Absolute Roulette:
The Absolute Priority Rule in Individual Chapter 11 Cases

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ABSOLUTE ROULETTE

Right now, the odds of the "fixed principle" of the Absolute Priority Rule (the "Rule")[1] applying in an individual chapter 11 case are roughly the same as landing on red or black on the Roulette Table. Although the Rule was articulated by the Supreme Court during the Taft Administration[2] and the Great Depression,[3] some bankruptcy courts believe that it has been written out of individual chapter 11 cases by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005[4] ("BAPCPA"), while others believe that it still applies. In most instances, a bankruptcy attorney will not know in advance who their client's bankruptcy judge will be, so there is currently no way to pre-determine how the future judge has ruled on the application of the Rule post-BAPCPA. For those attorneys who file individual chapter 11 cases, or represent creditors in those cases, it is therefore vitally important to understand the Rule as well the arguments for and against its application in individual cases.

WHAT IS THE ABSOLUTE PRIORITY RULE?

The requirements for chapter 11 plan confirmation are set forth at 11 U.S.C. Section 1129. Many successful chapter 11 cases result from the use of these requirements as guidelines in negotiations with creditors, ultimately producing a plan that has been consented to by each class of creditors.[5] Even in these consensual cases, however, the requirements of Section 1129(a)(1) through (16) must be met. For the most part, these requirements protect creditors,

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[1] The Rule is currently codified at 11 U.S.C. § 1129(b)(1)-(2). The label "fixed principle" comes from *Case v. Los Angeles Lumber Case*, *infra*.

[2] *Northern Pacific Railroad v. Boyd*, 228 U.S. 482 (1913); The genesis of the Rule appears in post-Civil War railroad cases, where it was held that stockholders could retain no equity or dividends until "all debts of the corporation are paid." *Chicago Rock Island and Pacific Railroad v. Howard*, 74 U.S. 392, 409-410 (1868).

[3] *Case v. Los Angeles Lumber Products Co*., 308 U.S. 106 (1939).

[4] The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Public Law 109-8, 119 Stat 23.

[5] A class of claims accepts a chapter 11 plan if creditors holding at least 2/3 in amount, and ½ in number of claims vote to accept the plan (11 U.S.C. §1126(c)); a class of claims that is not impaired is deemed to have accepted a chapter 11 plan (11 U.S.C. §1124).

for example, by requiring that a plan be feasible[6] (not likely to be followed by another reorganization or liquidation), that the plan is in the "best interest of creditors"[7] (creditors receive at least as much as would be received on liquidation) and by requiring that the each class of creditors consent to the plan.[8]

However, if all of the requirements of chapter 11 plan confirmation contained in Section 1129 are met – except that the plan proponent has not obtained consent from each class, the plan may nonetheless be confirmed if the remaining requirements of Section 1129(a) are satisfied and the plan does not "discriminate unfairly"[9] and is "fair and equitable." Section 1129(b)(2)(B) defines *fair and equitable* as to unsecured creditors as:

> (i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or
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> (ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property, **except that in the case which the debtor is an individual, the debtor may retain property included in the estate under section 1115, subject to the requirements of subsection (a)(14) of this section.**[10]

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[6] 11 U.S.C. §1129(a)(11).
[7] 11 U.S.C. §1129(a)(7)(B).
[8] 11 U.S.C. §1129(a)(8).
[9] Unfair discrimination may be determine by considering whether the proposed discrimination has a reasonable basis and whether the discrimination is necessary for the reorganization: "The Code does not prohibit unequal treatment of claims that are properly classified in different classes so long as the discrimination is not unfair." *In re Cypresswood Land Partners, I*, 409 B.R. 396, 434 (Bankr. S.D. Tex. 2009); or by a four factor test: (1) whether the discrimination has a reasonable basis; (2) whether the plan can be confirmed without the discrimination; (3) whether the discrimination is proposed in good faith; and (4) how the discriminated classes are treated under the plan. *In re Snyders Drug Stores, Inc.*, 307 B.R. 889, 894-95 (Bankr. N.D. Ohio 2004).
[10] The emphasis is added and refers to the portion of Section 1129(b)(2)(B) which were added by BAPCPA.

