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BAPCPA's Exception to the Absolute Priority Rule for Individual Chapter 11 Debtors

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INTRODUCTION

Under the absolute priority rule of 11 U.S.C. § 1129(b)(2)(B)(ii), a reorganization plan that gives a junior class of creditors an interest in the estate will not be confirmed unless each senior class receives full payment or gives its consent. The absolute priority rule was amended in 2005 by the Bankruptcy Abuse Prevention and Consumer Protection Act ("BAPCPA") by adding an exception that allows individual chapter 11 debtors to retain property included in the estate under newly added section 1115. This amendment furthers the congressional intent of allowing chapter 11 to function more like chapter 13, under which there is no absolute priority rule for individual debtors.

Recently, in *In re Tegeder*, *In re Roedemeier*, and *In re Bullard*, bankruptcy courts have interpreted this amendment as creating an exception to the absolute priority rule for individual chapter 11 debtors, as retention of pre-petition property and post-petition property and earnings is now acceptable. The exception to the absolute priority rule has also effected unsecured creditor protection. The absolute priority rule must be met in order for "cram down," the confirmation of a reorganization plan over an impaired class' rejection of the plan, to occur. Before the amendment, "cram down" could not occur if an individual debtor retained property. However, the negotiating ability once offered to unsecured creditors under the absolute priority

rule has disappeared. Since the BAPCPA amendment, confirmation is permitted when an individual retains pre-petition property and post-petition property and earnings, even over the objections of unpaid unsecured creditors. Still, some protection for unsecured creditors may remain under the chapter 11 disposable income requirement of section 1129(a)(15). Section 1129(a)(15), which mirrors section 1325(b)(2) for chapter 13, requires the value of property distributed under the plan be no less than the unsecured claim or the commitment of disposable income over at least five years.

I. THE ABSOLUTE PRIORITY RULE AND CHAPTER 11 DEBTORS

A. *The Absolute Priority Rule as Amended by BAPCPA*

The absolute priority rule, as amended by BAPCPA, provides that “the holder of any claim or interest that is junior to the claims of [the class of unsecured creditors] . . . will not receive or retain . . . 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.” 11 U.S.C. § 1129(b)(2)(B)(ii) (2006). Section 1115 provides that property of the estate under chapter 11 includes all property under section 541 acquired post-petition, as well as earnings acquired post-petition, “in addition to the property specified in section 541.” *See* 11 U.S.C. § 1115. Section 541 provides that the estate includes, among other things, “all legal and equitable interests of the debtor in property as of the commencement of the case,” as well as “any interest in property that the estate acquires after the commencement of the case.” *See* 11 U.S.C. § 541(a)(1), (a)(7). Taken together, the estate therefore includes pre-petition property and post-petition property and earnings. Prior to BAPCPA, post-petition earnings were not considered part of the estate.

The 2005 BAPCPA amendment has therefore altered the absolute priority rule, which is central to the law of reorganization. The rule, which predates the Bankruptcy Code, is the source of both substantive rights and procedural protections for reorganization participants. *See In re Armstrong World Indus., Inc.*, 432 F.3d 507, 512 (3d Cir. 2005); Douglas G. Baird, *THE ELEMENTS OF BANKRUPTCY* 81–82 (Rev. ed., The Foundation Press, Inc. 1993). It was intended to give unsecured creditors negotiating power. 432 F.3d at 514–15 (citing H.R. Rep. No. 95-595, at 416).

