No. 11-1105

IN THE
UNITED STATES BANKRUPTCY APPELLATE PANEL
FOR THE NINTH CIRCUIT COURT OF APPEALS

In re GREGORY A. FRIEDMAN AND JUDITH MERCER-FRIEDMAN,
Debtors.

GREGORY A. FRIEDMAN AND JUDITH MERCER-FRIEDMAN,
Appellants
— v. —

UNITED STATES INTERNAL REVENUE SERVICE,
and
P+P, L.L.C.,
Appellees

ON APPEAL FROM THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF ARIZONA

BRIEF OF *AMICUS CURIAE* NATIONAL ASSOCIATION OF CONSUMER BANKRUPTCY ATTORNEYS IN SUPPORT OF DEBTORS-APPELLANTS

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CORPORATE DISCLOSURE STATEMENT

Pursuant to Fed. R. App. P. 26.1(a), *amicus curiae*, The National Association of Consumer Bankruptcy Attorneys states that it is a nongovernmental corporate entity that has no parent corporations and does not issue stock.

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STATEMENT OF INTEREST OF *AMICUS CURIAE*

Incorporated in 1992, the National Association of Consumer Bankruptcy Attorneys (NACBA) is a non–profit organization consisting of more than 4,800 consumer bankruptcy attorneys nationwide.

NACBA's corporate purposes include education of the bankruptcy bar and the community at large on the uses and misuses of the consumer bankruptcy process. Additionally, NACBA advocates nationally on issues that cannot adequately be addressed by individual member attorneys. It is the only national association of attorneys organized for the specific purpose of protecting the rights of consumer bankruptcy debtors. NACBA has filed *amicus curiae* briefs in various cases seeking to protect the rights of consumer bankruptcy debtors. *See, e.g., Schwab v. Reilly*, 560 U.S. —, 130 S.Ct. 2652 (2010); *Kawaauhau v. Geiger*, 523 U.S. 57 (1998).

NACBA members primarily represent individuals in bankruptcy cases. Individuals who are sole proprietors often are ineligible for chapter 13 because their debts exceed the limits set forth in 11 U.S.C. § 109(e). Once in chapter 11, many sole proprietors that want to reorganize are forced into liquidation because of the application of the absolute priority rule. In 2005, Congress made significant amendments to chapter 11 for individuals, which give sole proprietors a realistic opportunity to reorganize while continuing to protect unsecured creditors. This case presents one of the first opportunities for an appellate court to address whether the 2005 amendments to the Code abrogate the absolute priority rule for individual

chapter 11 debtors. As such, it is of great importance to NACBA and its membership.

SUMMARY OF ARGUMENT

Chapter 11 of the Bankruptcy Code is designed to facilitate reorganization rather than liquidation. Integral to the rehabilitation of the chapter 11 debtor is the plan of reorganization. Section 1129 sets forth in detail the substantive requirements that a reorganization plan must satisfy to be confirmed. If a class of creditors objects then section 1129(b) requires the plan to be fair and equitable. With respect to unsecured creditors, fair and equitable means that (i) claims must be paid in full or (ii) that senior creditors are paid in full before any party with a junior claim or interest, including the debtor, receives or retains any property on account of such claim or interest. This provision is generally referred to as the "absolute priority rule."

In 2005, Congress made significant changes to chapter 11 as it applies to individual debtors. Among these changes was the addition of section 1115, which defines property of the estate for individual chapter 11 debtors, and an amendment to section 1129(b)(2)(B)(ii), which permits debtors to retain property of the estate under section 1115 notwithstanding the absolute priority rule. These amendments effectively abrogate the absolute priority rule with respect to individual chapter 11 debtors.

The bankruptcy court erred in holding that the absolute priority rule still applies to individuals in chapter 11 and in denying confirmation of the Friedmans' plan of reorganization. The plain language of the statute, the history of the absolute priority rule and purpose of the 2005 amendments affecting individual chapter 11 debtors all point to the abrogation of the absolute priority rule for individuals.

