CHAPTER 11 CRAMDOWN FOR AN INDIVIDUAL AND THE ABSOLUTE PRIORITY RULE (as of 2015)

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The 2005 Bankruptcy Abuse Prevention and Consumer Protection Act ("BAPCPA") provided a number of amendments to the Bankruptcy Code with respect to individuals. Many of the changes have been refined by judicial interpretation over the past ten years. One of the changes that has become more clear as court decisions have developed is whether the absolute priority rule applies to individuals in a chapter 11 case. The early case law analyzing this issue gave rise to a clear split among bankruptcy courts as to whether the absolute priority rule no longer applied with respect to individuals. This analysis was due to the changes made to Bankruptcy Code §§ 1115 and 1129(b)(2)(B)(ii). These sections permit an individual in a cram down situation, with respect to unsecured creditors, to retain property included in the bankruptcy estate under §1115. The question became, how much property could be retained in a cram down? This provision differs from the cram down test under the absolute priority rule with respect to unsecured creditors in a non-individual case where the debtor is not allowed to retain or receive any property on account of the plan. The fair and equitable test with respect to gaining confirmation of a plan over the dissent of a class of unsecured creditors was modified with respect to individuals to account for the fact that the then newly added §1115 included within the estate the debtor's post-petition personal service income. The cram-down provisions had to adjust to allow the debtor to retain the use of personal income in order to survive and allow for a plan confirmation despite the rejecting vote of unsecured creditors. While the model is based on chapter 13, the application of the absolute priority rule causes unique problems for a practitioner who cannot develop a consensual plan.

11 U.S.C. §1115

The 2005 amendments added §1115 to the Bankruptcy Code. Prior to 2005, § 541(a)(7) provided that post-petition income derived from personal services of an individual was not property of the estate. The individual could include all or a portion of their income to fund a plan or pay creditors but they were not required to do so. §1115 was added to the Code to include within the bankruptcy estate all income derived by the

debtor from personal services as well as all of the property described in §541 that the debtor acquires after commencement of the case and before the case is closed, dismissed, or converted to a case under chapter 7, 12, or 13. This amendment had tremendous ramifications for the individual debtor. Once all assets including income were included in the estate, creditors could arguably have a say as to how the income was spent. In order to allow the debtor to confirm a plan over the dissenting vote of unsecured creditors, Congress amended §1129(b) to allow the Debtor to retain certain assets included in the estate under §1115.

11 U.S.C. §1129(b)(2)(B)(ii)

The rules for a cram down of a plan on unsecured creditors are generally contained in §1129(b). A chapter 11 plan could generally be confirmed over the rejection of the plan by unsecured creditors if either the plan paid the unsecured creditors in full or the plan provided that there was no class junior to the unsecured creditor class that would "receive or retain under the plan on account of such junior claim or interest any property". Payment in full was never a very popular option in chapter 11 so the latter portion of this provision received all of the attention. The latter portion became known as the absolute priority rule. It required payment in full to senior classes before a junior class received or retained anything. In short, if the unsecured creditors were not paid in full and they rejected the plan, the plan could not be confirmed over the rejection if the existing shareholders, members or equity received or retained any property. This provision did not work well with an individual who now found their income included in the estate. As a result, §1129(b)(2)(B)(ii) was amended to include the following:

> 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.

The drafting of this provision created the issue of whether the absolute priority rule had been abrogated for individuals. Did the provision mean that the debtor could retain all property included in the estate under §1115 including the property that had traditionally been part of the estate under §541 or did it mean the debtor could only retain the property that was newly added to the estate under §1115, such as personal service income.

