Robesonian* (June 28, 2020), *available at* robesonian.com/news/135707/shootings-in-orrum-leave-three-people-dead-one-man-wounded (last visited Feb. 23, 2022).
4 Order at *3.

> the value, as of the effective date of the plan, of property to be distributed under the plan on account of each allowed unsecured claim is not less than the amount that would be paid on such claim if the estate of the debtor were liquidated under chapter 7 of this title on such date.

The negotiated and consensual confirmed plan required Rouse to pay $50,687 pursuant to the liquidation test over the life of the plan. The confirmed plan further stated that it "shall continue until the completion of payments under the Liquidation Test and payment of administrative claims ... and at that time the Court may enter a discharge."[5]

Since the shooting occurred prior to Rouse's completion of payments under the confirmed plan, he had two options to consider: convert to chapter 7, or move for a "hardship discharge" under 11 U.S.C. § 1228(b). The considerations included the debtor's desire to retain assets, the extent of the discharge available with each option, tax issues and the existence of post-petition debt. The debtor decided to pursue a hardship discharge. Section 1228(b) states, in part, that:

> at any time after confirmation of the plan and after notice and a hearing, the court may grant a discharge to a debtor that has not completed payments under the plan only if —
>
> (1) the debtor's failure to complete such payments is due to circumstances for which the debtor should not justly be held accountable;
>
> (2) the value, as of the effective date of the plan, of property actually distributed under the plan on account of each allowed unsecured claim is not less than the amount that would have been paid on such claim if the estate of the debtor had been liquidated under chapter 7 of this title on such date; and
>
> (3) modification of the plan under section 1229 of this title is not practicable.

The circumstances of this case and the extent of the debtor's injuries left the parties and the court with no doubt that Rouse met the tests of subsections (1) and (3), the hardship was not of his own making, and modification of the plan was not practicable, as the bankruptcy court stated in its opinion. Therefore, the only disputed issue was whether the debtor had satisfied subsection (b)(2). This seemingly straightforward question turned on how that subsection is to be interpreted and applied.

Nutrien objected to the motion for hardship discharge, arguing that since the confirmed plan required payment of $50,687, § 1228(b)(2) required that the debtor pay at least that much to receive a hardship discharge. Conversely, Rouse argued that § 1228(b)(2) requires an analysis separate and distinct from the best-interests analysis established at confirmation. Since the confirmation hearing will necessarily precede the effective date, § 1225(b)(4) requires certain projections or estimates. How much would a liquidation realize? How much would it cost to conduct the liquidation? How much will the chapter 12 administrative expenses be prior to the effective date?

By contrast, a § 1228(b)(2) analysis requires — as Rouse argued — a retrospective analysis of known facts. The question is this: How much would the unsecured creditors have *actually* received if a liquidation had *actually* occurred on the effective date?

At confirmation, as part of the best-interests analysis, Rouse projected chapter 12 administrative costs of $10,000 for debtor's counsel's pre-effective-date fees. The bankruptcy court subsequently approved pre-effective-date administrative expenses of $18,380.40, which would have reduced the liquidation test amount to $42,306.57.[6] The parties agreed that Rouse had paid $43,465.64 toward satisfaction of the liquidation test.[7] However, Nutrien argued that the balance owed by Rouse before he would be eligible for a hardship discharge was approximately $19,479.96 plus interest at 6 percent.

On the other hand, Rouse argued that because the *actual* pre-effective-date administrative expenses turned out to be higher than had been *projected* at confirmation, the holders of allowed unsecured claims had received more than they would have received from a liquidation occurring on the plan's effective date.[8] The debtor argued that the hardship-discharge analysis should be based on actual administrative expenses through the effective date, since the goal is to determine whether the amount "actually" distributed on account of each unsecured claim is at least the amount such claim would have received if a liquidation had actually occurred on the effective date.

Therefore, the ultimate question was whether the liquidation/best-interests test for confirmation purposes under § 1225(a)(4) is binding on a § 1228(b)(2) analysis or, stated differently, whether § 1228(b)(2) requires an independent analysis or requires simply that the unsecured creditors receive the amount projected at confirmation under § 1225(a)(4). Yet another way to frame the issue is whether a debtor seeking a hardship discharge is bound by the liquidation-test provisions in the plan.

The bankruptcy court sustained Nutrien's objection and denied Rouse's request for hardship discharge, holding that he was unsuccessful in satisfying § 1228(b)(2) by failing to pay the plan's liquidation test of $50,687 plus interest.[9] In short, the bankruptcy court held that a § 1228(b)(2) analysis is controlled by the terms of the plan.

After adjusting the interest rate, the bankruptcy court held that Rouse owed the unsecured class $11,339.62 as of Aug. 15, 2020, plus *per diem* interest of $0.925 thereafter.[10] Rouse appealed the ruling to the U.S. District Court for the Eastern District of North Carolina, which affirmed the bankruptcy court's ruling.

While the courts disagreed with the debtor's argument, a question remains as to the precedential value of this decision. Does *Rouse* stand for the proposition that the liquidation amount determined at confirmation is *binding* on a

5 *In re Rouse*, Docket No. 69, p. 5 of 29.

