BAPCPA's Impact On Application Of The Absolute Priority Rule In Individual Chapter 11 Cases

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Introduction and Summary

A common misconception about bankruptcy is that reorganization under Chapter 11 is available only to corporations or other business entities. This is not the case: individuals have sought protection under Chapter 11 since the Bankruptcy Code's enactment, and prior to that, under the predecessor Bankruptcy Act. Common reasons why individuals file under Chapter 11, rather than Chapter 7 or Chapter 13, include ineligibility for Chapter 13 (*i.e.*, debt in excess of the statutory limits), ineligibility for Chapter 7, or ownership of too many non-exempt assets to protect in a Chapter 7. Individuals forced into Chapter 11 by these and other circumstances include not only so-called "super Chapter 13" debtors but small business owners and small real estate holders who may, for example, own a lot adjoining their residence, second home, or investment property. The ability of individuals such as these to fund a plan often depends on their ability to retain these non-exempt assets and then operate, develop, market, or sell them over the term of a plan. Chapter 11 offers these individuals a way out of a quagmire of financial stress, default, and possible forced liquidation; however, a successful exit from Chapter 11 almost always requires confirmation of a plan.

Recent case law has brought into focus a critical question arising in the planning and prosecution of individual Chapter 11 cases: what property can the debtor retain if unsecured creditors do not consent to proposed plan treatment of their debts? The answer depends upon whether Congress abrogated the Absolute Priority Rule[1] when it enacted the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005[2] ("BAPCPA") or instead modified it to diminish what property debtors can retain. This article examines that question, reports on the progress of appellate review of a case before the Ninth Circuit Bankruptcy Appellate Panel and another on direct appeal to the Fourth Circuit, discusses the likely outcomes of these cases, and identifies questions that remain if one view is adopted over the other.

BAPCPA expanded the definition of property of the estate for individuals in Chapter 11 to make it nearly identical to the definition in Chapter 13 and, arguably, created a new exception to the Absolute Priority Rule. A split of case authority on the meaning and intent of these changes followed. The first five reported bankruptcy court decisions,[3] published from 2007 to 2010, uniformly adopted what has been called the "broad" view of the aforementioned exception to include not only post-petition earnings and post-petition acquired property, but also all of the debtor's pre-petition assets. The next twelve reported cases[4] date from 2010 forward, and all employed a "narrow" view of the same language to hold that only the debtor's post-petition earnings and post-petition acquired property are excepted from the Absolute Priority Rule. Under this narrow view, no debtor can retain non-exempt pre-petition property without either full payment to the holders of allowed unsecured claims or a lesser treatment to which the unsecured creditors consent. The three most recent cases on the issue are a U.S. district court opinion from Florida, upholding a bankruptcy court ruling that adopted the broad view in confirming a plan, and two subsequent bankruptcy court decisions following the narrow view.[5]

All of the reported cases but one are trial level decisions. There is no binding authority in any circuit to guide debtors and creditors as to whether individual Chapter 11 debtors can propose plans under which they might retain non-exempt pre-petition property and the circumstances under which such a plan might be confirmed. The reviewing courts will need to apply their interpretations of

BAPCPA's amendments in this area carefully to avoid narrowing the shrinking window within which individual debtors can reorganize in Chapter 11.

Cramdown and the Absolute Priority Rule

A plan of reorganization can be confirmed if it meets the requirements set forth in Bankruptcy Code section 1129(a), including acceptance by all classes of claims specified in section 1129(a)(8). A plan can also be confirmed over the objection of a class of claims that does not vote to accept it if the plan meets the requirements set forth in Bankruptcy Code section 1129(a), other than section 1129(a)(8), and the debtor proves it to be "fair and equitable" by meeting the requirements of section 1129(b). Confirmation of a plan in this manner without acceptance by all impaired classes is commonly referred to as a "cramdown."[6] Bankruptcy Code section 1129(b)(2)(B)(ii), which must be met to confirm a plan through a cramdown, is called the "Absolute Priority Rule."

From the enactment of the Bankruptcy Code in 1978 until the passage of BAPCPA in 2005, there was little dispute that the Absolute Priority Rule in a cramdown generally[7] precluded a debtor from retaining pre-petition assets under a plan[8] unless it also provided for full payment of unsecured claims.

