

## Whether the Absolute Priority Rule Has Been Abrogated in Individual Chapter 11 Cases

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### Introduction

In recent years, a debate has been raging over whether the absolute priority rule in applies to individual chapter 11 debtors.<sup>1</sup> Essentially, the absolute priority rule dictates that junior creditors cannot retain anything under a plan if an objecting senior creditor is not paid in full.<sup>2</sup> If each class of creditor does not consent to a plan of reorganization, a bankruptcy court can still confirm the plan if it meets statutory requirements and is deemed “fair and equitable.”<sup>3</sup> This method of confirmation is known as a “cramdown.”<sup>4</sup> In order for a plan to be “fair and equitable,” it must, among other things, satisfy the absolute priority rule.<sup>5</sup> The absolute priority rule states that the claims of a class of dissenting unsecured creditors must be satisfied in full before debtors can retain any property. Before Congress passed the Bankruptcy Prevention and Consumer Protection Act (BAPCPA), there was a general consensus among bankruptcy courts and scholars

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<sup>1</sup> David S. Jennis et al., *Application of Absolute-Priority Rule and New-Value Exception in Individual Chapter 11s*, 30 AM. BANKR. INST. J. 56 (2011).

<sup>2</sup> See 11 U.S.C. §1129(b)(2)(B)(ii) (2010).

<sup>3</sup> *SPCP Group, LLC. Biggins*, 465 B.R. 316, 320 (Bankr. M.D. Fla. 2011) (citing *In re Shat*, 424 B.R. 854, 857-58 (Bankr. D. Nev. 2010)).

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*

that the absolute priority rule applied to individuals.<sup>6</sup> This consensus, however, was called into question when Congress passed BAPCPA. The absolute priority rule, codified in 11 U.S.C. §1129(b)(2)(B)(ii) states: “[w]ith respect to a class of unsecured claims...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*” (emphasis added).<sup>7</sup> The emphasized language was added to the statute as part of the Bankruptcy Prevention and Consumer Protection Act (“BAPCPA”).<sup>8</sup>

Currently, section 1115 defines “property of the estate” in individual cases as: “in addition to the property specified in section 541. . . all property of the kind specified in section 541 that the debtor acquires after the commencement of the case. . . and earnings from services performed by the debtor after the commencement of the case[.]”<sup>9</sup> Section 541 defines “property of the estate,” with some exceptions, as: “. . . all legal or equitable interests of the debtor in property as of the commencement of the case.”<sup>10</sup> All courts agree that post-petition property is excluded from the absolute priority rule by section 1115.<sup>11</sup> However, there is disagreement over whether pre-petition property is also exempted because section 1115 references section 541,

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<sup>6</sup> *In re Shat*, 424 B.R. 854, 862 (Bankr. D. Nev. 2010).

<sup>7</sup> *Id.*; 11 U.S.C. §1129(b)(2)(B)(ii) (2010).

<sup>8</sup> *SPCP Group*, 465 B.R. at 321.

<sup>9</sup> 11 U.S.C. §1115(a) (2010).

<sup>10</sup> 11 U.S.C. §541(a)(1) (2010).

<sup>11</sup> *Compare In re Shat*, 424 B.R. 854, 865 (Bankr. D. Nev. 2010) (holding section 1115 supersedes section 541 which leads to the conclusion that both pre-petition and post-petition is exempted from the absolute priority rule in cases involving individual debtors), *with In re Maharaj*, 681 F.3d 558, 570 (4th Cir. 2012) (arguing the “context demonstrates that Congress intended §1115 to add property to the estate already established by §541”).

which in turn defines “property of the estate” to include pre-petition property.<sup>12</sup> The combined effect of these statutes on the applicability of the absolute priority rule to individual debtors has caused extensive debate in the bankruptcy community.<sup>13</sup>

This Article examines the current court split as to whether the absolute priority rule applies to individual debtors and the implications of each view.<sup>14</sup> The first view, known as the “broad view,” is that Congress abrogated the absolute priority rule when it passed the BAPCPA.<sup>15</sup> Part I of this Article will discuss the legal and practical arguments courts use to justify adopting “broad view.” The second view, known as the “narrow view,” is that the language added by the BAPCPA only exempted future earnings and post-petition property from the absolute priority rule.<sup>16</sup> Part II of this Article will focus on the interpretive arguments courts rely on in adopting the “narrow view.” Part III of the Article will discuss the policy implications of each view. The Article will then conclude with a brief summary of both views and the argument that the debate over the applicability of the absolute priority rule on individual debtors under chapter 11 will likely only be resolved by further Congressional input.

