Individual Chapter 11s: Pitfalls and Advantages

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ABSOLUTE PRIORITY RULE

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DID BAPCPA ELIMINATE THE ABSOLUTE PRIORITY RULE?

As more and more individual Chapter 11 cases wind their way to the bankruptcy trial and appellate courts, more and more cases decide whether the absolute priority rule applies in individual Chapter 11 cases and, if so, what the exceptions to the absolute priority rule are in individual Chapter 11 cases.

Prior to BAPCPA, the absolute priority rule required, in the context of a Chapter 11 plan of reorganization, that the proposed plan be fair and equitable, it must provide "[t]he holder of any claim or interest that is junior to the claims of such [dissenting] class will not receive or retain under the plan on account of such junior claim or interest any property." 11 U.S.C. §1129(b)(2)(B)(ii). There was little doubt that the absolute priority rule applied in individual Chapter 11 cases prior to BAPCPA. The United States Supreme Court's decision in *Norwest Bank Worthington v. Ahiers,* 45 U.S. 197 (U.S. 1988), held that the absolute priority rule applied in that individual chapter 11 case. However, BAPCPA added to the above noted section, so that now, in order for a plan to be fair and equitable, it must provide that "[t]he holder of any claim or interest that is junior to the claims of such [dissenting] class will not receive or retain under the plan on account of such junior claim or interest any property, *except that in a case in 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)(15) of this section.*" [Amendment emphasized.]

BAPCPA also amended prior law by including, as property of the estate, the Debtor's post-petition personal service income and other property acquired during the case up to closing, dismissal or conversion. After BAPCPA became effective, courts have differed as to whether BAPCPA eliminated the absolute priority rule in individual Chapter 11 cases. Most of the earlier cases, one

Bankruptcy Appellate Panel, one district court and a recent bankruptcy court case (which now appear to be in the minority) adopted the so-called "broad" view that since Congress included in Section 1129(b)(2)(B)(ii) a reference to the debtor's retention of property included in the estate under Section 1115, it had intended to allow the individual Chapter 11 debtor to retain all of the Bankruptcy estate as property, post-confirmation, so that the absolute priority rule would thus be abrogated in individual Chapter 11 cases. *See, e.g., In re Friedman*, 466 B.R. 471 (9th Cir. BAP 2012); *In re O'Neal*, 2013 Bankr. LEXIS 1531, 3637 (Bankr. W.D. Ark. 2013), *SPCP Group, LLC v. Biggins*, 465 B.R. 316 (M.D. Fla. 2011); *In re Shat*, 424 B.R. 854 (Bankr. D. Nev. 2010); *In re Johnson*, 402 B.R. 851 (Bankr. N.D. Ind. 2009); *In re Tegeder*, 369 B.R. 477 (Bankr. D. Neb. 2007); *In re Rodemeier,* 374 B.R. 264 (Bankr. D. Kan. 2007); *In re Bullard*, 359 B.R. 541 (Bankr. D. Conn. 2007).

The *Friedman* BAP opinion noted: "A plain reading of Sections 1129(b)(2)(B)(ii) and 1115 together mandates that the absolute priority rule is not applicable in individual chapter 11 debtor cases."

By contrast, it appears that most of the later cases (and perhaps the emerging trend in the trial courts) find and rule that the absolute priority rule still applies in individual chapter 11 cases. *In re Arnold*, 471 B.R. 578 (Bankr. C.D. Cal. 2012); *In re Tucker*, 2011 WL 5926757 (Bankr. D. Or. 2011); *In re Borton*, 2011 WL 5439285 (Bankr. D. Idaho 2011); *In re Lindsey*, 453 B.R. 886 (Bankr. E.D. Tenn. 2011); *In re Maharaj*, 449 B.R.484, 491-94 (Bankr. E.D. Va. 2011); *In re Kamell*, 451 B.R. 505, 507-12 (Bankr. C.D. Cal. 2011); *In re Draiman*, 450 B.R. 777, 820-22 (Bankr. N.D. Ill. 2011); *In re Walsh*, 447 B.R. 45, 47-49 (Bankr. D. Mass. 2011); *In re Stephens*, 445 B.R. 816, 820-21 (Bankr. S.D. Tex. 2011); *In re Karlovich*, 456 B.R. 677 (Bankr. S.D. Cal. 2010); *In re Steedley*, 2010 L 3528599 (Bankr. S.D. Ga. 2010); *In re Gelin*, 437 B.R. 435, 440-43

