Virginia Judges Weigh in on Whether Absolute Priority Rule Still Applies in Individual Chapter 11 Cases

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Introduction

Congress created uncertainty about plenty of issues when it enacted the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA). Many if not most of those issues have been cleared up since 2005 as the courts have had to interpret and apply BAPCPA in actual cases. However, one question created by BAPCPA remains unresolved: did or did not BAPCPA wipe out the absolute priority rule in individual Chapter 11 cases? That question has spawned numerous decisions by bankruptcy courts, but no definitive answer. Some courts have ruled that BAPCPA eliminated the rule in individual Chapter 11 cases, while others have held that the rule is still alive and well in individual Chapter 11 proceedings. *See, e.g. In re Shat*, 424 B.R. 854, 862-68 (Bankr. D. Nev. 2010); *In re Roedemeier*, 374 B.R. 264, 273-76 (Bankr. D. Kan. 2007); *In re Tegeder*, 369 B.R. 477, 480 (Bankr. D. Neb. 2007)(all holding that the absolute priority rule still applies in individual Chapter 11 cases post-BAPCPA). But *see In re: Joseph A. Stephens, Jr.*, 2011 Bankr. LEXIS 593 (Bankr. S.D. Tex. Feb. 22, 2011); *In re Karlovich*, 2010 Bankr. LEXIS 4014 (Bankr. S.D. Cal. Nov. 16, 2010)(holding that the absolute priority rule does not apply in individual Chapter 11 cases post-BAPCPA).

Two of the more thoughtful and thorough opinions were issued by our own judges here in Virginia, both of whom ruled that individuals filing for relief under Chapter 11 must satisfy the absolute priority rule to achieve confirmation in a cramdown situation. *See In re: Mullins*, 435 B.R. 352 (Bankr. W.D.Va. 2010) (Judge Stone); *In re Maharaj*, 2011 Bankr. LEXIS 1748 (Bankr. E.D.Va. May 9, 2011) (Judge Mitchell). Noting that "a number of able jurists have held to the contrary, and the reported opinions are more or less evenly split," on May 25, 2011, Judge Mitchell certified the *Maharaj* case for direct appeal to the Fourth Circuit pursuant to 28 U.S.C. §158(d)(2)(A)(i) as a matter that "involves a question of law as to which there is no controlling decision of the court of appeals for the circuit or the Supreme Court…, or involves a matter of public importance." Thus, the Fourth Circuit will soon have the opportunity to clear up, at least in this circuit, whether the absolute priority rule survived BAPCPA in individual Chapter 11 reorganizations—or not.

The Absolute Priority Rule—Before and After BAPCPA

Confirmation of a Chapter 11 Plan

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of Reorganization ordinarily requires that all impaired classes accept the Plan by casting ballots in favor of the Plan equivalent to two-thirds in dollar amount and more than one-half in number of the creditors actually voting in each class. 11 U.S.C. §1129(a)(8). However, if the requisite votes cannot be obtained, the debtor can still obtain plan confirmation via the "cramdown" process, which allows the debtor to confirm a plan if: (1) it meets all of the other requirements for confirmation; (2) it can demonstrate that the plan does not "discriminate unfairly"; and (3) is "fair and equitable" with respect to each class of impaired claims that has not accepted the plan. 11 U.S.C. §1129(b)(1). In order to pass the "fair and equitable" test, the plan must, at a minimum, provide that:

> The holder of any claim or interest that is junior to the claims of such [dissenting] 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. §1129(b)(2)(B)(ii).

In a business reorganization case, the absolute priority rule has the practical impact of preventing the owners of a company from retaining ownership of the company unless the plan proposes to pay all creditors in full or the requisite votes are obtained in favor of the plan. Otherwise, the owners, who hold only the lowest priority equity interest in the company, could retain that interest while paying less than full payment to the more senior interests of the company's unsecured creditors.

Prior to the enactment of BAPCPA, there was no question that the absolute priority rule applied to both business entities and to individual debtors in Chapter 11. In a case involving an individual debtor, the absolute priority rule would operate to ensure that the individual debtor did not retain any non-exempt property unless the plan was paying all creditors in full.

Then Congress came along in 2005 and, with BAPCPA, added the language to Section 1129(b)(2)(B)(ii) italicized above. Congress also added Section 1115, which is referenced in the italicized language. Section 1115 provides:

> (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
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> (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.
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> (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.

Last but not least, Congress added a new requirement for confirmation of an individual Chapter 11 plan, now set out in Section 1129(a)(15), which reads as follows:

> In a case in which the debtor is an individual and in which the holder of an allowed unsecured claim objects to the confirmation of the plan--
>
> (A) the value, as of the effective date of the plan, of the property to be distributed under the plan on account of such claim is not less than the amount of such claim; or

> (B) the value of the property to be distributed under the plan is not less than the projected disposable income of the debtor (as defined in section 1325(b)(2) to be received during the 5-year period beginning on the date that the first payment is due under the plan, or during the period for which the plan provides payments, whichever is longer.