### **I. The “Broad View”**

Proponents of the “broad view” argue that the absolute priority rule does not apply to individual debtors because section 1129(b)(2)(B)(ii) references section 1115, which defines

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<sup>12</sup> Compare *In re Shat*, 424 B.R. 854, with *In re Maharaj*, 681 F.3d 558.

<sup>13</sup> See Jennis et al., *supra* note 1, at 56-57 (discussing the evolution of judicial rulings on the effect of the BAPCPA amendments on the absolute priority rule).

<sup>14</sup> *Id.* at 56 (stating the original view of most courts was that the amendments to §1129(B) and the addition of §1115 eliminated the application of the absolute priority rule to individual debtors, but later courts have held that the absolute priority still applies).

<sup>15</sup> *Id.* at 57 (stating the *Tegeeder*, *Roedemeier*, and *Shat* courts all held that reading §1129(b)(2)(B)(ii) and §1115 together eliminated the absolute priority rule in individual cases, and that this “became known as the ‘broad’ interpretation”).

<sup>16</sup> *Id.* at (declaring “[m]ore recently, courts are increasingly adopting a more ‘narrow view of § 1115, finding that the absolute-priority rule continues in individual chapter 11 cases, and that the amendments to § 1129 only exclude the debtor's future earnings and property acquired post-petition from the application of the absolute-priority rule”).

“property of the estate” to include post-petition property,<sup>17</sup> but also references property listed in section 541.<sup>18</sup> Section 541 defines “property of the estate” to include pre-petition property.<sup>19</sup> Therefore, courts adopting the “broad view” hold that Section 1129(b)(2)(B)(ii) exempts both pre- and post-petition property owned by an individual debtor.<sup>20</sup> Several rationales have been put forward in support of this interpretation.<sup>21</sup> The first is that the plain meaning of the applicable statutes mandates the adoption of the “broad view”.<sup>22</sup> Other courts which adopt the “broad view,” argue that even if the language of section 1129(b)(2)(B)(ii) is ambiguous, the legislative history shows that Congress intended to abrogate the application of the absolute priority rule to individual chapter 11 debtors.<sup>23</sup>

The United States Bankruptcy Court for the Middle District of Florida adopted the “broad view” in *SPCP Group, LLC v. Biggins*, because the court concluded that a plain reading of section 1115 leads to the conclusion that all of an individual debtor’s property is excluded from

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<sup>17</sup> 11 U.S.C. §1115.

<sup>18</sup> 11 U.S.C. §1129(b)(2)(B)(ii).

<sup>19</sup> 11 U.S.C. §541.

<sup>20</sup> *In re Shat*, 424 B.R. 854, 865 (Bankr. D. Nev. 2010) (holding that §1115 “absorbs and then supersedes” §541, which leads to the conclusion that the exemption in §1129(b)(2)(B)(ii) “extends to *all* property of the estate”; *In re Tegeder*, 369 B.R. 477, 480 (Bankr. D. Neb. 2012); *In re SPCP Group*, 465 B.R. at 321 (stating a broad interpretation allows debtor’s to retain both pre-petition and post-petition property, therefore eliminating the absolute priority rule in individual cases); *In re Roedemeier*, 374 B.R. 264, 274 (Bankr. D. Kan. 2007) (explaining a broad reading of the statutes exempts all of a debtor’s property); *Friedman v. P+P, LLC (In re Friedman)*, 466 B.R. 471, 482 (B.A.P. the Cir. 2012) (holding that §1115 exempts property under §541 and “newly acquired property and income”).

<sup>21</sup> *In re Shat*, 424 B.R. at 865-867 (discussing case law adopting the “broad view” for reasons including plain meaning of the statute, congressional intent, and public policy).

<sup>22</sup> *In re Tegeder*, 369 B.R. at 480 (quoting §1115 and holding that it clearly exempts both pre-petition and post-petition property); *In re SPCP Group*, 465 B.R. at 322 (stating the court adopts the “broad view” by focusing on the statutes’ plain language).