The Bankruptcy Court Decisions

Several courts have interpreted §1129(b)(2)(B)(ii) and §1115 together to indicate that Congress intended to exempt individual chapter 11 debtors from the absolute priority rule. *See In re Roedemeier*, 374 B.R. 264 (Bankr. D. Kan. 2007) and *In re Tegeder*, 369 B.R. 477, 480-81 (Bankr. D. Neb. 2007). The *Tegeder* and *Roedemeier* cases were two of the first cases to examine the issue as to the elimination of the absolute priority rule for individuals. In *Tegeder* the court concluded the absolute priority rule was eliminated because §541 was referenced within §1115. In *Roedemeier* the court believed Congress intended to make chapter 11 more like chapter 13 and therefore repealed the absolute priority rule. In the case of *In re Shat*, 424 B.R. 854 (Bankr. D. Nev. 2010) the court analyzed the language of the property of the estate under new §1115 and the apparent ties between chapter 11 and 13 and concluded that the absolute priority rule had been eliminated in order to further the rehabilitative goals of chapter 11. Therefore, according to these courts, a chapter 11 debtor may retain prepetition and post-petition property and still cram-down a plan of reorganization over the objection of unsecured creditors. These courts adopted the so-called "broad view" reading of the statute.

Following these decisions were a series of "narrow view" cases that held that the exception to the absolute priority rule only applied to the property added by §1115 to the definition of property of the estate under §541. The narrow view cases included *In re Gbadebo*, 431 B.R. 222 (Bankr. N.D. Cal. 2010), *In re Mullins*, 435 B.R. 352 (Bankr. W.D. Va. 2010), *In re Karlovich*, 456 B.R. 677 (Bankr. S.D. Cal. 2010), *In re Stephens*, 445 B.R. 816 (Bankr. S.D. Tex. 2011), *In re Walsh*, 447 B.R. 45 (Bankr. D. Mass 2011), *In re Draiman*, 450 B.R. 777 (Bankr. N.D. Ill. 2011), *In re Kamell*, 451 B.R. 505 (Bankr. C.D. Cal. 2011), *In re Maharaj*, 449 B.R. 484 (Bankr. E.D. Va. 2011), *In re Lindsey*, 453 B.R. 886 (Bankr. E.D. Tenn 2011), and *In re Tucker*, 2011 WL 5926757 (Bankr. D.Or. 2011). The cases from 2010 and 2011 were overwhelmingly sided on the narrow view approach. In 2012 through 2014 the cases were similarly overwhelmingly sided with the narrow view reading of the statute.

The Circuit Courts Weigh In

Beginning in 2013, we had Circuit Court decisions that all adopted the narrow view. The rulings by the Circuit Courts have been consistent and their answer is, there is no change in the law for individual debtors with respect to the absolute priority rule. While the debtor may retain post-petition income notwithstanding the fact that it is now included in the estate, the debtor could always retain such income since it was never included in the estate prior to 2005. *In re Lively, 717 F. 3d 406 (5th Cir. 2013); In re Stephens, 704 F. 3d 1279 (10th Cir. 2013); In re Maharaj, 681 F. 3d 558 (4th Cir. 2012),* and *In re Cardin*, 2014 WL 1887583 (6th Cir. 2014). The absolute priority rule clearly applies in these Circuits. The remaining Circuits still contain a mix of Bankruptcy and District Court opinions, however it does seem as though courts are siding more with the narrow view rulings. The Circuit Court decisions contrast with the BAP decision of *In re Friedman*, 466 B.R. 471 (9th Cir. B.A.P. 2012) which adopted the broad view, has been widely criticized, and is not viewed as binding precedent. A court in the Central District of California has eroded the view that held that the absolute priority rule was eliminated by holding that the Ninth Circuit B.A.P. opinion in *Friedman* is not binding on bankruptcy courts in the circuit. *In re Arnold*, 471 B.R. 578 (Bankr. C.D. Cal. 2012).

Many of the narrow view decisions rely on the notion that there was no legislative history to support a change from the past application of the absolute priority rule and even though the statute is ambiguous Congress would have been more explicit if they were changing prior law. The individual debtor in a Chapter 11 is not permitted to retain any non-exempt property in a cram-down on unsecured creditors, with the exception of the new assets added to the estate under §1115, unless the dissenting unsecured creditor class is paid in full.