BAPCPA's Relevant Statutory Changes

In enacting BAPCPA, Congress expanded the definition of property of the estate in Chapter 11 by adding section 1115,[9] and it simultaneously excepted from the Absolute Priority Rule the "property *included* in the estate under section 1115" (emphasis added).[10] Section 1115 references both " . . . the property specified in section 541 . . ." and ". . . all property of the kind specified in section 541 that the debtor acquires after the commencement of the case . . ."

Statutory Ambiguity and the Absence of Legislative History

Only a few cases have found section 1115 to be clear and unambiguous, and these have come to opposite conclusions. Bankruptcy Judge Thomas Saladino found the words "property included in the estate under section 1115" from section 1129(b)(2)(B)(ii) to mean, without ambiguity, that section 1115 "clearly" includes the property described in section 541.[11] Bankruptcy Judge Peter Bowie conversely found that under a "plain, unambiguous reading of the statute," only property acquired post-petition is included in the estate under section 1115.[12]

Nearly all other cases addressing the issue have found or assumed ambiguity. The trend itself has even been used to support a determination of ambiguity: ". . . it is axiomatic that the language of section 1129(b)(2)(B)(ii) and section 1115 is ambiguous, otherwise there would be no split of authority and the arguments in favor of each position so diverse."[13]

When the words of a statute can be interpreted in more than one way, courts can use interpretive tools such as legislative history to ascertain the intent of Congress.[14] Unfortunately, there is virtually no legislative history to document the purpose and intent of sections 1115 and 1129(b)(2)(B)(ii). In *In re Shat*, building upon his earlier scholarly analysis of BAPCPA,[15] Bankruptcy Judge Bruce Markell traced in great detail the origins of these sections through the eight years of fitful efforts to modify the Bankruptcy Code prior to BAPCPA's passage. His conclusion that ". . . silence was a hallmark of all successive versions of the bill . . ."[16] is unchallenged. Cases espousing both the broad and narrow views find that BAPCPA's "legislative history is . . . scarce, equivocal and altogether unhelpful"[17] and is "entirely silent as to whether the drafters of the amendment to section 1129(b)(2)(B)(ii) intended to wholly except individual Chapter 11 debtors from the absolute priority rule."[18]

Comparative Evidence of Intent

Without the benefit of a legislative record to rely upon in interpreting the Absolute Priority Rule, courts have been forced to examine policy related to the passage of BAPCPA generally and its amendments to other sections of the Bankruptcy Code. The broad view finds the intent of Congress in two places: 1) "the general rehabilitative aim of chapter 11 . . ."[19] and 2) BAPCPA's addition of six Chapter 13 analogues to Chapter 11,[20] which allegedly created "a sort of hybrid chapter 13, in which many of the provisions of chapter 13 sit uneasily in chapter 11."[21]

Cases subscribing to the narrow view, perhaps somewhat simplistically, respond to the notion that Congress intended to make Chapter 11 more like Chapter 13 with the argument that, "[i]f that were Congress' intent, Congress would simply have amended the statutory debt ceilings for Chapter 13 cases set out in 11 U.S.C. [section] 109(e), and either eliminated them altogether or set them much higher."[22] Following the same question with a plausible surmise, another court asked "[w]hy couldn't the debt limitations of [section] 109(e) have been simply raised had Congress intended to make all larger individual reorganization cases alike? Clearly, Congress instead intended that the separate requirements of disclosure, voting, determination by percentages of 'consenting' impaired classes and other protections unique to Chapter 11 continue to have some application in larger individual reorganization cases."[23]

The narrow view posits, therefore, that the six provisions on which the broad view relies (listed in footnote 20 herein) are

evidence of an intent by Congress " . . . to impose greater burdens on individual chapter 11 debtor's rights so as to ensure a greater payout to creditors.[24]" In an attempt to summarize the overall purpose of BAPCPA, relying on the House Report, Judge Leslie Tchaikovsky judge opined that "[n]o one who reads BAPCPA as a whole can reasonably conclude that it was designed to enhance the individual debtor's 'fresh start.'"[25] Relying upon the four stated purposes for BAPCPA,[26] another court built on that conclusion with the following analysis: "[i]t is not reasonable to think that Congress would amend section 1129(b)(2)(B)(ii) to abrogate the absolute priority rule in its entirety as to individual Chapter 11 debtors while at the same time attempting to shift the majority of filings from liquidation to reorganization and requiring individual debtors to repay more of their debts. On the other hand, bringing post-petition wages and property acquired by debtors post-petition into their estates better serves those purposes by offering trustees and debtors-in-possession additional assets with which to reorganize."[27]