<sup>23</sup> *See e.g., In re Shat*, 424 B.R. at 868 (holding that the plain language of the statutes, as well as the legislative history and purpose of the BAPCPA justify adopting the “broad view”).

the absolute priority rule.<sup>24</sup> In reaching this decision, the court did not consider legislative history or congressional intent in its assessment.<sup>25</sup> Rather, the court opined that ““where a statute is unambiguous, the court need not, and ought not, consider legislative history.”<sup>26</sup> The court analyzed section 1115 and the cross-referenced statutes, and concluded that “property of the estate” under section 1115 includes pre- and post-petition property, and since “the meaning of these statutes is clear . . . the [c]ourt’s inquiry stop[ped] [t]here”.<sup>27</sup> In essence, the court held that in an individual chapter 11 bankruptcy case, section 1115 redefines “property of the estate” to explicitly include post-petition property, but also impliedly include the pre-petition property stated in section 541, and post-petition property. The result of this new definition is that “the absolute priority rule no longer applies to prevent individual [c]hapter 11 debtors from retaining pre-or post-petition property over an unsecured creditor’s objection.”<sup>28</sup>

Other courts argue that the legislative history of the BAPCPA amendments and congressional intent support the adoption of the “broad view.”<sup>29</sup> For example, The *Shat* court recognized that language of section 1129 is open to multiple, logical interpretations.<sup>30</sup> Therefore, the *Shat* court relied on the legislative history of the BAPCPA amendments when it adopted the “broad view.”<sup>31</sup> After examining the legislative history of the BAPCPA

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<sup>24</sup> *In re SPCP Group*, 465 B.R. at 322 (stating the court adopted the “broad view” based on the statutes’ plain language).

<sup>25</sup> *Id.* (stating that the court did not focus on legislative history in reaching its conclusion).

<sup>26</sup> *Id.* (citing *Reeves v. Astrue*, 526 F.3d 732, 734 (11th Cir. 2008)).

<sup>27</sup> *Id.* at 322-323.

<sup>28</sup> *Id.* at 323.

<sup>29</sup> See, e.g., *In re Shat*, 424 B.R. at 868 (holding that the plain language of the statutes, as well as the legislative history and purpose of the BAPCPA justify adopting the “broad view”).

<sup>30</sup> *Id.* at 863 (discussing the ambiguity of the word “included” § 1129(b)(2)(B)(ii) and the two conclusions which can be drawn from it).

<sup>31</sup> *Id.* at 859-61 (stating the BAPCPA was intended to include changes to the Bankruptcy Code proposed in 1999, which included adding post-petition property as exempt from the absolute priority rule).

amendments,<sup>32</sup> and assessing the effects of adopting the “narrow view,”<sup>33</sup> the court held that the absolute priority rule does not apply to individual debtors.<sup>34</sup>

The court reasoned that under the “narrow view only “the value of aggregate postpetition earnings payable after the fifth anniversary of plan confirmation” would be protected.<sup>35</sup> According to the court, this result would be inconsistent with the overall statutory scheme of BAPCPA, which was to make an individual chapter 11 bankruptcy case more closely resemble a chapter 13 bankruptcy case.<sup>36</sup> The court opined that because the absolute priority rule does not apply to individual debtors in a chapter 13 case, Congress likely intended to eliminate its application to individual debtors in a chapter 11 case as well.<sup>37</sup> Therefore, the exception in section 1129(b)(2)(B)(ii) “extends to *all* property of the estate[,]”<sup>38</sup> because “the phrase ‘in addition to the property specified in section 541’” found in section 1115 “absorbs and then supersedes [s]ection 541 for individual chapter 11 cases.”<sup>39</sup>

## II. The “Narrow View”

Courts which adopt the “narrow view” hold that the absolute priority rule does apply to individual debtors because the BAPCPA amendments only exempted property acquired post-petition.<sup>40</sup> Courts adopting the “narrow view,” similar to courts adopting the “broad view,” also

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<sup>32</sup> *Id.* at 859-861.

<sup>33</sup> *Id.* at 867-868.

<sup>34</sup> *Id.* at 868 (adopting the “broader interpretation”).

<sup>35</sup> *Id.*

<sup>36</sup> *Id.* at 867-868.