The Absolute Priority Rule—Dead or Alive?

Obviously Congress intended to impose different rules for obtaining plan confirmation in individual Chapter 11 cases compared to corporate Chapter 11s and particularly intended to change the way the absolute priority rule is applied. But Congress' poor draftsmanship left the door open for more than one interpretation of its intentions. Some courts have concluded that Congress intended to wipe out the absolute priority rule in individual cases. Those courts have read Section 1115's description of "property of the estate" as including *all* property interests of the debtor, both pre and post-petition. There is no doubt that Section 1115 includes property acquired after commencement of the case because subparagraphs (1) and (2) refer to it explicitly.

However, the courts that hold that the absolute priority rule is dead (at least in Chapter 11 cases involving individual debtors) interpret Section 1115 "with its internal reference to Section 541, not merely as expanding upon what constitutes property of the estate for an individual debtor, but as defining it." *Maharaj*, 2011 Bankr. LEXIS 1748 at *13. Thus, when those courts read Section 1129(b)(2)(B)(ii), which allows individual debtors to "retain property included in the estate under section 1115," they conclude that Congress intended to allow individual debtors to retain all property, both pre and post-petition, because both are included in section 1115. *See, e.g. Tegeder*, 369 B.R. at 480-81.

The courts that have ruled in this manner have stressed that elimination of the absolute priority rule is consistent with Congress' intent to treat individuals in Chapter 11 as they would in Chapter 13, which has no absolute priority rule. *Roedemeier*, 374 B.R. at 275-76. Courts or litigants in this camp also stress that elimination of the absolute priority requirement prevents the situation that would otherwise occur when an individual operates a closely held business. *Roedemeier*, for example, involved a dentist who owned a limited liability entity through which he conducted his dental practice. Debtor's counsel in that case argued that application of the absolute priority rule would prevent the dentist from retaining his interest in his own LLC which was essential to his livelihood. The argument was raised there, and has been advanced in other cases, that retention of the absolute priority rule would virtually preclude confirmation of Chapter 11 plans by individuals who own their own companies.

On the other hand, those arguing that the absolute priority survives in individual Chapter 11 cases say that Section 1115 only describes post-petition property notwithstanding its cross-reference to Section 541. This camp concludes that, when Section 1129(b)(2)(B)(ii) refers to property "included in the estate under section 1115," it is referring only to post-petition property and earnings, not to pre-petition property that was already in the estate pursuant to Section 541.

Judge Stone's opinion in *In re Mullins*, and Judge Mitchell's decisions in *Maharej* and *Hindin* analyzed the issue and concluded that the absolute priority rule in individual Chapter 11 cases did survive the BAPCPA amendments. The fluid nature of the debate was acknowledged by Judge Mitchell when he observed that, when Judge Stone issued his opinion in I*n re Mullins*, it was considered to be the minority view, but the trend in recent opinions may have placed Judge Stone

in the majority camp.

The courts which have ruled that the absolute priority rule is alive and well have focused less on the perceived intent of Congress and more on the language of the statute itself. In *Karlovich*, for example, the court noted that if Congress had wanted to wipe out the absolute priority rule in individual cases, it could have simply amended the statutory debt ceilings for Chapter 13 cases set out in 11 U.S.C. 109(e) by eliminating them altogether or setting them much higher. *Karlovich*, 2010 Bankr. LEXIS 4014 at *11. In *Mullins*, Judge Stone observed that a congressional intent to eliminate the absolute priority rule could have been accomplished simply by declaring that "except in a case in which the debtor is an individual, this provision shall not apply" rather than awkwardly referring to Section 1115. *Mullins*, 435 B.R. at 360-61.

In our opinion, Judge Mitchell and Judge Stone got it right. Their reading of Sections 1129 and 1115 is more consistent with the express wording of the statute that other interpretations. The statutory language should trump interpretations of what Congress must have been trying to do from a policy perspective. And even if we consider Congress' intent, Congress could have easily eliminated the absolute priority rule instead of including the BAPCA language referencing Section 1115, as Judge Stone has pointed out. Therefore, the authors of this article believe the absolute priority rule should apply in individual Chapter 11s post BAPCPA, even putting aside the fact that such a position benefited our client in the *Hindin* case.

Conclusion

Thanks to Judge Mitchell, practitioners within the Fourth Circuit should soon have a definitive ruling as to whether an individual in Chapter 11 will be able to cramdown a plan of reorganization on objecting creditors without satisfying the absolute priority rule. Meanwhile, both Judge Stone's opinion in *Mullins* and Judge Mitchell's opinion in *Maharaj* contain useful summaries of the divergent opinions on this question by various courts and thoughtful explanations of their own reasoning and conclusions. Both are must-reads for Virginia and Fourth Circuit bankruptcy practitioners.