Applied Interpretation of Statutory Language

Under the broad view, the phrase "in addition to the property specified in section 541" is held to "mean that Section 1115 absorbs and then supersedes Section 541 for individual chapter 11 cases."[28] Under the narrow view, section 1129(b)(2)(B)(ii) is read as referring only to the additional property brought into the estate by section 1115, not property that would already be property of the estate under section 541.[29]

Moving to rules of statutory interpretation, some narrow view decisions rely on Bankruptcy Code section 103(a) which "provides that section 541 applies in a chapter 11 case, including an individual chapter 11 case. Section 541 provides that when a petition is filed, a bankruptcy estate is created, consisting of the debtor's pre-petition property. Section 1115 provides that in an individual chapter 11 case, in addition to the property specified in section 541, the estate includes the debtor's post-petition property."[30] Another court reasoned that "[b]ecause BAPCPA changed neither of these sections, there is no reason for section 1115 to 'absorb' and 'supersede' section 541 to define property of the estate for individual Chapter 11 cases, as suggested by the *Shat* court. To add property to the estate, however, Congress need only add a provision stating that post-petition acquired property is *also* included in the estate when the debtor is an individual. In light of pre-BAPCPA operation of section 541, this is most likely what the drafters meant by the phrase 'in addition to property specified in section 541' in section 1115."[31]

The unfortunate fact is sections 541 and 1115 seem not to integrate seamlessly. It is unclear, for example, whether section 541 was imported into section 1115 with all of its enumerated exceptions. If so, how do the limitations in section 541 on after-acquired property (such as property acquired within 180 days by bequest, devise, or inheritance under 541(a)(5)) apply in section 1115 when the latter instructs that property of the estate includes items "in addition to the property specified in section 541…"?

Cases Under Appellate Review

In re Friedman is on appeal to the Bankruptcy Appellate Panel of the Ninth Circuit,[32] and *In re Maharaj* was certified for appeal directly to the Fourth Circuit. In both cases, the appellant is a debtor challenging a bankruptcy court's adoption of the narrow view. *Amicus* briefs have been filed in both cases, and *In re Friedman* is set for oral argument in February 2012.

There is a substantial likelihood that the emerging majority following the narrow view will be affirmed. The weight of fourteen opinions advocating the narrow view, coupled with the development of more and more cogent reasoning, will likely give reviewing courts sufficient cause to provide an interpretation consistent with what Congress likely intended but utterly failed to write into BAPCPA.

Compelling reasons nevertheless exist for appellate courts to adopt the broad view. While "the absolute priority rule has long been a feature of American bankruptcy law,"[33] it is not "sacrosanct."[34] An unsecured creditor that objects to confirmation and votes to reject the debtor's plan is still protected by the plan confirmation process in at least five ways: first, the "best interests of creditors" of section 1129(a)(7) still requires that, in the event of a vote to reject by even a single unsecured claimant, the debtor prove that the plan distribution will equal at least that in a Chapter 7 liquidation. Second, newly added section 1123(a)(8) requires the individual debtor to commit his or her post-petition income to plan payments. Third, newly added section 1129(a)(15) sets a disposable income test requiring an individual debtor paying less than 100% to unsecured creditors to commit at least five years of net disposable income to the plan. Fourth, secured creditors whose claims are being stripped down to the value of their collateral retain the right to have the claim treated as fully secured under section 1111(b). Fifth, in any cramdown the bankruptcy court must still find that the plan does not "discriminate unfairly" and is "fair and equitable" taking into account all requirements for confirmation. This is because the bankruptcy court has an independent duty to ensure that all the confirmation requirements have been satisfied.[35]

Adoption of the broad view would not mean the disenfranchisement of unsecured creditors who, by dollar amount or number of votes, would otherwise control acceptance or rejection of the plan by their class. Instead, it would mean that such creditors would not hold unchecked veto power over any plan in which the individual debtor retains for purposes of the plan anything more than exempt pre-petition property.