<sup>37</sup> *Id.*

<sup>38</sup> *Id.* at 865.

<sup>39</sup> *Id.*

<sup>40</sup> *In re Maharaj*, 681 F.3d 558, 570 (4th Cir. 2012) (arguing the “context demonstrates that Congress intended §1115 to add property to the estate already established by §541”); *In re Stephens*, 704 F.3d 1279, 1285 (10th Cir. 2013) (explaining the narrow view only exempts post-petition property from the absolute priority rule); *In re Gelin*, 437 B.R. 435, 442 (Bankr. M.D. Fla 2010) (stating the “phrase ‘included in the estate under section 1115’ refers only to the post-

examine the language of the statute in making their determinations. The first court to adopt the “narrow view” was the United States Bankruptcy Court for the Northern District of California, in *In re Gbadebo*.<sup>41</sup> The *Gbadebo* court held that the phrase “included in the estate under section 1115” does not mean “absorbed” or “superseded” like the court held in *Shat*.<sup>42</sup> Rather, the only reasonable interpretation is that the phrase means “added to the bankruptcy estate by [section]1115.”<sup>43</sup>

Proponents of the “narrow view” also rely on what they perceive as Congress’s intent when it passed BAPCPA.<sup>44</sup> Many proponents of the “narrow view” argue that since it is not clear that Congress intended to eliminate the application of the absolute priority rule, courts should not overturn longstanding bankruptcy practice.<sup>45</sup>

After concluding that the legislative history of the BAPCPA is not enlightening, some courts have looked at how section 1129(b)(2)(b)(ii) interacts with rest of the code to help define it.<sup>46</sup> In *In re Gelin*, the court held that before BAPCPA, section 103(a) stated that section 541 was applicable to individual chapter 11 bankruptcies. The court goes on to state that since BAPCPA left both of these sections untouched, there is no reason to assume that Congress intended section 1115 to “supersede” section 541, as the court held in *Shat*. The court

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petition property. . .”); *In re Arnold*, 471 B.R. 578, 607 (Bankr. C.D. Cal. 2012) (holding the statutes limit what a debtor can retain to the property “enumerated in §1115(a)(1) and (2)”); *In re Gbadebo*, 431 B.R. 222, 230 (Bankr. N.D. Cal. 2010); *In re Lively*, 467 B.R. 884, 888 (Bankr. S.D. Cal. 2012) (holding “BAPCPA did not abrogate the absolute priority rule for individual Chapter 11 cases”).

<sup>41</sup> *In re Gbadebo*, 431 B.R. 222.

<sup>42</sup> *Id.* at 230.

<sup>43</sup> *Id.* at 229.

<sup>44</sup> See e.g., *In re Gelin*, 437 B.R. at 442.

<sup>45</sup> *Id.* at 218 (citing *Cohen v. Dela Cruz*, 523 U.S. 213, 221 (1998) (holding that amendments should not be interpreted “to erode past bankruptcy practice absent a clear indication that Congress intended such a departure.”)

<sup>46</sup> See e.g., *Id.*; See also, *In re Stephens*, 704 F.3d 1279.

concluded that the “narrow view” was correct because if Congress had wanted to eliminate the absolute priority rule in individual Chapter 11 cases, it would have done so explicitly.<sup>47</sup> The Tenth Circuit made a similar analysis in *In re Stephens*, holding that by looking at the absolute priority rule in the context of the BAPCPA, it is clear that Congress did not intend to repeal the absolute priority rule by implication.<sup>48</sup>

Proponents of the “narrow view” have also argued that courts should be hesitant to overturn long-standing bankruptcy practice when it is unclear whether Congress intended to do so.<sup>49</sup> The *Stephens* court held that: “[b]ecause both the statutory language and Congress’ intent are ambiguous we heed the presumption against implied repeal. ‘Repeals by implication are not favored and will not be presumed unless the intention of the legislature to repeal is clear and manifest.’”<sup>50</sup> Therefore, it follows that the *Stephens* court believed that until Congress explicitly states that the absolute priority rule no longer applies to individual debtors in chapter 11, courts should assume that it did not intend to overturn long-standing bankruptcy practice when it passed BAPCPA.<sup>51</sup>

Courts which adopt the “narrow view” hold that the purpose of the BAPCPA was “to make debtors pay more.”<sup>52</sup> “Narrow view” courts disagree with the contention of the “broad view” courts that Congress intended the BAPCPA amendments to make chapter 11 resemble chapter 13.<sup>53</sup> The court in *In re Arnold* points out that while it is true that the absolute priority rule does

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<sup>47</sup> *Id.* at 442

<sup>48</sup> *In re Stephens*, 704 F.3d at 1286 (citing *Nat’l Ass’n of Home Builders v. Defenders of Wildlife*, 551 U.S. 644, 662 (2007)).