(Bankr. M.D. Fla. 2010); *In re Mullins*, 435 B.R. 352, 359-61 (Bankr. W.D. Va. 2010); and *In re Gbadebo*, 431 B.R. 222, 227-30 (Bankr. N.D. Cal. 2010).

The district court for the Eastern District of Tennessee, in affirming the bankruptcy court's decision, found that the absolute priority rule applies in an individual chapter 11 case. *In re Lindsey*, 2012 U.S. Dist. LEXIS 146802, 3-4 (E.D. Tenn. 2012).

In addition, all of the courts of appeal to address the issue have applied the so-called "narrow view" and ruled that the absolute priority rule remains viable in individual chapter 11 cases. In *Maharaj v. Stubbs & Perdue, P.A.*, 681F.3d 558 (4th Cir. 2012), the Fourth Circuit noted that the applicable statutory language was ambiguous and, as a result, the Court was required to review the legislative history of the 2005 BAPCPA amendments. The Court noted: "Furthermore, there is nothing in the BAPCPA's legislative history that suggests that Congress intended to repeal the absolute priority rule. To say the least, that would be an odd occurrence for such a significant change."

The Fourth Circuit thoroughly discussed the history of the absolute priority rule, BAPCPA changes and analyzed the issue:

> Accordingly, we begin our analysis by reference to the language of the BAPCPA, which we conclude is ambiguous because it is susceptible to more than one reasonable interpretation. We then look to the specific and broader context within which Congress enacted the BAPCPA, as well as a familiar canon of statutory construction, the presumption against implied repeal, and conclude that Congress did not intend to abrogate the absolute priority rule. Thus, notwithstanding the ambiguity of the plain language of the relevant BAPCPA provisions, when the 2005 BAPCPA amendments are viewed in light of the specific context in which they were enacted and the broader context of the BAPCPA and the field of bankruptcy law, we arrive at the conclusion that Congress did not intend to alter longstanding bankruptcy practice by effecting an implied repeal of the absolute priority rule for individual debtors proceeding under Chapter 11. Finally, we consider, and reject, appellants' public policy contentions as unfounded.
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> In light of the foregoing, we conclude that the language of § 1129(b)(2)(B)(ii) and § 1115 lends itself to more than one reasonable interpretation, and thus does not have a "plain" meaning. Perhaps the only thing that is clear and plain is that the courts that have considered this issue have arrived at plausible, competing arguments as to why their respective approaches are consistent with Congressional purpose in enacting BAPCPA. In short, the meaning of the BAPCPA amendments is anything but "plain." It is ambiguous. *See Friedman*, 466 B.R. at 485 (Jury, J., dissenting) ("[T]he meaning of the words is not plain. There can be more than one cogent interpretation of their meaning and intent[.]").
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> As we discussed above, in addition to analyzing the plainness or ambiguity the statute's language, we must also look to the specific context in which that language is used, and the broader context of the statute as a whole. In doing so, we find persuasive the argument that the amendment to § 1129(b)(2)(B)(ii) preserved the absolute priority rule as it operated prior to the passage of BAPCPA.
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> In our view, the context demonstrates that Congress intended § 1115 to add property to the estate already established by § 541. This position is supported by the Sixth Circuit's holding in *In re Seafort*, 669 F.3d 662 (6th Cir.2012), in which the court interpreted § 1306(a)—the parallel Chapter 13 provision to § 1115. 8 [Footnote omitted.] The Sixth Circuit interpreted the statute as follows: " Section 1306(a) expressly incorporates § 541. Read together, § 541 fixes property of the estate as of the date of filing, while § 1306 adds to the 'property of the estate' property interests which arise post-petition." *Seafort*, 669 F.3d at 667.
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> Looking to the text of both §§ 1129(b)(2)(B)(ii) and 1115, we find no clear indication that Congress intended to abrogate the longstanding absolute priority rule for individual Chapter 11 debtors. As we discussed above, the language at issue is ambiguous, and we are unable to draw from it a clear Congressional intent to abrogate the rule. To the contrary, we are in agreement with those courts that have concluded that, if Congress intended to abrogate such a well-established rule of bankruptcy jurisprudence, it could have done so in a far less convoluted manner....