Do Creditors Really Control the Debtor's Earnings Prior to Confirmation

While §1115 does include the debtor's post-petition earnings in the estate, the question arises as to what degree such assets are subject to the control of creditors. Are the earnings to be treated as if they are cash collateral in which unsecured creditors have an interest or does the debtor have control over their use. Prior to plan confirmation there could be an extended period of estate administration. During this time the debtor should have the right to any applicable state earnings exemption. Under many of these

exemptions the debtor may be able to exempt up to 75% of their earnings from creditor claims, depending upon the state. While 100% of the earnings are property of the estate, there is no limit on the application of exemptions. In fact, §1123(c) provides that in a plan proposed by a creditor in an individual case, the plan may not provide for the use, sale, or lease of exempt property unless the debtor consents. While the debtor may provide under their plan that exempt assets will be used to pay creditors, that provision will not be effective until the plan is confirmed and a debtor should not give up the right to exempt assets prior to plan confirmation. The right to choose to use exempt assets under a plan may be a key bargaining point. The use of exempt assets may constitute "new value" to allow the debtor to retain assets in a cram-down situation.

Is the "new value exception" working?

Several recent cases focus on individual debtors who have attempted to address the absolute priority rule, generally through the new value exception. In *In re Batista-Sanchez*, 505 B.R. 222 (Bankr. N.D. Ill. 2014), the debtor proposed bidding on equity interests to allow unsecured creditors to credit bid on the debtor's equity interests in a sole-proprietorship as a means of satisfying the absolute priority rule. In *In re Gerard*, 495 B.R. 850 (Bankr. E.D. Wis. 2013), the debtor proposed to contribute $27,000 in new value to the plan to retain non-exempt interests. This was ultimately denied because the debtor had a cash account and other assets that exceeded the new value contribution. In *In re Lee Min Ho Chen*, 482 B.R. 473 (Bankr. D.P.R. 2012) the debtor was similarly denied the use of the new value exception because the funds did not come from an external source. While the reported cases on debtors' attempts to utilize the new value exception have largely been found to be unsuccessful primarily because not enough money was being contributed, at least one court has recognized that an individual debtor may use the new value exception to retain non-exempt property in a cram-down and allowed the debtor to retain exempt property. *See Van Buren Indus. Investors v. Henderson (In re Henderson)*, 341 B.R. 783 (M.D. Fla. 2006). In the *Van Buren* case, the new value exception was met through new cash in the amount of $525,000 contributed by the debtor's former wife.

What Else Might Work

In certain cases, the debtor may be able to propose a full payment plan over an extended period of time. The debtor may allow the estate to continue to exist for the duration of the plan and utilize the estate assets as they are used in turn by the debtor to generate the income necessary to fund the plan. At some point in time the debtor will have: a) accomplished the goal of paying off the creditors; b) worked hard enough to allow for a plan amendment to provide for less than full payment and an accepting vote; or c) converted the case to chapter 7 after selling off assets over time and not realizing enough to pay the creditors in full. In many cases, the debtor just needs time to try to sell an asset and pay creditors. Such a strategy may or may not work but at least the debtor will have had a chance to make it work.

The debtor may be able to create a liquidating trust under the plan and transfer all assets to the trust. The trust may then be able to resell the assets to the debtor over time or to the debtor's family members in order to retain continuity and allow the income or profit from sale to be paid to creditors. In the interim the assets could be leased to the debtor by the trust.

In each of these situations, the debtor will have to find a source of "new value" whether it's an outside investor, partner, relative or a wealthy ex-spouse as in the *Van Buren* case. The alternatives include selling the assets over time while retaining them in the estate or an entity created under the plan or placing the assets in a newly created entity to be used to generate value for creditors over time. In such a case an earn back or creditor pay off situation may allow the debtor to reacquire the assets over time.