The Relationship of Sections 1306 and 1115

No case has yet addressed the implications of the nearly identical language of sections 1115 and 1306. Such an analysis should be critical to a discussion of what property of the estate is excepted from the Absolute Priority Rule. A survey of case law referencing sections 541 and 1306 discloses no uncertainty as to the interaction between the two or as to the fully inclusive character of section 1306:

> Sections 541 and 1306 of the Bankruptcy Code broadly incorporate all of Debtor's pre-petition and post-petition property into Debtor's estate. Upon the filing in bankruptcy, an estate comprised of all legal and equitable interests of a debtor is created. 11 U.S.C. § 541(a). . . .
>
> The Chapter 13 estate . . . includes all property specified in § 541, and also all property that a debtor acquires after the commencement of the case but before the case is closed, dismissed, or converted. 11 U.S.C. § 1306(a)(1) . . . .[36]

Section 1306 unambiguously includes all of a Chapter 13 debtor's pre- and post-petition property, effectively absorbing section 541 in any Chapter 13 case. Section 1115 contains the same operative language. Any conclusion that the same language can lead to different results under different chapters of title 11 should be difficult to sustain. If section 1306 includes all property specified in section 541 and all property that a debtor acquires after the commencement of the case, how can the exception for "property included in the estate under section 1115" limit an individual Chapter 11 debtor's ability to retain pre-petition property in a cramdown? This appears to be a compelling argument for application of the plain meaning rule[37] and would end the guessing game about Congressional intent that has so far characterized cases adopting both the broad and narrow views.

Final Questions and Conclusion

The passage of bankruptcy reform was a long and difficult task for Congress. Divisions and delays over the eight years preceding BAPCPA's enactment led to an internally inconsistent law devoid of useful legislative history to guide courts as to the intent of Congress. Both the narrow and broad views strain to harmonize BAPCPA's provisions and rely more on supposition than evidence of actual intent. Neither view fully explains all potential questions.

Should the narrow view be adopted by the majority of appellate courts, it is uncertain whether debtors will be able to retain even their exempt property without violating the Absolute Priority Rule. New value plans may well be the only method of retaining pre-petition property even though such plans are not possible in most individual cases.

Congress has an obligation to revisit the Absolute Priority Rule as it applies to individuals and express its intent in an unambiguous amendment supported by clear legislative history. Until it does so, reviewing courts should consider which view most fairly treats the competing interests of debtors and creditors without unduly burdening the limited prospects for reorganization of individual Chapter 11 debtors, and they should not ignore the nearly identical wording of sections 1306 and 1115. ■

Endnotes

1 Defined in the Cramdown and the Absolute Priority Rule Section, *infra.*

2 Pub. L. No. 109-8, 119 Stat. 23 (April 28, 2005).

3 *In re Bullard*, 358 B.R. 541 (Bankr. D. Conn. 2007); *In re Tegeder*, 369 B.R. 477 (Bankr. D. Nev. 2007); *In re Roedemeier*, 374 B.R. 264 (Bankr. D. Kan. 2007); *In re Shat*, 424 B.R. 854 (Bankr. D. Nev. 2010); *In re Johnson*, 402 B.R. 851 (Bankr. N.D. Ind. 2009).

4 *In re Gbadebo*, 431 B.R. 222 (Bankr. N.D. Cal. 2010); *In re Steedley*, 2010 WL 3528599 (Bankr. S.D. Ga. 2010); *In re Mullins*, 435 B.R. 352 (Bankr. W.D. Va. 2010); *In re Gelin*, 437 B.R. 435 (Bankr. M.D. Fla. 2010); *In re Stephens*, 445 B.R. 816 (Bankr. S.D. Tex. 2011); *In re Karlovich*, 456 B.R. 677 (Bankr. S.D. Cal. 2010); *In re Walsh*, 447 B.R. 45 (Bankr. D. Mass. 2011); *In re Maharaj*, 449 B.R. 484 (Bankr. E.D. Va. 2011); *In re Draiman*, 450 B.R. 777 (Bankr. N.D. Ill. 2011); *In re Kamell*, 451 B.R. 505 (Bankr. C.D. Cal. 2011); *In re Friedman*, __ B.R.__ , 2011 WL 871748 (Bankr. D. Ariz. 2011); *In re Lindsey*, 453 B.R. 886 (Bankr. E.D. Tenn. 2011).

5 *SPCP Group, LLC v. Biggins*, 2011 WL 4389841 (M.D. Fla. 2011); *In re Tucker*, 2011 WL 5926757 (Bankr D. Or. 2011); *In re Borton*, 2011 WL 5439285 (Bankr. D. Idaho 2011).

6 As used in this article, the term "cramdown" refers only to confirmation of a plan without the consent of one or more classes of *unsecured* claims.

