BANKRUPTCY

RECENT COURT DECISIONS HOLD THAT THE ABSOLUTE PRIORITY RULE STILL PROTECTS CREDITORS OF INDIVIDUAL CHAPTER 11 DEBTORS.

by Daniel F. Gosch

As the economic recovery continues to wind along through the up and down financial cycles that have been the hallmark of the last four years, there can be little doubt that some individuals historically on the higher end of the economic spectrum have felt the impact of the crisis more than others. More than a few "high net worth individuals" have seen personal fortunes eroded to a degree that has caused them to consider what would have once been unthinkable—personal bankruptcy. However, many times, the bankruptcy relief utilized most often by individual debtors, Chapter 13, or Chapter 7, won't be quite the right fit. The debt ceilings in Chapter 13 preclude some from filing. Means testing, limited exemptions, and the fact that Chapter 7 is after all a *liquidation* proceeding create difficulty under that chapter. What's a poor high net worth debtor to do?

For some the answer has been an individual chapter 11 case. Individual chapter 11 cases have historically not been the norm, because they required that the individual debtor comply with the same requirements to confirm a plan of reorganization that were applicable to corporations and businesses. To confirm a plan of reorganization, all classes of claims not paid in full in cash on the effective date of the plan have to agree to the alternative treatment the plan proposes. If they do not, the only way to confirm the plan over their dissent is through what is called "cram down"—the process of confirming a plan *notwithstanding* the dissent of an impaired class of creditors. In order to "cram down" a plan on unsecured creditors, the plan must comply with the so-called "Absolute Priority Rule".

The Absolute Priority Rule has been part of bankruptcy jurisprudence since at least 1939. It mandates that in a chapter 11 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 (by voting yes on the plan) to the treatment that pays them less than in full. In a corporate context, this means that shareholders/equity (the lowest priority interest) cannot retain their shares in the debtor if they pay unsecured creditors less than 100% of their claims (unless the creditors *agree* to take less). While there are some "exceptions" to this general rule (they aren't critical here) for an individual chapter 11 debtor, who plainly has no shareholders, this rule meant that the debtor could not retain the property owned when the case was filed unless unsecured creditors were paid in full. Effectively then, the Absolute Priority Rule provided unsecured creditors with a "blocking vote" in an individual chapter 11 case, as the 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. From the debtor's perspective, giving up all of one's pre-petition property would have the effect of rendering the whole "reorganization" process meaningless, as a practical matter.

However, in 2005, Congress amended the Bankruptcy Code through a set of amendments commonly referred to as "BAPCPA" (the "Bankruptcy Abuse Prevention and Consumer Protection Act" of 2005). One of the numerous BAPCPA changes altered the part of Section 1129 of the Bankruptcy Code that implements the Absolute Priority Rule. What the change appeared to do was to permit an individual debtor to confirm a plan of reorganization over the dissent of a senior class of unsecured creditors even while retaining some or even all of his or her property. Depending on how the new language was interpreted a debtor could either retain all of his property or just additional property obtained by the debtor after the commencement of the bankruptcy case (typically a much more limited amount). If the correct interpretation of the changed language was that a debtor could keep all property (the so-called "broad view"), 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 that only the more limited amount of post-petition property could be retained (the so-called "narrow view"), then the Absolute Priority Rule would still be alive and well.

After BAPCPA, the bankruptcy courts split over which of these two interpretations was correct. There were a number of arguments either way. Some courts that adopted the "broad view" concluded that the statutory language plainly and unambiguously abolished the Absolute Priority Rule. Others found the language ambiguous, but still found that the amendment abolished the Absolute Priority Rule because such a conclusion was consistent with what they perceived as a Congressional desire to make individual chapter 11 cases more like chapter 13 cases. On the other hand, the courts adopting the "narrow view" found the language of the amendment ambiguous, and concluded that Congress could not have intended to abrogate such a longstanding concept as the Absolute Priority Rule through ambiguous language. Recently, the Circuit Courts of Appeal in the United States are starting to weigh in on the issue, and some consistency is starting to appear in the analysis.