681 F.3d at 568-571.

The Tenth Circuit adopted the "narrow view" in *Dill Oil Company v. Stephens,* 704 F.3d 1279 (10th Cir. 2013). Like the Fourth Circuit, the Tenth Circuit found that the language of the statute was ambiguous but further determined that the congressional intent in adopting the 2005 changes to Section 1129(b)(2)(B)(ii) was also ambiguous. The Court noted: "the statutory language

and legislative history lack any clear indication that Congress intended to erode a pillar of creditor bankruptcy protection." 704 F.3d at 1287.

The Fifth Circuit, in *In re Lively*, 717 F.3d 406 (5th Cir. 2013), in adopting the "narrow view" found: "[a] plain reading of § 1129(b)(2)(B)(ii) in light of § 1115(a) is that both provisions were adopted when BAPCPA was passed in order to coordinate individual debtor reorganization cases to some extent with Chapter 13 cases, whose debt limit may throw [certain chapter 13 debtors] into a chapter 11 reorganization." The Fifth Circuit, following the other circuit courts of appeal, found that to the extent there was an ambiguity in the statutes, the Court declined to find that the ambiguity caused an implicit repeal: "[t]he absolute priority rule, in particular, has been a cornerstone of equitable distribution for Chapter 11 creditors for over a century." 717 F.3d at 406. In the Ninth Circuit, a case has been certified for direct appeal on this question so it remains to be seen how the Ninth Circuit uses the *Friedman* decision. *See In re Arnold*, 471 B.R. 578 (Bankr. C.D. Cal. 2012).

A recent bankruptcy court decision in Arkansas went against the recent trend and adopted the broad view. *In re O'Neal*, 490 B.R. 837 (Bankr. Ark. 2013). In that case, Judge Mixon compared some of the BAPCPA amendments to similar requirements in chapter 13 cases.

> The *Friedman* court pointed out that Chapter 13 does not contain an absolute priority rule and pointed to several BAPCPA amendments to individual Chapter 11s which are similar if not identical to Chapter 13. *In re Friedman*, 466 B.R. 471, 483 (B.A.P. 9th Cir. 2012). These provisions include section 1123(a)(8) which adds a requirement to individuals that the plan must provide payments of all or such portion of earnings from personal services or other future income of the debtor, resembling section 1322(a)(1). Section 1129(a)(15) was added which states that the plan must contribute an amount equal to the Debtors' projected disposable income over the longer of five years or the plan payment period upon objection by any unsecured creditor, resembling section 1325(b). Section 1141(d)(5)(A) was added, whereby the discharge is not granted until completion of all payments under the plan, resembling section 1328(a). Section 1141(d)(5)(B) was also added, whereby a discharge is permitted for cause before completion of payments, resembling the hardship discharge located

> in section 1328(b). Finally, section 1127(e) was added that permits modification of a plan after substantial consummation, resembling section 1329(a). *In re Friedman*, 466 B.R. 471, 483 (B.A.P. 9th Cir. 2012).
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> Other support has been found in the fact that section 1115 mirrors section 1306 which was part of the original 1978 code which gave the definition of property of the estate a broader definition in a Chapter 13 than the definition of property of the estate in Chapter 11 and Chapter 7. See *In re Friedman*, 466 B.R. 471 (B.A.P. 9th Cir. 2012); Bruce A. Markell, *The Sub Rosa Subchapter: Individual Debtors in Chapter 11 After BAPCPA*, 2007 U. Ill. L.Rev. 67, 75-76 (2007).

