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BANKRUPTCY LAW

Absolute Uncertainty About the Absolute Priority Rule

Does the rule remain applicable to Chapter 11 cases filed by individuals?

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The passage of the Bankruptcy Abuse Prevention and Consumer Protection Act, Pub. L. No. 109-08, 199 Stat. 23 (2005) (BAPCPA), resulted in significant changes in the bankruptcy landscape, particularly regarding the ability of individuals to obtain bankruptcy relief. Prior to the passage of BAPCPA, virtually all bankruptcy cases filed by individuals were filed under either Chapter 7 of the United States Bankruptcy Code, which provides for a liquidation of nonexempt assets, or Chapter 13, by which a portion of the debt is paid over time under a court-approved plan. BAPCPA enacted the "means test" into law, which essentially precludes individuals with certain levels of income and expenses from obtaining bankruptcy relief under Chapter 7 of the code. This limitation, coupled with the statutory debt ceilings that BAPCPA made applicable to Chapter 13 cases, left some individuals with no ability to obtain bankruptcy relief other than under Chapter 11.

Pre-BAPCPA, Chapter 11 cases filed by individuals were relatively rare and frequently filed by debtors with businesses and/or substantial assets. Since passage of BAPCPA, the number of individuals filing for Chapter 11 has rapidly increased. In 2005, there were 861 nonbusiness Chapter 11 filings nationwide, whereas by 2012 that number had risen to 1,527. These numbers do not include filings by individuals whose business debts "predominate."

The Absolute Priority Rule

The absolute priority rule, codified in section 1129(b) of the Bankruptcy Code, is one of the most fundamental forms of creditor protection. The rule bars any class of junior creditors and equity interest holders from receiving or retaining any bankruptcy estate property or value unless all senior classes have been paid in full. 11 U.S.C. § 1129(b) (2010). The effect of this provision is to provide the nonconsenting class with a virtual veto over a Chapter 11 individual debtor's reorganization plan. Although the code provides that an individual may file for relief under Chapter 11, the provisions of this chapter were largely designed for business bankruptcy cases. As such, there is often difficulty and uncertainty in applying the provisions of Chapter 11, including the absolute priority rule, to the individual debtor.

In 2005, BAPCPA amended section 1129(b) to add an exception to its reach. As amended, section 1129(b) now provides in relevant part:

> (b)(2) [T]he condition that a plan be fair and equitable with respect to a class includes the following requirements:
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> [...]
>
> (B) With respect to a class of unsecured claims –
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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 a case in which the debtor is an individual, the*

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debtor may retain property included in the estate under section 1115, subject to the requirements of subsection (a)(14) of this section.

11 U.S.C. § 1129(b)(2)(B)(ii). (The italicized language was added by BAPCPA.)

Post-BAPCPA Decisions

Since passage of BAPCPA and the attendant proliferation of Chapter 11 filings by individuals, an increasing number of courts have addressed the question of whether the absolute priority rule remains applicable to a Chapter 11 bankruptcy case filed by an individual. Notably, the holdings are inconsistent. A survey of the decisions reflects that a majority of the earliest post-BAPCPA bankruptcy courts addressing this issue held that the absolute priority rule is in fact applicable to the individual Chapter 11 debtor. Some recent circuit court precedent holds otherwise.

Prior to the passage of BAPCPA, it was clear that compliance with the absolute priority rule was necessary for an individual to confirm a nonconsensual Chapter 11 plan. However, BAPCPA's addition of the phrase, "included in the estate under section 1115," and the proper interpretation of that language has produced an ongoing debate. Section 1129(b)(2)(B)(ii) excepts property "included in the estate under section 1115" from the application of the absolute priority rule for the individual debtor. Thus, if a debtor's property is "included in an estate under section 1115," it may be retained by a debtor under a nonconsensual non-100 percent plan.

