

BURR ALERT

Split Continues Over the Interpretation of the Absolute Priority Rule as Applied to Individual Chapter 11 Debtors

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The Bankruptcy Abuse Prevention and Consumer Protection Act ("BAPCPA")¹ was enacted almost ten years ago, but the effect of these bankruptcy amendments is still being decided, particularly in the realm of individual Chapter 11 bankruptcy cases. Financially distressed, higher net worth individuals who are precluded from filing bankruptcy under Chapter 13 (as they may have debt in excess of the statutory limits for Chapter 13 debtors)² are having to seek protection under Chapter 11 of the Bankruptcy Code.³ While Chapter 11 is typically associated with big business bankruptcies, a reorganization under this Chapter is equally available to (and may be the only realistic choice for), a debtor with a more complex portfolio.

As the increased number of individual Chapter 11 cases work their way through the court system, the impact of BAPCPA, enacted to ensure that "debtors . . . repay creditors the maximum they can afford,"⁴ is playing out. Currently, a significant split of authority exists regarding the effect of the BAPCPA amendments on the absolute priority rule in individual Chapter 11 cases. The issue underlying this split is whether the BAPCPA amendments essentially did away with this rule as it applies to individual Chapter 11 debtors, and allows individual debtors to retain certain property interests through the reorganization process over the objection of impaired creditors.⁵

In interpreting the relevant post-BAPCPA statutory provisions, courts have developed two completely different approaches to answering this question. To date, the 11th Circuit has not had the opportunity to issue an opinion on this matter, but a recent opinion issued by the Bankruptcy Court for the Middle District of Florida (Tampa Division) has adopted a narrow reading of relevant statutes, indicating that the absolute priority rule is alive and well in Chapter 11 bankruptcies in the Eleventh Circuit.

To fully understand the effects of BAPCPA on the absolute priority rule in individual Chapter 11 cases, a brief restatement of the absolute priority rule may be helpful. When a debtor (either a business or an individual) proposes to reorganize under Chapter 11, it has to advance a plan that is confirmable, or that meets the many requirements set forth in Bankruptcy Code section 1129. One element of confirmation is complying with the absolute priority rule, which generally provides

¹ Pub.L. No. 109-8, 199 Stat. 23 (2005).

² 11 U.S.C. § 109(e). In order to file under Chapter 13, an individual with regular income cannot have more than \$1,149,525 in secured debt and \$383,175 in unsecured debt.

³ 11 U.S.C. § 101 *et seq.*

⁴ *Ransom v. FIA Card Servs., N.A.*, 131 S. Ct. 716, 721 (2011)

⁵ *In re Martin*, 8:13-BK-00624-MGW, 2013 WL 5229816 (Bankr. M.D. Fla. Sept. 17, 2013).

that a debtor cannot pay creditors of lower priority more than those of higher priority. This rule most often applies to prevent equity owners of a debtor (who have the lowest priority in, or claim to, the assets of the bankruptcy estate) from retaining (or paying themselves from) estate assets.⁶ However, since BAPCPA, the question faced by some courts is whether this rule applies to individual Chapter 11 debtors at all. Without this rule, individual Chapter 11 debtors may be able to retain certain assets in derogation of the intent of the Bankruptcy Code.⁷

The source of the disagreement among courts on this issue is BAPCPA's amendment to the text of the absolute priority rule itself, which now exempts certain post-petition property of an individual Chapter 11 debtor's estate from the rule's application.⁸ The exempt property is described in Bankruptcy Code section 1115 (which was added to the Code by BAPCPA in 2005), and includes, for an individual debtor, both pre-petition assets *and* post-petition income.⁹ Because the amended absolute priority rule allows individual Chapter 11 debtors to retain section 1115 property (which arguably could constitute all property of a debtor's estate) without regard to the absolute priority rule, some courts believe that the exception has swallowed the rule.