490 B.R. at 850.

Judge Mixon goes on to discuss and criticize the narrow view:

> The weakness of the narrow view is illustrated if one were to ask the question: "If Congress was not attempting to write out of individual Chapter 11 cases the absolute priority rule, what was the purpose of all of the BAPCPA amendments to Chapter 11, including section 1115, which were obviously borrowed from Chapter 13?" [Footnote omitted.] Chapter 13 has no absolute priority rule and would not be of much use if it did. The means test for Chapter 7 debtors created by BAPCO was to move debtors who could pay something to their creditors to reorganization chapters. Here, these Debtors have no recourse to either Chapter 13 or Chapter 12 because of the debt limits imposed by Congress.
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> Section 1129(b)(2)(B)(ii) with respect to individual debtors eliminates the application of the absolute priority rule from property described in section 1115. Section 1115 provides that all property described in Section 541 and property from post petition personal services is included in an individual Chapter 11 estate. Section 1115 is written word for word like section 1306 and courts interpreting section 1306 have never bifurcated this section into two species of property as the narrow view does in individual Chapter 11. To read section 1115 and section 1129(b)(2)(B)(ii) as exempting only future income from the absolute priority rule renders ineffective any practical application of section 1115, especially in light of the additional requirements of section 1129(a)(15)(B). When considered in the context of all the applicable sections, section 1115 accomplishes nothing of substance under the narrow view. As one author paraphrased the explanation of the Ninth Circuit BAP in *Friedman*:
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> > [I]t would be "illogical" to require individual debtors to devote five years of disposable income to their plans, but remove the debtors' means of providing that income, which would be the result if the application of the absolute priority rule were to prevent debtors from retaining valuable prepetition business assets.

> Andrew G. Balbus, *Continued Disagreements Over the Application of the Absolute Priority Rule to Individuals in Chapter 11: Friedman and Maharaj*, 21 Norton Bankr. L. & Prac. 755, 761 (2012).

490 B.R. 850, 851.

In a recent district court case, *In re Brown*, 505 B.R. 638 (D.Ct. 2014), the court held that the absolute priority rule remains viable, affirming the same decision made by the bankruptcy court at the trial level. The court noted:

> Three circuit courts and seventeen bankruptcy Courts have adopted the narrow view. [Footnote omitted.] On the other side of the issue, one bankruptcy appellate panel, one district Court and seven bankruptcy Courts have adopted the broad view.
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> Not only is there no clear and unequivocal expression of Congressional intent to repeal the absolute priority rule from which one could conclude that Congress intended to overturn such a significant pre-existing practice, there is no mention of the absolute priority rule in the legislative history of BAPCPA. Congress is presumed to have been aware of the courts' interpretation of the rule and its significance. [Citations omitted.] That Congress did not express its intent to eliminate the **Absolute Priority Rule** in Section 1129(b)(2)(B)(ii) for **individual** debtors militates against finding that it did so by implication. Thus, given the **Rule's** history and its importance, and Congress's lack of explicit expression of its intent to repeal the **Rule**, we conclude that the BAPCPA amendments do not abrogate the **Absolute Priority Rule** in **individual Chapter 11 cases**.
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> Preservation of **Absolute Priority Rule** is also consistent with Congress's express goal of curbing abuses of the **bankruptcy** system when it enacted BAPCPA. . . . [Emphasis in the original.]

505 B.R. 643-649.

NEW VALUE EXCEPTION IN INDIVIDUAL CHAPTER 11 DEBTOR CASES

One of the exceptions to the absolute priority rule is the exception for "new value," which allows the holders of the debtor's equity to retain an interest in the reorganized debtor even though classes senior to the equity holders have not accepted the plan and are not being paid in full. This issue was presented in *In re Eagan*, 2013 WL 237812 (W.D.N.C. 2013). Although the *Eagan* court

correctly observed that individual debtors have no shares of stock, memberships or the like to offer potential, hypothetical investors, nevertheless the new value exception to the absolute priority rule applies in individual chapter 11 cases where the plan provides for the debtor to retain equity interests in estate property because the debtor's family members were contributing new value. The Court observed: "[a] reasonable middle ground must therefore be found if individual chapter 11 cases are to retain any practical utility." The Court ultimately found that the new value exception applied, and held that the contributions were adequate to cause the plan to be confirmed as within the new value exception of the absolute priority rule.