7 The "new value corollary" to the Absolute Priority Rule allows a debtor to retain property that would otherwise have to be used to satisfy creditor claims. The doctrine remains valid in the Seventh and Ninth Circuits. *See Bank of America v. 203 N. LaSalle St. P'ship*, 126 F.3d 955 (7th Cir. 1997); *Bonner Mall P'ship v. U.S. Bancorp Mortg. Co. (In re Bonner Mall P'ship)*, 2 F.3d 899 (9th Cir. 1993) (omitting subsequent history). The new value corollary or exception to the Absolute Priority Rule permits equity holders or, in an individual case, the debtor, to provide money or money's worth sufficient based on a market test, to allow the debtor to retain the non-exempt pre-petition property.

8 Some authority has held that even exempt pre-petition property cannot be retained. *In re Yasparro*, 100 B.R. 91 (Bankr. M.D. Fla. 1989); *In re Gosman*, 282 B.R. 45 (Bankr. S.D. Fla. 2002). A contrary view is expressed in *In re Henderson*, 321 B.R. 550 (Bankr. M.D. Fla. 2005), *aff'd* 341 B.R. 783 (M.D. Fla. 2006).

9 "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 . . . ; and (2) earnings from services performed by the debtor after the commencement of the case but before the case is closed, dismissed, or converted . . . "

10 "Fair and equitable" includes: (B) With respect to a class of unsecured claims (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 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. section 1129(b)(ii)(B)(ii) (emphasis added to show amendment).

11 *See In re Tegeder*, 369 B.R. at 480.

12 *Id.*; *see also In re Karlovich*, 456 B.R. at 681.

13 *In re Lindsey*, 453 B.R. at 903.

14 *Blum v. Stenson*, 465 U.S. 886, 896 (1984); *In re Lindsey*, 453 B.R. at 893.

15 In his 1996 article, *The Sub Rosa Subchapter: Individual Debtors In Chapter 11 After BAPCPA*, 1 U. ILL. L. REV. (2007), Judge Markell first examined in great detail the structure of BAPCPA, and the operation of amended Bankruptcy Code sections 1115, 1123(a)(8), 1129(a)(15), 1141(d)(5) and 1127(e), compared them to their Chapter 13 counterparts, and remarked upon the difficulties resulting from the murky Congressional intent behind these changes.

16 *In re Shat*, 424 B.R. at 860.

17 *In re Kamell*, 451 B.R. at 509.

18 *In re Gelin*, 437 B.R. at 401.

19 *In re Shat*, 424 B.R. at 865.

20 "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 the completion of all plan payments as in section 1328(a); permitting a 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)." *Id.* at 862.

21 *Id.*

22 *In re Karlovich*, 456 B.R. at 682.

23 *In re Kamell*, 451 B.R at 510.

24 *In re Gbadebo*, 431 B.R. at 229; *In re Lindsey*, 453 B.R at 897.

25 *In re Gbadebo*, 431 B.R. at 229.

26 (1) The rising number of consumer filings; (2) significant losses by creditors associated with bankruptcy filings; (3) loopholes and incentives that allow and encourage opportunistic personal filings and abuse; and (4) the fact that some bankruptcy debtors are able to repay a significant portion of their debts, but current law has no clear mandate to compel repayment.

27 *In re Lindsey*, 453 B.R. at 905.

28 *In re Shat*, 424 B.R. at 865.

29 *In re Maharaj*, 449 B.R. at 492.

30 *In re Gbadebo*, 431 B.R at 229.

31 *In re Gelin*, 437 B.R. at 442.

32 Included as an issue on appeal in *In re Friedman* is the following: "If the 'absolute priority rule' applies in a case for individual Debtors, can Debtors avoid a strict application of the rule by contributing 'new value' into a plan in the form of exempt assets?"

33 *Bank of New York Trust Co., NA v. Official Unsecured Creditors' Comm.*, 584 F.3d 229, 244 (5th Cir. 2009).

34 *In re Shat*, 424 B.R. at 867. Indeed, neither Chapter 13 nor Chapter 12 has a "fair and equitable requirement" for confirmation. *See* sections 1325(b)(1) and 1225(b)(1).

35 *In re Gbadebo*, 431 B.R. at 227, n. 5.

36 *In re Curry*, 362 B.R. 394, 398-399 (Bankr. N.D. Ill. 2007).

37 *In re Ron Pair Enterprises, Inc.*, 489 U.S. 235, 241 (1989) ("[t]he plain meaning of legislation should be conclusive, except in the 'rare cases [in which] the literal application of a statute will produce a result demonstrably at odds with the intentions of its drafters.'" [citation omitted]).