<sup>49</sup> See e.g., *In re Stephens*, 704 F.3d 1279.

<sup>50</sup> *Id.* (citing *Nat’l Ass’n of Home Builders v. Defenders of Wildlife*, 551 U.S. 644, 662 (2007)).

<sup>51</sup> *Id.* at 1287 (citing *Hamilton v. Lanning* 560 U.S. 505 (2010)).

<sup>52</sup> See e.g., *In re Arnold*, 471 B.R. 578.

<sup>53</sup> See e.g., *Id.* at 611.



not apply in chapter 13, creditors are protected in chapter 13 by debt limits.<sup>54</sup> Since there are no debt limits in chapter 11, abrogating the application of the absolute priority rule on individual debtors in chapter 11 would eliminate all creditor protection.<sup>55</sup> Therefore, the “broad view” would eliminate the “balance between the rights of an individual debtor to cram down and the rights of creditors to be given fair and equitable treatment.”<sup>56</sup> Logically, if the purpose of BAPCPA was to make chapter 11 more closely resemble chapter 13 and the absolute priority rule was consequently abrogated, it follows that Congress would have instituted debt limits, or at least some other type of creditor protection in the BAPCPA amendments.

### III. Implications

This section of the Article will discuss the policy implications of adopting each view. The “broad view” ensures that several of the goals of bankruptcy are met, especially when the debtor is a small business owner.<sup>57</sup> The first such goal is ensuring that the debtor receives a “fresh start.”<sup>58</sup> When a large corporation declares bankruptcy it can have a “fresh start” when all of the executives and managers are replaced.<sup>59</sup> This is not necessarily true for a small business.<sup>60</sup> Therefore, when a small business owner goes through bankruptcy, it is imperative that he have the ability to obtain a “fresh start” if the business is going to continue to function. A small business often cannot function without the principal owner/manager.<sup>61</sup> Therefore, if a small

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<sup>54</sup> *Id.*

<sup>55</sup> *Id.*

<sup>56</sup> *In re Arnold*, 471 B.R. at 610.

<sup>57</sup> Andrew G. Balbus, *Does the Absolute Priority Rule Apply to Individuals in Chapter 11?*, 20 J. BANKR. L. & PRAC. 79, 98 (discussing why applying the absolute priority rule to individual debtors is much more harmful to small businesses than large corporations).

<sup>58</sup> *Id.* (citing *Gorgan v. Garner*, 498 U.S. 279, 286 which held that granting debtors a fresh start is the principal purpose of the Bankruptcy Code).

<sup>59</sup> *Id.*

<sup>60</sup> *Id.*

<sup>61</sup> *Id.*

business owner becomes discouraged and leaves the business, he loses the benefit of a “fresh start,” and the business is likely to fail.

In the small business scenario, a small business owner’s creditors can also benefit from the business owner’s assets being exempt from the absolute priority rule.<sup>62</sup> When a debtor is a small business owner, creditors are more likely to be compensated if the business continues to operate.<sup>63</sup> A small business’ most valuable asset is often its connection with the local community.<sup>64</sup> Therefore, if a debtor’s assets are not exempted from the absolute priority rule, the debtor has no incentive to continue his involvement with his small business.<sup>65</sup> This causes the business to lose its most valuable asset, and therefore decreases the chances of creditors being able to recover their investment.<sup>66</sup>

Abolishing the absolute priority rule may increase the overall compensation to creditors by having more chapter 11 plans approved which avoids debtors choosing to not file bankruptcy at all, or filing under chapter 7 instead.<sup>67</sup> Under the “narrow view,” it is harder for debtors to cram down plans when unsecured creditors do not approve of them. It follows therefore that the chances of a chapter 11 plan of reorganization being approved are greater under the “broad view.” However, it can also be argued that if the “broad view” were to become the consensus, creditors would be less likely to invest without security. This could make it more difficult for small business owners and individuals to obtain necessary credit.