See also In re Henderson, 341 B.R. 783, 790-91 (M.D. Fla. 2006) (a contribution of $525,000 by spouse (who was not in bankruptcy) to fund the plan justified retention of non-exempt assets having a market value of approximately $410,600 and a liquidation value of $212,500).

Application of the new value exception in individual chapter 11 cases is, as the *Eagan* court noted, more difficult than in a corporate case or a case where tangible stock and membership interests exist that can be offered to investors. Moreover, the Supreme Court's requirements in *Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. Lassalle St. Partnership*, 526 U.S. 434 (U.S. 1999) will also be more difficult to comply with due to the nature of the ownership/equity interests of an individual debtor, especially in a case where the individual debtor is not actively engaged in business pursuits or commercial activities.

USE OF EXEMPT PROPERTY TO AVOID THE ABSOLUTE PRIORITY RULE

One of the interesting questions presented by the BAPCPA amendments in individual chapter 11 cases is whether the debtor's attempted retention of property that is exempt is a violation of the absolute priority rule. As was the case with whether the absolute priority rule exists in individual chapter 11 cases, this issue has also caused a conflict among some of the decisions considering it. The issue was before the Court in *In re Egan*, 142 B.R. 730 (Bankr. E.D. Pa. 1992). In *Egan*, the debtors' plan did not provide for any payments to the unsecured creditors. The debtors had claimed exemptions for property they were retaining. No objections had been timely filed to the claimed exemptions. Most of the unsecured creditors voted against the plan but they did not file separate objections. The Bankruptcy Court observed: "if debtors intend to retain only exempt property, then they are merely retaining that which is their absolute right to retain in any event, and they are not, properly speaking, receiving or retaining 'any interest that is junior to the interests' of any class of creditors, 11 U.S.C. § 1129(b)(2)(B)(ii), including the class of unsecured creditors." 142 B.R. at 733.

The case of *In re Grosman*, 282 B.R. 45 (Bankr. S.D. Fla. 2002) reached a contrary result. There, the debtor's plan proposed limited payments to the unsecured creditors and sought to exempt (and keep) the exempted assets. The Bankruptcy Court denied confirmation (through denial of approval of the disclosure statement because the plan lacked feasibility) and found: "[t]here can be no question that the Debtor in this case is a 'holder of an interest that is junior' to the claims of unsecured creditors...[because] Debtor owns an interest in the Exempt Property." 282 B.R. at 48. The *Grosman* court also ruled that the § 1129(b)(2)(B)(ii) reference to including "any property"

prevents a debtor from retaining exempt or non-exempt property without paying the value of all such property to creditors.

The trial court in the original *Maharaj* case mentioned this issue, 449 B.R. 484, 493 at n.4. (Bankr. E.D. Va. 2011), although it was not critical to the Court's ultimate holding. There, the *Maharaj* trial court indicated that allowing an individual chapter 11 debtor to retain exempt property in a plan under 1129(b) was consistent with the correct reasoning in the *Egan* decision and was also correct in light of 11 U.S.C, § 1123(c).

See also In re Shin, 306 B.R. 397, 404 n. 17 (Bankr. D.C. 2004) (relying on West's Bankruptcy Law Letter (October 2002) "to apply the absolute priority rule to an individual debtor's wholly exempt property stands the absolute priority rule on its head – affording to unsecured creditors an artificial 'priority' in exempt property that unsecured creditors simply do not otherwise possess"); *In re Brotby*, 303 B.R. 177, 195-96 (9th Cir. BAP 2003) (a contribution from an exempt pension would constitute new value). *And see Colliers on Bankruptcy* ¶ 1129.03[4][c].