6 The debtor also suggested an interest rate reduced from 6 percent to 3 percent, which the bankruptcy court accepted.

7 Order at *8.

8 The debtor acknowledged that under his calculation there remained a necessary balance under the liquidation test of $1,125.41, which he was prepared to pay.

9 This amount is the result of the liquidation analysis agreed upon by the parties at the confirmation hearing based on appraisals of relevant assets retained by Rouse, including equipment and some real estate, and deductions for projected administrative expenses.

10 Order at *17. Further, the bankruptcy court required that payment pursuant to the Order would need to add the chapter 12 trustee's commission, making the final payment $12,473.58.

hardship-discharge analysis, or did the *Rouse* case turn on the peculiar facts of that particular case? Since the hardship-discharge tests are identical under chapters 11, 12 and 13, the application of this decision could have consequences that extend beyond the limited application of chapter 12.

The bankruptcy court appears to have relied on the fact that the liquidation test and the plan's minimum payments to the unsecured class were the result of negotiations between the debtor and Nutrien, negotiations that led directly to a consensual confirmation under § 1225(a). The bankruptcy court noted that "Nutrien actively participated in negotiations with [the debtor] and drove the bargain," and that "if an agreement is reached, the parties must live with a differing and unexpected outcome — particularly where, as here, confirmation was not contested."[11] In short, the debtor's promise to pay the amount provided in the plan was bargained-for in exchange for the creditor's consent to confirmation.

In affirming, the district court reviewed the decision for an abuse of discretion, although the interpretation of a statute is a legal issue to be reviewed *de novo*. The district court held:

> Rouse's argument ignores the Bankruptcy Court's thorough and thoughtful analysis of the statutory provisions and the specific facts of this case, and the Bankruptcy Court's explanation why it was not making new calculations in this case. The Bankruptcy Court did not abuse its discretion.[12]

The debtor's arguments turn on the interpretation of 11 U.S.C. § 1228(b)(2). Interpretation of a statute depends, first and foremost, on a plain reading of that statute.[13] Section 1228(b)(2) expressly requires an analysis of the amount of property "actually" distributed under the plan, and the amount that "would have been paid" if the debtor had been liquidated on the effective date. This section requires a retrospective analysis, which in this case revealed that actual administrative expenses were higher, and that the distribution *would have* been commensurately lower, than had been predicted at the time of plan confirmation. A § 1228(b)(2) analysis — the discharge analysis — is separate and independent of the best-interests analysis under § 1225(a)(4), which is the confirmation analysis.

Congress could easily have worded § 1228(b)(2) to provide that unsecured creditors must receive the amount projected pursuant to § 1225(a)(4). In other words, Congress could have expressly tied the hardship-discharge requirements to the projections made at confirmation, and have simply incorporated § 1225(a)(4) into § 1228(b)(2). However, Congress did not do that; rather, it established a retroactive analysis separate and distinct from § 1225.

Further, tying the hardship requirements to the terms of the plan runs counter to the very purpose of the hardship discharge, which is available "to a debtor that has not completed payments under the plan."[14] The hardship-discharge analysis presumes that payments under the plan have not been made. The *Rouse* courts effectively ruled that a debtor is only entitled to a hardship discharge if he *has completed* payments under the plan. Such an interpretation renders the language of § 1228(b) meaningless and superfluous.

The decisions in *Rouse* appear to have been influenced by the negotiated manner of the plan's liquidation-test analysis, and by the district court's deference to the bankruptcy court's discretion. A different framework for a § 1228(b)(2) analysis that emphasizes the phrase "actually distributed" would provide parties with clarity and avoid questions regarding abuse of discretion. Such a framework would require that two questions be answered: (1) How much would the unsecured creditors have received if the debtor's estate had been liquidated on the effective date; and (2) how much did the unsecured creditors actually receive?

Using this framework, the actual (*i.e.*, historical) administrative expenses must be considered, since that affects the amount that would have actually been paid on unsecured claims. At the time of a hardship-discharge motion, the answer to both questions is easily determined. In addition, since the amount that must be paid is fixed as of the effective date, there is no risk of the debtor manipulating the process to his advantage. This framework has a number of advantages: (1) it provides certainty, as the analysis requires a simple mathematical calculation of known figures; (2) it recognizes the fundamental prerequisite for a hardship discharge that payments have not been completed under the plan; (3) it follows the plain language of § 1228(b)(2); (4) it relies on facts rather than projections; and (5) it rewards the debtor who has made a best effort to pay unsecured claims as much as possible. While it is likely that few clients will be victim to the type of hardship experienced by Rouse, such a simplified and straightforward analysis will give relief to all types of debtors who are unable to complete their plans despite their best efforts to complete their plans as contemplated. abi

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11 Order at *8, 13.
12 *Rouse v. Nutrien AG Sols. Inc (In re Rouse)*, 2021 U.S. Dist. LEXIS 132279, *11 (E.D.N.C. 2021).
13 *Conn. Nat'l Bank v. Germain*, 503 U.S. 249, 253 (1992).
14 11 U.S.C. § 1228(b).