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Commercial Judges Panel 2012

25TH Annual Seminar of the Alabama State Bar Bankruptcy and Commercial Law Section
June 8 - 9, 2012

BANKRUPTCY AT THE BEACH
COMMERCIAL PANEL
Individual Debtor Chapter 11 Cases and the Absolute Priority Rule
June, 2012

Confirmation of a plan in an individual Chapter 11 case has always been problematic. It is not unusual for a debtor's individual assets, including his home, automobiles and bank accounts, to be entangled with business assets, including real estate and equipment. It is also not unusual for one or more classes of creditors to be dominated by one creditor. When a class is dominated by one creditor, such creditor can dictate the nature of the debtor's plan if the debtor seeks consensual confirmation pursuant to 11 U.S.C. § 1129(a). If the debtor fails to achieve consensual confirmation, the debtor must then comply with the absolute priority rule contained in 11 U.S.C. § 1129(b)(2)(B)(ii). The absolute priority rule "provides that a dissenting class of unsecured creditors must be provided for in full before any junior class can receive or retain any property [under a reorganization] plan." Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 202, 108 S. Ct. 963, 966 (1988) (citations omitted).

The absolute priority rule causes problems in individual Chapter 11 cases because it makes it extremely difficult for the debtor to maintain control of his business, as demonstrated by the ruling in Norwest Bank Worthington v. Ahlers, 485 U.S. 197 (1988). In this case, the Supreme Court of the United States held that a nonconsensual plan in which the family farmer proposed to retain his land, the value of which was exceeded by the amount of the mortgage, could not be confirmed: the debtor's retention of the land was sufficient to qualify as retaining an interest in property under 11 U.S.C. § 1129(b)(2)(B)(ii) and therefore violated the absolute priority rule. The debtor's intention to contribute what is now referred to as "sweat equity" by

his future labor was not sufficient to qualify as an exception to the absolute priority rule, i.e. did not qualify as new value.

The Ahlers decision concerning the application of the absolute priority rule made it difficult for a debtor to retain his business. Because an individual debtor's bankruptcy case usually includes his individual assets as well as his business assets, it can be difficult for the debtor to retain his individual assets and comply with the absolute priority rule. This is particularly true because there is a split of authority over whether the debtor may retain exempt assets and still comply with the absolute priority rule if junior creditors are not paid in full. Compare In re Gosman, 282 B.R. 45 (Bankr. S.D. Fla. 2002) (finding that retention of exempt property is a retention of an interest in property which violates the absolute priority rule) with Van Buren Indus. Investors v. Henderson (In re Henderson), 341 B.R. 783 (M.D. Fla. 2006) (affirming a bankruptcy court's ruling that the debtor can retain exempt property in the absence of any objection to the claimed exemption and that such retention does not violate the absolute priority rule) and In re Bullard, 358 B.R. 541 (Bankr. D. Conn. 2007) ("The better line of authority holds that the debtor's retention of his exempt property does not offend Section 1129(b)(2)(B)(ii) because such retention is not 'on account of . . . [the debtor's] junior interest . . . ' in property."). In addition, because the contribution of sweat equity or future labor does not constitute a new value, the individual debtor has few options when trying to propose new value. In the courts allowing debtors to retain exempt assets, such exempt assets could be a potential source of new value.

All of this is, of course, assuming the new value exception to the absolute priority rule still exists after the codification of the Bankruptcy Code in 1978. Whether the new value

exception exists is still unclear after the Supreme Court of the United States handed down the decision in Bank of America Nat'l Trust and Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 119 S.Ct. 1411 (1999), wherein the Supreme Court of the United States held that, assuming a new value exception to the absolute priority rule, any proposed retention of property by the contribution of new value must be exposed to competition and market valuation.

Against this backdrop, Congress amended § 1129(b) as it relates to confirmation in an individual Chapter 11 case. 11 U.S.C. § 1129(b)(2)(B)(ii), which contains the absolute priority rule, now provides:

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.*

Section 1115 was also added by the 2005 amendments and provides 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.

11 U.S.C. § 1115.

What do these amendments mean for the continued application of the absolute priority rule in an individual Chapter 11 case? Two interpretations of these amendments have formed in the case law: a narrow interpretation and a broad interpretation. The cases interpreting the amendments narrowly assert that the amendments allow a debtor to retain only post-petition

property over the objection of creditors, “[choosing] to read § 1129(b)(2)(B)(ii) as referring only to the additional property brought into the estate by § 1115, not property that would already be property of the estate under § 541.” In re Maharaj, 449 B.R. 484, 492 (Bankr. E.D. Va. 2011) (adopting the narrow construction and concluding that “the absolute priority rule continues to exist in individual chapter 11 cases with respect to non-exempt property that was owned by the debtor on the filing date of the petition”). See also, In re Gbadebo, 431 B.R. 222 (Bankr. N.D. Cal. 2010) (finding that the phrase “included in the estate under section 1115,” which was added to § 1129(b)(2)(B)(ii) by BACPA, referred only to post-petition property); In re Lindsey, 453 B.R. 886 (Bankr. E.D. Tenn. 2011) (adopting the narrow interpretation). The cases interpreting the amendments broadly assert that the amendments allow a debtor to retain both pre- and post-petition property over the objection of creditors, thus eliminating the absolute priority rule in individual Chapter 11 cases. See, e.g., Friedman v. P+P, LLC (In re Friedman), 466 B.R. 471, 482 (9th Cir. BAP 2012) (“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 debtor cases.”); In re Shat, 424 B.R. 854 (Bankr. D. Nev. 2010) (adopting the broad interpretation).