ARGUMENT

I. The statutory framework for chapter 11 encourages reorganization, rather than liquidation.

The principal purpose of the Bankruptcy Code is to grant a fresh start to the honest but unfortunate debtor. *See Marrama v. Citizens Bank of Mass.*, 549 U.S. 365, 367 (2007); *Kokoszka v. Belford*, 417 U.S. 642, 645 (1974). More specifically, chapter 11 of the Bankruptcy Code is designed to facilitate reorganization and rehabilitation of the debtor. *See In re Thritieth Place, Inc.*, 30 B.R. 503, 504 (B.A.P. 9th Cir. 1983)("Chapter 11 of the Bankruptcy Code has one purpose; the rehabilitation or reorganization of entities entitled by statute to its relief"); *see also Nat. Labor Relations Bd. v. Bildisco*, 465 U.S. 513, 527 (1984); S.Rep. No. 95-989, 9-10 (1978)("Chapter 11 deals with the reorganization of a financially distressed business enterprise, providing for its rehabilitation by adjustment of its debt obligations and equity interests"). It is intended to avoid liquidations under chapter 7, since liquidations have a negative impact on jobs, suppliers of the business and the economy as a whole, *see U.S. v.*

Whiting Pools, 462 U.S. 198, 203 (1983), and, per 11 U.S.C. § 1129(a)(7), creditors receive more in a successful chapter 11 than in a chapter 7 liquidation.

Integral to the rehabilitation of the chapter 11 debtor is the plan of reorganization. Section 1129 sets forth in detail the substantive requirements that a reorganization plan must satisfy to be confirmed. 11 U.S.C. § 1129. A chapter 11 plan that meets the requirements of section 1129(a) and is accepted by all impaired classes of creditors must be confirmed by the bankruptcy court. By contrast, if there are impaired classes that have not accepted the plan, the plan must conform to the dictates of section 1129(b). That section permits a court to confirm a chapter 11 plan over the objection of creditor classes "if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan." 11 U.S.C. § 1129(b). Section 1129(b)(2)(B) requires unsecured creditors (i) to be paid the value of the allowed amount of the claim as of the effective date of the plan; or (ii) that senior creditors are paid in full before any party with a junior interest, including the debtor, receives or retains any property, except that an individual debtor may retain estate property under section 1115, subject to certain domestic support obligations. This provision is generally referred to as the "absolute priority rule."

In 2005, Congress made significant changes to chapter 11 as it applies to individual debtors. Among other provisions, Congress added section 1115, which states as follows:

> (a) In a case in which the debtor is an individual, property of the estate includes, in addition to the property specified in section 541—
>
> (1) all property of the kind specified in section 541 that the debtor acquires after the commencement of the case but before the case is closed, dismissed or converted to a case under chapter 7, 12, or 13, whichever occurs first; and
>
> (2) earnings from services performed by the debtor after the commencement of the case but before the case is closed, dismissed, or converted to a case under chapter 7, 12, or 13, whichever occurs first.
>
> (b) Except as provided in section 1104 or a confirmed plan or order confirming a plan the debtor shall remain in possession of all property of the estate.

Congress amended section 1129(b)(2)(B)(ii) to except in individual cases "property included in the estate under section 1115, subject to the requirements of subsection (a)(14),"[1] from the absolute priority rule. Congress also added a projected disposable income test, similar to that in chapter 13, to the confirmation requirements for individual chapter 11 plans.

When read plainly, the amendments to chapter 11 with respect to individual debtors show that the absolute priority rule has been abrogated in favor of the projected disposable income test as the mechanism to protect unsecured creditors. Nevertheless, the bankruptcy court below held that the debtors must continue to satisfy the absolute priority rule to cram down unsecured creditors. Thus, the bankruptcy court opted for an interpretation of the statute that forces "honest but unfortunate" individual chapter 11 debtors into liquidation rather than allowing for effective reorganization.

