

BANKRUPTCY**SIXTH CIRCUIT JOINS APPELLATE COURTS HOLDING THAT THE ABSOLUTE PRIORITY RULE APPLIES IN INDIVIDUAL CHAPTER 11 CASES***by Daniel F. Gosch*

A little over a year ago, I authored an article addressing the question of whether the “Absolute Priority Rule” applied to Chapter 11 bankruptcy cases filed by an individual. That article, which focused on the decision of the Fourth Circuit Court of Appeals in *In re Maharaj* 681 F.3d 558 (4th Cir. 2012), noted that the trend appeared to be towards the conclusion that the Absolute Priority Rule did apply in such cases—but that in Michigan, the issue had not yet been addressed by the Sixth Circuit Court of Appeals. That has now changed.

Some quick review: The “Absolute Priority Rule” mandates that in a chapter 11 bankruptcy case no junior class of claims or interests can receive or retain anything under the plan of reorganization, unless senior classes of claims or interests are either paid in full or consent to the treatment that pays them less than in full (i.e., by voting yes on a plan of this type). Prior to 2005, for an individual chapter 11 debtor this rule meant that the debtor could not retain pre-petition property (owned when the case was filed) unless unsecured creditors were paid in full—instead that pre-petition property would have to be contributed in some fashion to fund the plan. Effectively then, the Absolute Priority Rule provided unsecured creditors with a “blocking vote” in an individual chapter 11 case, as creditors could demand that the debtor either pay the unsecured creditors in full, or give up all of his or her pre-petition property to fund the plan. This created real problems for individual chapter 11 debtors who might want to fund a plan by running a post-petition business that would use the pre-petition property.

However, amendments to Section 1129 of the Bankruptcy Code in 2005 called into question whether the Absolute Priority Rule continued to apply in individual chapter 11 cases, by allowing an individual chapter 11 debtor to retain some property even though creditors weren’t paid in full. The question was what property could be retained? Depending on how the new language of the Code added at that time was interpreted, a debtor could either retain all of his property (including pre-petition property) or just the additional property that became property of the debtor’s estate after the commencement of the bankruptcy case (typically a much more limited amount). If the correct interpretation of the changed language was the former, the effect would be that the Absolute Priority Rule was effectively gone as it related to individual chapter 11 debtors. Alternatively, if the correct view was the latter of these two, and only the more limited amount of post-petition property could be retained, then the Absolute Priority Rule would continue to apply. Cases initially split over which of these

two interpretations was correct. However, as the Circuit Courts of Appeal started to weigh in on the issue, a clear trend emerged finding that the Absolute Priority Rule continued to apply. The Sixth Circuit Court of Appeals, in *Ice House America, LLC v. Cardin* Slip Opinion 13-5764 (6th Cir. May 13, 2014) has now joined the majority view on this subject.

Cardin presented a somewhat typical individual chapter 11 debtor scenario. The debtor had purchased ice cube making machines from Ice House America, and operated them at various locations as his business. The relationship between the parties soured, and ultimately Ice House obtained two judgments against Cardin. Cardin was ineligible for relief under chapter 13 of the Code, because his debts exceeded the chapter 13 debt limitations, so he filed an individual chapter 11 case instead to try to address the judgments and other debts. Although Cardin had more than \$200,000 of combined equity in several assets at the time he filed his bankruptcy case, his chapter 11 plan provided only that he would make a single payment of \$124,000 to satisfy the claim of Ice House (which was owed more than \$1.5 million). Because this allowed Cardin to retain his pre-petition property while failing to pay unsecured creditors like Ice House in full, the parties in the case stipulated that the debtor’s plan did not satisfy the Absolute Priority Rule. At the confirmation hearing, the debtor argued that it didn’t matter, because the Absolute Priority Rule had been abrogated by the 2005 amendments to the Bankruptcy Code. The Bankruptcy Court, siding with the minority view on this topic, agreed and confirmed the plan. Ice House appealed and the District Court certified the question for appeal directly to the Sixth Circuit.

The Sixth Circuit had little difficulty in reversing the decision of the Bankruptcy Court. Finding the construction of the Bankruptcy Code urged by the debtor to be a “Rube-Goldberg reading at best”, the Court conducted its own grammatical parsing of the language of Section 1129 (b)(2)(B)(ii) of the Bankruptcy Code and concluded that the effect of the 2005 amendments was to protect from the effect of the Absolute Priority Rule only the additional property that became property of the debtor’s estate after the commencement of the bankruptcy case. It supported its conclusion by noting that it had decided a case involving “parallel language in Chapter 13” the same way, and by reference to the importance of the Absolute Priority Rule in historical bankruptcy practice (from which it was disinclined to depart, absent a “clear indication” of congressional intent). In this regard, like other courts before it, the Court found that if Congress had intended to completely abrogate the Absolute Priority Rule, it could have done so through much simpler language. And, while conceding that the effect of the ruling was to create a “double whammy” for an individual debtor (who, unlike an individual Chapter 13 debtor, must both contribute five years of disposable post-petition income to the plan and comply with the Absolute Priority Rule), the Court found it was not theirs to say whether the law was “fair”, only that it was their job to interpret the law, as enacted.



Thus the Court joined the 4th Circuit in *Maharaj*, as well as the 10th Circuit in *In re Stephens* (704 F. 3d 1279 (10th Cir. 2013), and the 5th Circuit in *In re Lively* 717 F. 3d 406 (5th Cir. 2013), in finding that the Absolute Priority Rule continues to apply in individual Chapter 11 cases. Barring some future attention to this issue by either the United States Supreme Court (which seems a bit unlikely given the consistency emerging in the Circuits), or further congressional action, the *Cardin* decision should put to an end any uncertainty on this topic here in the Sixth Circuit (which covers Michigan, Ohio, Kentucky, and Tennessee).

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