

Bankruptcy, Restructuring and Creditors' Rights Client Service Group

To: Our Clients and Friends

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The Absolute Priority Rule: An Endangered Species in Individual Chapter 11 Cases?

The absolute priority rule of Section 1129(b) of the Bankruptcy Code is a fundamental creditor protection in a Chapter 11 bankruptcy case. In general terms, the rule provides that if a class of unsecured creditors rejects a debtor's reorganization plan and is not paid in full, junior creditors and equity interestholders may not receive or retain any property under the plan. The rule thus implements the general state-law principle that creditors are entitled to payment before shareholders, unless creditors agree to a different result. Recent litigation has raised the issue whether the absolute priority rule continues to apply in Chapter 11 cases filed by individuals.

The absolute priority rule has played a prominent role in bankruptcy disputes, including a number of Supreme Court decisions. The current controversy concerns whether the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), which otherwise is a very creditor-friendly statute, modified the Bankruptcy Code in such a way as to eliminate the absolute priority rule if the debtor is an individual. The issue is particularly important because BAPCPA's restrictions on eligibility for relief under Chapter 7 have made Chapter 11 the only realistic option for many debtors. (Even before BAPCPA, Chapter 13 contained limits on a debtor's secured and unsecured debts, so it is not an option for many debtors who are likely to present absolute priority disputes.)

This Client Alert discusses the first appellate opinion on this issue, in which a divided panel of the Bankruptcy Appellate Panel of the Ninth Circuit held that the absolute priority rule no longer applies in individual Chapter 11 cases. *Friedman v. P&P, LLC*, No. 11-1105, 2012 WL 911545 (B.A.P. 9th Cir. Mar. 19, 2012). Two other appeals are in the works. On March 21, a bankruptcy judge in Texas certified his decision that the absolute priority rule continues to apply in individual Chapter 11 cases for direct appeal to the Fifth Circuit. *In re Lively*, No. 10-35471, 2012 WL 959286 (Bankr. S.D. Tex. Mar. 21, 2012). And the day after that, a panel of the Fourth Circuit heard oral arguments in a direct appeal from a Virginia bankruptcy judge's ruling that the absolute priority rule survived BAPCPA. *In re Maharaj*, No. 11-1747 (4th Cir.).

Background of the *Friedman* Decision

The Friedmans filed Chapter 11 in Arizona in October 2007 to stay foreclosure by a junior lienholder of the debtors' part-time residence in Breckenridge, Colorado. After relief from the automatic stay was granted to the senior lienholder, which then foreclosed, the junior lienholder's claim against the bankruptcy estate of \$556,000 was left unsecured. In their plan, the debtors proposed to pay \$634 per month to unsecured creditors (including the junior lienholder), while retaining all of their interests in various pre-bankruptcy business ventures. Although these business were valued at more than \$600,000, they yielded income to the debtors of

only \$2,000 per month. The junior lienholder objected to the plan, asserting that it violated the absolute priority rule because it permitted the debtors to retain valuable assets while unsecured creditors were not being paid in full. The bankruptcy court entered an order denying confirmation of the debtors' plan because it violated the absolute priority rule, though the court recognized the split of authority as to whether the rule applies in individual Chapter 11 cases. After the debtors failed to amend their plan, the bankruptcy court converted the case to Chapter 7. The debtors appealed.

The BAP's Decision

On appeal, the Bankruptcy Appellate Panel focused on language added to Section 1129(b)(2)(B)(ii) of the Bankruptcy Code by BAPCPA. That language, which creates an exception to the absolute priority rule, states that "in a case in which the debtor is an individual, the debtor may retain property included in the estate under section 1115." Section 1115, which also was added by BAPCPA, provides that if a Chapter 11 debtor is an individual, property of his or her bankruptcy estate "includes, in addition to the property specified in section 541," property acquired by the debtor post-bankruptcy and the debtor's post-bankruptcy earnings. Section 541 defines the baseline property of a debtor's bankruptcy estate for purposes of cases under Chapters 7, 11, and 13—with some exceptions, it includes property owned by the debtor on the date of the bankruptcy filing and excludes post-bankruptcy earnings. The question for the BAP in *Friedman*, then, was whether "property included in the estate under section 1115," which a debtor may retain without paying creditors in full, means all property of the bankruptcy estate (because Section 1115 incorporates Section 541 property) or property that is included in the bankruptcy estate *solely* because it is added by Section 1115 (essentially, post-bankruptcy earnings and acquisitions).

The BAP majority concluded that the plain meaning of the exception permits a debtor to retain all property of the bankruptcy estate without paying creditors in full. The BAP acknowledged that its decision (interpreting the exception broadly) is in the minority; most bankruptcy courts have interpreted the exception narrowly to include only post-bankruptcy earnings and acquisitions. Because it believed that the exception added by BAPCPA was unambiguous, the BAP declined to review legislative history or to consider the policies behind BAPCPA. In a vigorous dissent, Judge Jury chastised the majority for its "simplistic outcome," "strained reading" of the statute, and "result-driven approach." She also argued that the majority's interpretation of the BAPCPA amendments violates several principles of statutory construction, including those disfavoring interpretations that render statutory language superfluous, produce absurd results, and are demonstrably at odds with the purpose of the statute.

Significance of *Friedman*

Friedman represents a significant shift in the balance of power in individual Chapter 11 cases. If a debtor may retain property without paying creditors in full, the debtor has little incentive to engage in negotiations toward a consensual plan, which is the typical resolution of a Chapter 11 case. Creditors retain other protections against abusive plans—for example, a plan must be proposed in good faith, and a dissenting creditor must receive at least as much as it would get in a Chapter 7 liquidation—but those remedies are dependent on judicial factfinding and, in many cases, the opinions of expert witnesses. The BAP's conclusion that Congress eliminated the absolute priority rule strips creditors of a much more straightforward means to block the confirmation of a debtor-friendly plan or, more likely, to compel the debtor to negotiate an acceptable resolution.

To discuss this issue further, please speak to your Bryan Cave contact, or to:

Robert J. Miller
Bryan Cave LLP
Phoenix, Arizona
Tel 1 602 364 7043
Fax 1 602 716 8043
rjmiller@bryancave.com

Brian C. Walsh
Bryan Cave LLP
St. Louis, Missouri
Tel 1 314 259 2717
Fax 1 314 552 8717
brian.walsh@bryancave.com

Gwendolyn J. Godfrey
Bryan Cave LLP
Atlanta, Georgia
Tel 1 404 572 4536
Fax 1 404 420 0536
gwendolyn.godfrey@bryancave.com

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