[1] Section 1129(a)(14) deals with domestic support obligations and is not relevant to the case at bar.

II. The plain language of sections 1129(b)(2)(B)(ii) and 1115 demonstrate that the absolute priority rule no longer applies to individual debtors.

The starting point for the court's inquiry should be the statutory language of 11 U.S.C. §§ 1115 and 1129(b)(2)(B)(2). *See Lamie v. U.S. Trustee*, 540 U.S. 526, 534, 124 S.Ct. 1023, 1030 (2004). It is well established that when the "statute's language is plain, the sole function of the court, at least where the disposition required by the text is not absurd, is to enforce it according to its terms." *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 530 U.S. 1, 6 (2000) (internal quotations omitted). A result will be deemed absurd only if it is unthinkable, bizarre or demonstrably at odds with the intentions of its drafters. *See In re Spradlin*, 231 B.R. 254, 260 (Bankr. E.D. Mich. 1999) (citing *Public Citizen v. Dept of Justice*, 491 U.S. 440, 109 S. Ct. 2558, 105 L.Ed.2d. 377 (1989)).

Section 1129(b)(2)(B)(ii) permits the debtor to retain "property included in the estate under section 1115." Section 1115(a) provides that property of the estate of an individual Chapter 11 debtor includes the following:

1. The property specified in section 541;
2. All section 541-type property acquired post-petition; and
3. Earnings from post-petition wages.

The natural reading of the plain language demonstrates that section 1115 broadly defines property of the estate to ***include*** property specified in section 541 as well as property acquired post-petition and earnings from services performed post-petition. *See In re Tegeder*, 369 B.R. 477 (Bankr. D. Neb. 2007); *In re Bullard*, 358 B.R.

541 (Bankr. D. Conn. 2007). The word "includes" is not limiting, but rather logically encompasses everything that follows. *See* 11 U.S.C. § 102(3); *see also Burgess v. U.S.*, 553 U.S. 124, n.3 (2008)("The word 'includes' is usually a term of enlargement, and not of limitation'), *citing* 2A N. Singer & J. Singer, Sutherland on Statutory Construction § 47:7, p. 305 (7th ed. 2007). In this case what follows is both property as specified in section 541 and a list of additional items that will be considered property of the estate.

Courts agreed that the exception to the absolute priority rule encompassed both pre-petition and post-petition property for individual debtors until the court in *In re Gbadebo*, 341 B.R. 222 (Bankr. N.D. Cal. 2010), reached the opposite result. Subsequently, several courts have followed *Gbadebo* in holding that the absolute priority rule still applies to individual debtors. *See, e.g., In re Kamell*, 2011 WL 1760282 (Bankr. C.D. Cal. May 4, 2011); *In re Maharaj*, 2011 WL 1753795 (Bankr. E.D. Va. May 9, 2011); *In re Steedley*, 2010 WL 3528599 (Bankr. S.D. Ga. Aug. 27, 2010). However, a close analysis of *Gbadebo* demonstrates that this line of cases is based on a rewriting of the statutory language.

In *Gdabedo*, the debtor, a licensed engineer and sole shareholder of his engineering firm, filed a chapter 11 plan that proposed to retain the debtor's equity interest in the estate, strip down judgment liens on real property and treat the underlying judgment debt as a general unsecured claim. *Id.* The plan proposed to pay approximately a 2.6% distribution to unsecured creditors over 60 months. *Id.* at 225.