In re Maharaj 681 F. 3d 558 (4th Cir. 2012) was a prototypical example of the criticality of adopting the "narrow" vs. the "broad" view. In this case the debtors ran a small business (an auto body shop), and fell into debt through their exposure to a fraud scheme. Because their debts exceeded the chapter 13 debt limitations, and they desired to continue their business, they filed an individual chapter 11 case. Their chapter 11 plan proposed to refinance or continue to pay most of their secured debt, and proposed to pay their unsecured creditors roughly two cents on the dollar over five years. The plan would be funded by the debtors retaining and continuing to operate the existing pre-petition business. However, if the Absolute Priority Rule applied, the debtors would be unable to retain the pre-petition business assets unless each of the classes of creditors under the plan voted to accept

the plan. The secured creditors accepted the plan, but only one small unsecured creditor voted on the plan—and they voted no.

The result was that the Absolute Priority Rule applied, and that the debtors could only confirm their plan if they liquidated their business—which of course would have resulted in their having no future business, and no means to fund the plan—a classic individual chapter 11 "catch-22". While sympathetic to this outcome, the bankruptcy court rejected the debtors' arguments that the court should adopt the "broad view" of the BAPCPA amendments, held that the plan could not be confirmed because of the application of the Absolute Priority Rule, and certified the case for appeal directly to the Fourth Circuit Court of Appeals. The Fourth Circuit Court of Appeals affirmed the ruling of the Bankruptcy Court, and held that the BAPCPA amendments did not abrogate the Absolute Priority Rule. In doing so, the Fourth Circuit concluded:

1. The specific BAPCPA amendments at issue were ambiguous because they were susceptible to multiple interpretations (as evidenced by the varying decisions of the bankruptcy courts);

2. BAPCPA did not evidence a Congressional intent to effect an "implied repeal" of the Absolute Priority Rule or "alter longstanding bankruptcy practice" in the context of individual chapter 11 cases; and

3. If Congress had intended to abrogate the Absolute Priority Rule, it could have done so in a much clearer fashion.

Maharaj is proving to be a leading case on the subject, and since the decision, the "narrow view" is clearly gaining the most traction with the courts. Another Circuit Court decision has now followed this reasoning (see *In re Stephens* 704 F. 3d 1279 (10th Cir. 2013)), and at least one other case is presently pending in the 5th Circuit Court of Appeals, from a bankruptcy court decision following the "narrow view". In the Sixth Circuit, which includes Michigan, there is at least one decision from the Bankruptcy Court in Tennessee which also adopts the "narrow view", which has now been affirmed on appeal by the United States District Court. Even in California, a state in which the 9th Circuit Bankruptcy Appellate Panel early on adopted the "broad view", a recent case, decided after the *Maharaj* decision has now concluded that it is not bound to apply the "broad view".

Thus clearly the trend is towards the conclusion that the Absolute Priority Rule is alive and well in individual Chapter 11 cases. And, notwithstanding the "catch-22" experienced by the *Maharaj* debtors, the narrow view doesn't mean that things are hopeless for an individual Chapter 11 debtor. As one court indicated, when it rejected the argument that the Absolute Priority Rule made it impossible for an individual Chapter 11 debtor to confirm a plan unless it paid unsecured creditors in full: "To the contrary, such a plan may be confirmed if the holders of such claims vote in favor of the plan. They are likely to do so if a reasonable dividend is proposed and they conclude that they will receive no dividend in a chapter 7 case." *In re Gbadebo* 431 B.R. 222 (Bankr. N. D. Cal. 2010).

If you're a creditor, you're nodding your head up and down after reading that quote, and the *Maharaj* decision and the cases that have followed it now put some real weight on the scale in favor of creditors. Keep it in mind the next time you encounter an individual chapter 11 case.

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