This is the codification of the Absolute Priority Rule, which in a nut shell means that senior classes of creditors may require payment in full before a class of creditors or interests junior to them receives anything under the chapter 11 plan. Traditionally, when a chapter 11 plan proponent did not obtain consent from all classes, plan confirmation over the dissenting class would only occur when either the dissenting class was paid in full or – via *cram down* – where no class junior to the dissenting class retained anything under the plan.

An important twist to the Rule, the "New Value Exception," allows a chapter 11 debtor to confirm a plan over a dissenting class of unsecured creditors while still retaining an interest in the reorganized debtor if the debtor offers value that is "(1) new, (2) substantial, (3) money or money's worth, (4) necessary for a successful reorganization, and (5) reasonably equivalent to the value or interest received."[11] Therefore, <u>if</u> the Rule applies in individual chapter 11 cases, in order to overcome a dissenting class of creditors that is not paid in full, the debtor would be required to make a valuable contribution in order to retain property that existed on the instant of the chapter 11 filing.

THE BAPCPA AMENDMENTS

In addition to the aforementioned changes to Section 1129(b)(2)(B)(ii), BAPCPA also added Section 1115 to define property of the bankruptcy estate for individual chapter 11 debtors.

This new section provides:

(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 -

[11] *In re Bonner Mall Partnership*, 2 F.3d 899, 908-09 (9th Cir. 1993).

(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.

The results of the current crap shoot of whether or not the Absolute Priority Rule will apply in an individual chapter 11 case is determined by one of two views: whether (a) the bankruptcy court believes that the newly added language of section 1129(b)(2)(B)(ii) and Section 1115 means that the debtor may keep all pre-bankruptcy property (as defined by Section 541) and all post-bankruptcy petition property (as defined by Section 1115), without adhering to the Rule (the "Broad View"), or (b) the bankruptcy judge believes that the individual Debtor may only retain post-bankruptcy petition property – leaving the Rule intact and requiring either payment in full to the dissenting senior class, or no retention of pre-Petition property absent compliance with the New Value Exception (the "Narrow View"). The published decisions come to their conclusions using differing grammatical interpretations of the new sections, they disagree over whether the amendments to Sections 1115 and 1129(b)(2)(B are *plain and unambiguous*[12] and they offer divergent views over how much Congress intended individual 11s to be akin to chapter 13 cases.

[12] Hence, invoking the Plain Meaning Rule as set forth in *Lamie v. U.S. Trustee,* 540 U.S. 526, 534 (2004).

THE BROAD VIEW

The Broad View gets its moniker from the conclusion that Congress intended that an individual Chapter 11 Debtor keep both pre and post-Petition property through the reorganization process, without the requirement that senior classes be paid in full. But courts that adhere to the Broad View arrive at this conclusion for different reasons. For example, the Bankruptcy Appellate Panel in *In re Friedman*[13] based its decision on what it believed is the plain meaning of newly added portions of Section 1129(b)(2)(B)(ii) and Section 1115:

> Section 1115's identification of estate property consists of the property contained in §541 and the two post-petition acquired assets – newly acquired property and income. The so-called disputes over what "included" means in § 1129 (b) (2) (B) (ii) and "in addition to" in § 1115 arise from misinterpretation of the words. "Included" is not a word of limitation. To limit the scope of the estate property in §§ 1129 and 1115 would require the statute to read "included, except for the property set out in Section 541" (in the case of § 1129 (b) (2) (B) (ii)), and "in addition to, but not inclusive of the property described in Section 541" (in the case of § 1115).
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> A plain reading of §§ 1129 (b) (2) (B) (ii) and 1115 together mandates that the absolute priority rule is not applicable in individual chapter 11 debtors cases. [14]

Other Broad View decisions agree with courts that do not see a plain meaning in the new provisions, but nonetheless find congressional intent to abrogate the Rule and make individual chapter 11 cases much like *Chapter13s on steroids*. One of the earlier bankruptcy court decisions on the subject[15] reasoned:

> The broader view of the exception, on the other hand, helps to explain why a number of changes, including the exception, were made to Chapter 11, namely, so that it could function for individual debtors much like Chapter 13 does. Many of the BAPCPA's changes to Chapter 11 apply only to individual debtors and are clearly drawn from the Chapter 13 model:

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[13] 466 B.R. 471 (9th Cir BAP 2012).
[14] *Id.* at 482 (internal citations omitted). *Plain Meaning* was also found by the courts in *SPCP Group, LLC v. Biggins*, 465 B.R. 316 (M.D. Fla. 2011); *In re Tegeder*, 369 B.R. 477 (Bankr. D. Neb 2007).
[15] *In re Roedemier,* 374 B.R. 264 (Bankr. D. Kan. 2007)

1. § 1115 brings property the debtor acquires postpetition into the estate;

2. § 1123(a)(8) calls for the debtor's plan to provide for payment to creditors from the debtor's postpetition earnings from services or other future income;

3. the exception in § 1129(b)(2)(B)(ii) allows the debtor to keep property included in the estate under § 1115, without paying in full a class of unsecured creditors that rejected his or her plan;

4. § 1129(a)(15) authorizes the debtor to overcome an objection to the plan made by a single unsecured creditor by proposing to distribute under the plan property worth at least as much as the debtor's projected disposable income for a five-year period;

5. § 1141(d)(5) ordinarily delays the entry of the debtor's discharge until completion of all payments under the plan; and

6. § 1127(e) permits modification of a confirmed plan even after substantial consummation for certain purposes.

Significantly, Chapter 13 does not impose the absolute priority rule on debtors. Taken together, these changes indicate Congress intended to extend the exemption from the absolute priority rule to individual Chapter 11 debtors as well.[16]

Not surprisingly, courts that disagree with the Broad View are not convinced that the foregoing evidences intent by Congress to abrogate the Rule.

THE NARROW VIEW

The most recent, and the highest Court to date to publish a decision on the application of the Rule to individual chapter 11 cases, found (as many courts have[17]) ambiguity in the newly added language. In the *Maharaj*[18] decision, the Fourth Circuit Court of Appeals stated that:

> There are two competing constructions of the "included in the estate" language. On one view, the phrase "included in" means the equivalent of "added to," since property of the estate has long been defined under § 541. On another view, however, this language "included in" means something close to "referenced" in § 1115, in which case § 541 was

[16] *Id.* at 275, 276.
[17] See *Friedman*, 466 B.R. at 485, (Jury, J. Dissenting opinion); *In re Lindsey,* 453 B.R. 886 (Bankr. E.D. Tenn, 2011); *In re Kamell*, *451 B.R. 505* (Bankr. C.D. Cal. 2011). *In re Gelin*, 437 B.R. 435 (Bankr. M.D. Fla 2010).
[18] *In re Maharaj*, 681 F.3d 558 (4th Cir. 2012).

> merely "absorbed" and "superseded" into § 1115 for individual Chapter 11 debtors . *See, e.g., Kamell,* 451 B.R. at 509. On the face of the statute, either construction is plausible.
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> The same is true with respect to the "in addition to the property specified in section 541" language found in §1115. Court-Assigned Amicus-in this case asks us to treat that language as a signpost, used only to note that § 541 property is already included in the bankruptcy estate, because it is set aside from the rest of § 1115 by a comma and a dash, indicating that it is "not essential" to the statute's meaning. Stated differently, because §541 independently includes all § 541 property in the estate, it would be a redundancy to "reinclude" that property through the § 1115 language. On the other hand, several bankruptcy courts have noted that a plausible reading of that language (coupled with the "included in the estate" language) indicates that § 541 operates in § 1115 as a subset of § 1115. *See, e.g., Friedman,* 466 B.R. at 482. By that construction, § 541 property, which is referenced by § 1115, is literally "property included in the estate under § 1115."[19]

Finding no plain meaning, the Fourth Circuit Court of Appeals first relies on the statutory interpretation set forth by the California bankruptcy court in *Karlovic*[20] in favor of keeping the Rule intact:

> [P]rior to BAPCPA, property of the estate did not include post-petition acquired property and earnings for individuals and non-individuals alike. Hence, post-petition acquired property and earnings could be retained by a Chapter 11 debtor, individual and non-individual alike, without running afoul of the [absolute priority rule]. The addition of § 1115 potentially changed that by adding to the property of the estate of an individual post-petition acquired property and earnings. Without a corresponding change to § 1129(b)(2)(B)(ii), individual debtors could no longer retain post-petition acquired property and earnings if they wished to "cram down" a plan. By adding the language excepting the § 1115 property from the [absolute priority rule] of § 1129(b)(2)(B)(ii), Congress merely ensured that the [absolute priority rule] would be the same as it had been prior to BAPCPA and be the same for all Chapter 11 debtors. In other words, what Congress took from the individual debtor with its § 1115-hand, it returned for application of the [absolute priority rule] with its § 1129(b)(2)(B)(ii)-hand.[21]

Next, the Appellate Court in *Maharah*, like many of the Narrow View decisions, finds no clear indication that Congress intended to abrogate the Rule for individual debtors, holding that "to the contrary we are in agreement with those courts that have concluded that, if Congress

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[19] *Id*., at 569.
[20] *In re Karlovich*, 456 B.R. 677 (Bankr. S.D. Cal. 2010).
[21] *Maharaj*, 681 F.3d at 569 - 570 (citing *Karlovich*, 456 B.R. 677, 681).

intended to abrogate such a well-established rule of bankruptcy jurisprudence, it could have done so in a far less convoluted manner."[22] In fact, the Court contrasts the legislative history of BAPCPA with the 1952 amendment to the Bankruptcy Act that eliminated the "fair and equitable" requirement from small business cases:

> When Congress amended the Act in 1952 to eliminate the "fair and equitable" requirement, it clearly explained its actions in the accompanying legislative history. Not only did Congress amend the Act to state that plan confirmation shall not be refused because "the interest of a debtor . . . will be preserved under the arrangement," but Congress explained itself in the Congressional Record: "[T]he fair and equitable rule . . . cannot realistically be applied[.] *See* H.R. Rep. 82-2320. History shows that Congress knows how to abrogate the absolute priority rule, and it has not done so here.[23]

Finally, the Mahara Court simply did not buy into the *Chapter 13 on steroids* argument. The Court instead agreed with courts that reason that although Congress may have intended to harmonize chapter 11 and 13 in some respects, the overall legislative history of BAPCPA evidences intent that individual debtors pay creditors more, not less. Since the elimination of the Rule for individual chapter11 cases would allow debtors to retain all pre and post Petition property without payment in full to senior classes, or a new value contribution, the Court believed such a result runs contrary to congressional intent of BAPCPA.[24]

In a similar fashion, and notwithstanding the Bankruptcy Appellate Panel's decision in *Friedman*, some bankruptcy courts within the Ninth Circuit find that the Rule still applies in individual Chapter 11 cases.[25] As one post-*Friedman* bankruptcy court decision points out, negotiations that occur as a result of the "fine-tuned balance between the rights of a Chapter 11 debtor and the creditors" created by the Rule would be eliminated by the Broad View, resulting

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[22] *Maharaj*, 681 F.3d at 571.
[23] *Id. at* 572.
[24] *Id. at* 574.
[25] *In re Arnold*, 471 B.R. 578, 590 (Bankr. C.D. Cal. 2012)(bankruptcy court held that it was "not bound by, the decision of the BAP in *Friedman* ….").

in a lack of incentive for an individual chapter 11 debtor to bargain with creditors.[26] Conversely, the Narrow View retains the bargaining process via the Rule's creditor protections, reducing the danger of "too good a deal" for debtors. [27]

WHO WINS?

Having never left Vegas a financial winner, the author is remiss to make any attempt at predicting whether the *Broad View* or *Narrow View* will ultimately prevail. However, odds are certain that the outcome of the debate will be closely monitored by practitioners in the individual chapter 11 space.

[26] *Id.*at 611.
[27] *Id.*