A. A BROAD VIEW: NO ABSOLUTE PRIORITY RULE IN INDIVIDUAL CHAPTER 11 CASES.

On one side of this split of authority on this issue, courts have concluded that the BAPCPA amendments cited above effectively abrogate the absolute priority rule as it applies to individual Chapter 11 debtors. To date, lower courts and the Bankruptcy Appellate Panel for the Ninth Circuit have adopted this approach. Courts who adopt this approach have done so under a "plain language" reading of the applicable statutes – which has ultimately led to what is considered a "broad view" of the issue.¹⁰

According to the broad view, because Bankruptcy Code section 1115 "incorporates and *supersedes*" Bankruptcy Code section 541,¹¹ section 1115 property is comprised of both a debtor's pre-petition *and* post-petition property.¹² This interpretation leads to the conclusion that the exception to the absolute priority rule for individual debtors extends to *all assets of that debtor's estate*, including newly acquired property and income.¹³ Therefore, the absolute priority rule no longer applies to *any* property of an individual debtor's estate.¹⁴

⁶ *In re Martin*, 2013 WL 5229816 at *2 ("So in a typical Chapter 11 reorganization of a corporation, the corporation's shareholders cannot—absent consent of the unsecured creditors—receive any payment or retain any stock on account of their pre-petition shareholder interests if the plan does not provide for full payment of the unsecured creditors.")

⁷ *In re Martin*, 2013 WL 5229816 at *8 ("Abrogating the absolute priority rule would create the remarkable result that creditors would be denied a vote in Chapter 11 cases of individuals who could pay pennies on the dollar while keeping substantial assets—a result never contemplated for Chapter 11.")

⁸ 11 U.S.C. § 1129(b)(2)(B)(ii).

⁹ *Id.*, § 1115.

¹⁰ *See, e.g., In re Friedman*, 466 B.R. 471, 480 (B.A.P. 9th Cir. 2012).

¹¹ *In re Stephens*, 704 F.3d 1279, 1285 (10th Cir. 2013) (emphasis added).

¹² *Id.* at 1285 quoting *In re Shat*, 424 B.R. 854, 863 (Bankr. D. Nev. 2010) ("When § 1129(b)(2)(B)(ii) references the property 'included' by §1115, it 'refer[s] to all property Section 1115 itself references.'")

¹³ *See In re Stephens*, 704 F.3d at 1285.

¹⁴ *See id.*

B. THE NARROW VIEW: THE ABSOLUTE PRIORITY RULE IS ALIVE AND WELL.

On the other side of this circuit split is the view that the absolute priority rule still applies to individual Chapter 11 debtors, but only as to post-petition assets. This approach seems to be gaining ground, and the Fourth, Fifth, and the Tenth Circuits have expressly held the rule still applies,¹⁵ and recently, the Middle District of Florida (Tampa Division) issued an opinion which also follows this narrow approach.¹⁶

According to the narrow view, section 1115 simply *adds to*, but does not replace, the definition of estate property under section 541.¹⁷ Under this view, it is only the "additional" section 1115 property (*i.e.*, post-petition property) which individual Chapter 11 debtors can exclude from the absolute priority rule.¹⁸ Finding support for this interpretation, courts observe that Congress could have simply repealed the absolute priority rule as to individual Chapter 11 debtors by directly stating so in BAPCPA (or by raising the debt limits on Chapter 13 filings).¹⁹ Because of the "dramatic nature of such a departure from longstanding pre-BAPCPA law, the ambiguous language of the statutes, and the total lack of any indication in the legislative history of such an intent," courts adopting the narrow view are compelled to conclude that Congress preserved the absolute priority rule.²⁰

C. IMPACT OF THE SPLIT

The current split over the interpretation of the absolute priority rule as applied to individual Chapter 11 debtors could significantly impact not only bankruptcy planning for a higher net-worth client, but could also be critical to the evaluation of a debtor's reorganization plan from a creditor's viewpoint. Until the split of authorities is resolved, debtors and creditors alike are well advised to understand the current developments on this issue.

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¹⁵ *In re Maharaj*, 681 F.3d 558, 565-566 (4th Cir. 2012); *In re Lively*, 717 F.3d 406, 409-410 (5th Cir. 2013); *In re Stephens*, 704 F.3d at 1286.

¹⁶ See *In re Martin*, 2013 WL 5229816 at *2.

¹⁷ *In re Stephens*, 704 F.3d at 1285.

¹⁸ *In re Martin*, 2013 WL 5229816 at *2.

¹⁹ See *e.g.*, *Maharaj*, 681 F.3d at 565-566, *In re Stephens*, 704 F.3d at 1286.

²⁰ *In re Maharaj*, 681 F.3d at 575, *In re Lively*, 717 F.3d at 410.