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<sup>62</sup> *Id.* at 98-99.

<sup>63</sup> *Id.* at 99.

<sup>64</sup> *Id.* at 98.

<sup>65</sup> *Id.* at 99 (stating “[i]f the manager has no possibility of retaining the business, he will likely liquidate it.”)

<sup>66</sup> *Id.* (arguing “the absolute priority rule destroys the going concern value” to creditors).

<sup>67</sup> *Id.* at 753.

However, eliminating the application of the absolute priority rule could undermine the balance between the debtor’s ability to cram down a plan, and the rights of creditors to be treated fairly.<sup>68</sup> If the absolute priority rule had been left unchanged post-BAPCPA, it is possible that a debtor wishing to include any post-petition property listed in section 1115 in a cram down plan, would be forced “to negotiate an agreement with their creditors or pay the claims of dissenting creditors in full.”<sup>69</sup> It has been argued that the absolute priority rule had to be changed in order for individual debtors to make a living.<sup>70</sup> However, completely eliminating the absolute priority rule would eliminate the protection creditors receive from the rule, and essentially make the confirmation process irrelevant because debtors would know they could simply resort to a cram down if the plan was not approved.<sup>71</sup>

### **Conclusion**

From this analysis, it seems clear that there are two logical conclusions which can be reached when deciding whether the absolute priority rule applies to individuals post-BAPCPA. The statutory language, legislative history, and congressional intent are, at best, ambiguous. By adopting the “broad view,” a court can interpret BAPCPA to completely abrogate the application of the absolute priority rule on individual chapter 11 debtors. Or, a court can adopt the “narrow view” and hold that BAPCPA essentially left the absolute priority rule unchanged, and therefore only post-petition property is exempted.

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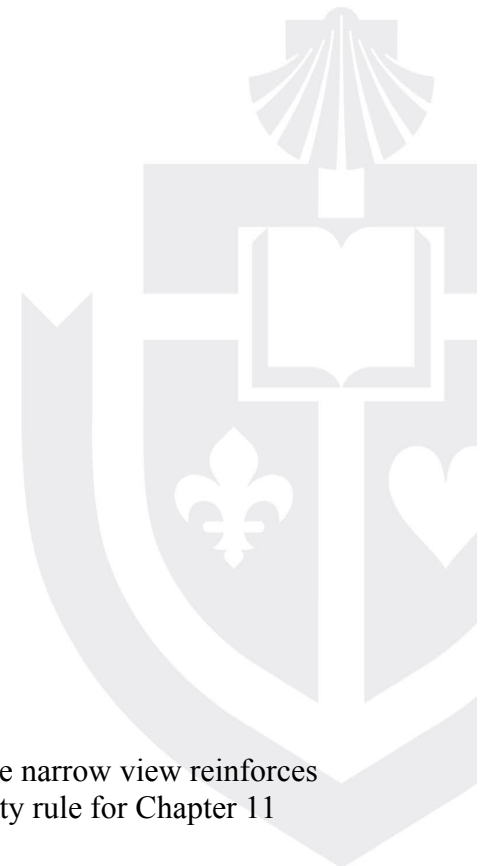
<sup>68</sup> *In re Arnold*, 471 B.R. at 610.

<sup>69</sup> *Id.*

<sup>70</sup> *In re Kamell*, 451 B.R. at 511.

<sup>71</sup> *In re Arnold*, 471 B.R. at 610.

With that said, there is a growing majority of courts adopting the “narrow view.”<sup>72</sup> If this trend continues, it is possible that a general consensus that the “narrow view” is correct will develop. For now, the answer to the question of whether the absolute priority rule applies to individual debtors depends upon what jurisdiction a debtor files for bankruptcy in. The debate is not likely to be settled until either the Supreme Court rules on the issue, or Congress addresses the problem by clarifying the applicable



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<sup>72</sup> *In re Arnold*, 471 B.R. at 613 (“The evolving majority in support of the narrow view reinforces this court’s conclusion that Congress did not abrogate the absolute priority rule for Chapter 11 cases of individual debtors in enacting BAPCPA”).