A judgment creditor controlled the voting of the unsecured class and rejected the plan and objected to confirmation. *Id.*

Prior to reaching the question of the absolute priority rule the court found that the debtor's plan was filed in bad faith because his car and house payments were unreasonable. *Id.* at 226. The *Gbadebo* court also concluded that the debtor did not satisfy section 1129(a)(15) because the debtor's financial information was not credible. Rather, the debtor's testimony persuaded the court that the debtor used his company as "his personal 'piggy bank,' drawing money from it or causing it to pay his personal as needed and failing to maintain its corporate separateness." *Id.*

After finding the debtor's chapter 11 plan unconfirmable based on section 1129(a)(3) and 1129(a)(15), the *Gbadebo* court nevertheless went on to consider the applicability of the absolute priority rule. Here the *Gbadebo* court inverted the statutory language of section 1115 to hold the absolute priority rule still applies to individual chapter 11 debtors and thereby added another proverbial nail to the coffin of this less than honest but unfortunate debtor. Specifically, the *Gbadebo* court stated that:

> Section 541 provides that, when a petition is filed, a bankruptcy estate is created, consisting of debtor's pre-petition property. Section 1115 provides that, in an individual chapter 11 case, *in addition to the property specified in § 541*, **the estate includes the debtor's post-petition property.**

431 B.R. at 229 (emphasis added). The *Gbadebo* court reads the phrase "in addition to the property specified in section 541" (italicized above) as preceding the phrase "the

estate includes the debtor's post-petition property" (bold above). Under the statute as rewritten by the *Gbadebo* court, property of the estate in section 1115 clearly does not "include" property specified in section 541. The *Gbadebo* court concludes that only property *added* to the bankruptcy estate by section 1115 may be retained by the debtor under the exception in section 1129(b)(2)(B)(ii). But, the language written by Congress is different from that rewritten and analyzed by the *Gbadebo* court.

First, section 1129(b)(2)(B)(ii) uses the phrase "property included in the estate under section 1115," not "property **added** to the estate by section 1115." "Included" does not mean "added." Something that is "added" may be included but the converse is not necessarily true. Limiting the word "included" to mean "added" as the *Gbadebo* court did is inconsistent with the Code, which uses "includes" expansively. *See* 11 U.S.C. § 102(3); *see also American Sur. Co. v. Marotta*, 287 U.S. 513 (1933)(in the bankruptcy context "'include' is frequently, if not generally, used as a word of extension or enlargement rather than as one of limitation or enumeration").

Second, while inverting the order of the clauses in section 1115 is consistent with and supports the conclusion reached by the *Gbadebo* court, it is not the language used by Congress. Congress used the words "property of the estate includes, in addition to the property specified in section 541—…" Here, section 1115 refers the superset of section 541(a) property and the debtor's postpetition service income. *See In re Shat*, 424 B.R. 854, 863 (Bankr D. Nev. 2010). Put another way section 1115 entirely supplants section 541 by specifically incorporating it and adding to it. *Id.*

Section 1129(b)(2)(B)(ii), therefore, permits the debtor to confirm a plan and retain both pre-petition and post-petition property of the estate so long as the other requirements of section 1129(a), except (a)(8), are satisfied.

The plain language of the statute, as written, abrogates the absolute priority rule for individual chapter 11 debtors. The fact that Congress could have opted for another way to relieve individual chapter 11 debtors of the obligations imposed by the absolute priority rule does not permit courts to simply ignore the language as written or rewrite the language to comport with the court's conclusion. It is simply irrelevant whether the language used by Congress is the most efficient way to achieve the intended result. Courts that find the absolute priority rule still applies to individual debtors because Congress could have, or should have, written the law differently have missed the mark in applying the foundational rule of statutory construction. *See In re Maharaj*, 2011 WL 1753795, at *7 (Bankr. E.D. Va. May 9, 2011)(applying APR where abrogation could have been "more straight-forwardly expressed"); *In re Karlovich*, 2010 WL 5418872, at *4 (Bankr. S.D. Cal. Nov. 16, 2010)(if abrogation of the APR for individual debtors was Congress' intent, it would simply have amended the statutory debt ceilings for chapter 13 cases); *In re Mullins*, 435 B.R. 352, 360 (Bankr. W.D. Va. 2010)(it would have been much clearer, easier and more direct to abrogate APR with different statutory language). The proper inquiry here is whether applying the plain language of the statute leads to a result that is unthinkable, bizarre or demonstrably at odds with the intentions of its drafters. *See In re Spradlin*, 231 B.R. 254, 260 (Bankr.