One view of this exception interprets the language added by BAPCPA narrowly to include only the limited property section 1115 expressly identifies as being added to the estate — postpetition acquired property and earnings from postpetition services. *In re Kamell*, 451 B.R. 505 (Bankr. C.D. Cal. 2011); *In re Maharaj*, 449 B.R. 484 (Bankr. E.D. Va. 2011). The result of this interpretation is that the exception is inapplicable to assets owned by the debtor as of the petition date. The other viewpoint, which has been expressed by a minority of courts, interprets the language broadly so as to include property of the debtor as of the petition date. *In re Shat*, 424 B.R. 854 (Bankr. D. Nev. 2010); *In re Roedemeier*, 374 B.R. 264 (Bankr. D. Neb. 2007). Under this view, the absolute priority rule was effectively abrogated by the passage of BAPCPA, and a debtor may retain all of his/her property under a nonconsensual plan, notwithstanding creditors not being paid in full, provided that the plan meets other confirmation requirements.

Friedman v. P&P, 466 B.R. 471 (B.A.P. 9th Cir. 2012), was the first appellate opinion to address whether the absolute priority rule in an individual Chapter 11 case survived the passage of BAPCPA. In *Friedman*, the senior lienholder of the debtors' part-time residence received stay relief and foreclosed on the property, leaving the junior lienholder's claim unsecured. In their plan, the debtors proposed to pay their unsecured creditors less than 100 percent while retaining all of their interests in various prepetition Internet business ventures from which the debtors yielded a monthly income. The junior lienholder objected to the plan, contending that it violated the absolute priority rule by permitting the debtors to retain assets while unsecured creditors were not being paid in full.

The court, noting the existing split of authority, denied confirmation of the debtors' plan as violative of the rule. On appeal, the Bankruptcy Appellate Panel (BAP) held that the absolute priority rule is no longer applicable in individual Chapter 11 cases. The BAP majority reasoned that the language added to section 1129(b)(2)(B)(ii) by BAPCPA, namely "in a case in which the debtor is an individual, the debtor may retain property included in the estate …" is unambiguous and creates an exception to the absolute priority rule. The BAP, recognizing that its view was in the minority, stretched the meaning of "property" under the statutory provision to include *all* property of the bankruptcy estate, as opposed to only post-bankruptcy earnings and acquisitions. Thus, the court concluded that Congress had eliminated the absolute priority rule for individual Chapter 11 debtors through BAPCPA.

In contrast, the Fourth Circuit agreed with the Virginia Bankruptcy Court that the absolute priority rule survived BAPCPA. *In re Maharaj*, 681 F.3d 558 (4th Cir. 2012). In *Maharaj*, the Fourth Circuit reasoned that BAPCPA did not impliedly repeal the absolute priority rule in an individual debtor's case under Chapter 11 because Congress had made no clear statement of repeal. The court noted that Congress could have repealed the absolute priority rule expressly or in a "far less convoluted manner," but did not choose to do so. In addition, the court commented that nothing in BAPCPA's legislative history suggested that Congress intended to repeal the absolute priority rule.

The Fifth Circuit is set to consider this issue in the case of *In re Lively*, 467 B.R. 884 (Bankr. S.D. Tex. 2012). In *Lively*, a Texas Bankruptcy Court held that the absolute priority rule was only partially abrogated by the BAPCPA amendments. This court deemed the phrase "included in the estate under section 1115" unambiguous, meaning property *added* to the estate by section 1115. See also *In re Stephens*, 445 B.R. 816 (Bankr. S.D. Tex. 2011) (concluding that the absolute priority rule was partially abrogated by BAPCPA so as to permit individual Chapter 11 debtors to retain only postpetition assets brought into the estate by section 1115 and not any prepetition property).

Unfortunately, although Bankruptcy Courts in the Third Circuit have recognized the ongoing debate, they have yet to address this issue. *In re Stigliano*, No. 11-10012, 2012 WL 5866187 *3 (Bankr. W.D. Pa. Nov. 19, 2012)(stating "there is currently a lively dispute among the courts as to whether this rule applies in individual Chapter 11 cases post BAPCPA."). Thus, uncertainty continues.

Conclusion

In light of the current uncertainty as to the applicability of the absolute priority rule to Chapter 11 filings by individuals, attorneys must consider the possibility that a single creditor class (or a single creditor controlling a class) may have a veto right with respect to any plan of reorganization proposed by the debtor. Case law will, of course, continue to develop with respect to this issue. Practitioners must therefore remain up to date with respect to decisional law on this subject, as it may have a profound impact on the ability of an individual to emerge from bankruptcy with some assets intact. ■