E.D. Mich. 1999). In this case, the abrogation of the absolute priority rule is not so bizarre that Congress could not have intended it.

III. To the extent this Court finds the language of sections 1129(b)(2)(B)(ii) and 1115 ambiguous, the history of the absolute priority rule and the 2005 amendments to the Code demonstrate that the absolute priority rule should not apply to individual debtors in chapter 11.

Though the plain language of sections 1129(b)(2)(B)(ii) and 1115 make the absolute priority rule inapplicable to individual chapter 11 debtors, some courts have found the meaning of these sections, as amended in 2005, to be ambiguous and open to multiple interpretations. *See, e.g., In re Gelin*, 437 B.R. 435 (Bankr. M.D. Fla. 2010); *In re Shat*, 424 B.R. 854, 863 (Bankr D. Nev. 2010). If this Court similarly concludes the language of these two sections is ambiguous, then the court must look beyond the words on the page to the statutory cross-references, legislative history, and Congressional intent. *See Ratslaf v. United States*, 510 U.S. 135, 147-48 (1994). Here, the history of the absolute priority rule and the 2005 amendments to the Code demonstrate that the absolute priority rule should no longer apply to individual chapter 11 debtors.

The absolute priority rule itself predates the Bankruptcy Code. It developed under the previous Bankruptcy Act as a judicially created doctrine to protect unsecured creditors from unscrupulous management and shareholders in corporate reorganizations. Fairness and equity required that "creditors…be paid before the stockholders could retain [equity interests] for any purposes whatever." *Bank of Am.*

Nat. Trust and Sav. Ass'n v. 203 North LaSalle St. P'ship, 526 U.S. 434, 444 (1999). The absolute priority rule was codified in the Bankruptcy Code as section 1129(b)(2)(B). The effect of the absolute priority rule was to make it almost impossible for shareholders to retain their interest in the reorganized debtor in the absence of a plan that paid 100% to creditors. The judicial exception to the absolute priority rule that permits equity to retain an interest in the reorganized debtor by contributing "new value" has provided a mechanism for corporate shareholders to contribute new capital, but provides little relief to sole proprietors and other individual chapter 11 debtors. *See Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988).

In 2005, Congress made significant amendments to chapter 11, applicable only to individual debtors, to make the administration of their cases more similar to chapter 13 cases, including:

> "• redefining property of the estate in chapter 11 under Section 1115 along the lines of property of the estate under Section 1306;
> • changing the mandatory contents of a plan pursuant to Section 1123(a)(8) to resemble Section 1322(a)(1);
> • adding the disposable income test of Section 1325(b) to Section 1129(a)(15);
> • delaying the discharge until completion of all plan payments as in Section 1328(a);
> • permitting discharge for cause before all payments are completed pursuant to Section 1141(d)(5), similar to the hardship discharge of Section 1328(b); and
> • the addition of Section 1127(e) to permit the modification of a plan even after substantial consummation for purposes similar to Section 1329(a)."

In re Shat, 424 B.R. at 862, *citing* 5 Keith M. Lundin, Chapter 13 Bankruptcy § 368.1 at 368-1 to 368-5 (3d ed. 2000 & Supp. 2006); *In re Roedemeier*, 374 B.R. 264, 275-76 (Bankr. D. Kan. 2007), *citing same*. Taken together, these changes indicate that

Congress intended to harmonize the treatment of individual debtors under both reorganization chapters, and, as part of that harmonization, remove the absolute priority rule as a factor for individual chapter 11 debtors. *Roedemeier*, 374 B.R. at 276.

The protection offered to unsecured creditors by the absolute priority rule in individual chapter 11 cases has been supplanted by the addition of the projected disposable income test. According to Congress, fairness and equity for unsecured creditors is embodied in the projected disposable income test, or means test, enacted as part of BAPCPA for both chapter 13 debtors and individual chapter 11 debtors. The means test—which applies in chapter 11 only to individual debtors—permits the holder of an allowed unsecured claim to object to confirmation of the debtor's plan if the plan fails to pay that creditor in full, or the value of the property to be distributed under the plan is less than the debtor's projected disposable income to be received during the 5-year period beginning on the date the first plan payment is due under the plan, or during the period for which the plan provides payments, whichever is longer. 11 U.S.C. § 1129(a)(15). Though chapter 13 debtors and individual chapter 11 debtors are now subject to the projected disposable income test, significantly, chapter 13 does not impose the absolute priority rule on debtors. *See Roedemeier*, 374 B.R. at 276.

Indeed, it is incongruous for Congress to make chapter 11 for individuals more like chapter 13 through the 2005 amendments, but leave the absolute priority rule and limitations on "new value" intact. Without abrogation of the absolute priority rule, it

is difficult to discern the purpose of the chapter 13-like amendments to chapter 11. *See Roedemeier*, 374 B.R. at 276. Pre-BACPA, the Bankruptcy Code made the absolute priority rule applicable to individual chapter 11 debtors while reserving to them their postpetition property and income, thus under the narrow view of sections 1129(b)(2)(B)(ii) and 1115 adopted by *Gbadebo* and its progeny, BAPCPA did little to change chapter 11 for individual debtors. As is evidenced by the dearth of case law under section 1129(a)(15) as compared to 1325(b), the projected disposable income test of section 1129(a)(15) is of little use to unsecured creditors so long as the absolute priority rule continues to applies to individual chapter 11 debtors. In essence, the narrow view renders surplusage the 2005 amendments with respect to individual chapter 11 debtors. "'[C]ourts should disfavor interpretations of statutes that render language superfluous.'" *Conn. Nat'l Bank v. Germain*, 503 U.S. 249, 253, 112 S.Ct. 1146, 117 L.Ed.2d 391 (1992).

IV. Retention of the absolute priority rule makes it virtually impossible for sole proprietors, who are individual chapter 11 debtors, to confirm a plan of reorganization.

As noted by the court in *In re Shat*, the uniform application of the absolute priority rule to individuals and nonindividuals alike, effectively means that individual debtors with small businesses could never confirm a chapter 11 plan. *See* 424 B.R. at 859. By contrast, the *Gbadebo* court found that all that was needed for individual debtors to obtain plan confirmation was to "sweeten the pot" so that holders of unsecured claims would vote in favor of the plan. 431 B.R. at 230-31. Based on the

experience of NACBA members, we find reality to be closer to the description provided by the court in *Shat*. Unsecured creditors routinely do not vote in favor of the plan even where they would receive, as they must under section 1129(a)(7), more through the proposed chapter 11 plan that in a chapter 7 liquidation. This is true, even where debtors are paying all that they can afford to pay and have committed all their projected disposable income to plan payments for five years. The absolute priority rule as applied to individual chapter 11 debtors after the 2005 amendments runs counter to the basic principles of the Bankruptcy Code, which offer the honest but unfortunate debtor a fresh start, and of chapter 11, which favor reorganization over liquidation.

CONCLUSION

For the reasons stated above, the opinion of the bankruptcy court below should be reversed.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that on June 21, 2011, I electronically filed the foregoing document with the Clerk of the Court for the Bankruptcy Appellate Panel for the Ninth Circuit by using the CM/ECF system.

I further certify that parties of record to this appeal who either are registered CM/ECF users, or who have registered for electronic notice, or who have consented in writing to electronic service, will be served through the CM/ECF system.

I further certify that some of the parties of record to this appeal have not consented to electronic service. I have mailed the foregoing document by First-Class Mail, postage prepaid, or have dispatched it to a third party commercial carrier for delivery within 3 calendar days, to the following parties:

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