The absolute priority rule must be met in order for “cram down” to occur under section 1129(b). “Cram down” is the confirmation of a reorganization plan despite an impaired class’ rejection of the plan. The “cram down” provision of section 1129(b)(1) provides that “the court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements [of confirmation] . . . if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interest that is impaired under, and has not accepted, the plan.” 11 U.S.C. § 1129(b)(1). Therefore, under this provision, a reorganization plan can be confirmed despite an impaired class’ rejection of the plan, as long as it does not discriminate unfairly, and is fair and equitable. *See In re Tegeder*, 369 B.R. 477, 479 (Bankr. D. Neb. 2007); 7 *COLLIER ON BANKRUPTCY*, ¶ 1129, at 1129.04 (Alan N. Resnick et al. eds., 15th ed. rev. 2006) (explaining a confirmation can be “crammed down” throat of dissenting class when requirements of 1129(b) are met) (quoting *New English Coal & Coke Co. v. Rutland R. Co.*, 143 F.2d 179, 189 (2d Cir. 1944), where phrase first used by court). In order to be fair and equitable, unsecured claims must be paid in full, or the absolute priority rule must be met. *In re Tegeder*, 369 B.R. at 479. Prior to the BAPCPA amendment to the absolute priority rule, an individual debtor was prohibited from retaining property in order for “cram down” to occur. 369 B.R. at 480.

As a result of BAPCPA's 2005 amendment, property and earnings acquired after the commencement of a case are considered property of the estate. *See* Donald R. Lassman, *Individual Chapter 11s Really Do Work*, 27 AM. BANK. INST. J. 18, 65 (2008). The intent of this new provision was to waive the absolute priority requirements imposed by section 1129(b)(2)(B)(ii) and permit an individual debtor to retain property and earnings included in the estate under section 1115. 6 NORTON BANKR. L. & PRAC. 3d § § 106:1, 113:21 (2008). Although not clearly worded, section 1115 clearly includes post-petition property and earnings as well as pre-petition property that becomes property of the estate under section 541. *See In re Goldstein*, 385 B.R. 496, 498–99 (Bankr. C.D. Cal. 2007). The bankruptcy courts have interpreted section 1115 to mean that the absolute priority rule no longer applies to individuals retaining property of the estate under section 1115. Therefore, confirmation of a plan is permitted when individual debtors retain property and earnings, even over the objections of unpaid unsecured creditors. *See In re Bullard*, 358 B.R. 541, 544 (Bankr. D. Conn. 2007); *In re Roedemeier*, 374 B.R. 264, 274 (Bankr. D. Kan. 2007); *In re Tegeder*, 368 B.R. 477, 478 (Bankr. D. Neb. 2007). Thus, chapter 11 has taken on characteristics of chapter 13, under which the absolute priority rule does not exist.

B. BAPCPA Aims to Allow Chapter 11 to Function Like Chapter 13

BAPCPA's ratification has led to the development of chapter 11 for individual debtors as a mingling of chapters 11 and 13, with the intention of allowing chapter 11 proceedings to function like those under chapter 13. *Another Court Holds that Absolute Priority Rule Does Not Apply to Individual Chapter 11 Debtors Post-BAPCPA*, <http://miamifloridabankruptcylawyer.wordpress.com> (Aug. 25, 2007, 17:53 EST). This is apparent in both the amendment to section

1129(b)(2)(B)(ii) and the addition of section 1115. The exception to the absolute priority rule for individual chapter 11 debtors under section 1129(b)(2)(B)(ii) is drawn from principles of chapter 13, under which there is no absolute priority rule. Furthermore, the definition of property of the estate provided in section 1115 for chapter 11 filings emulates the definition of property of the estate provided in section 1306(a) for chapter 13 filings. *Id.* Since the BAPCPA amendment, post-petition earnings are property of the chapter 11 estate. Therefore, in expanding the definition of property, section 1115 treats post-petition earnings under chapters 11 and 13 the same. *Id.* In doing so, BAPCPA addresses the concern that although individuals can file under chapter 11, it is not tailored for them.

A chapter 11 proceeding, although more complex and costly than one under chapter 13, can provide relief for those individuals deep in debt who cannot file under chapter 13. *See* Donald R. Lassman, *Individual Chapter 11s Really Do Work*, 27 AM. BANK. INST. J. 18, 18 (2008). Still, although individuals may be required to file chapter 11, most seeking rehabilitation will file chapter 13. Paul W. Bonapfel, *Individual Chapter 11 Cases Under BAPCPA*, 25 AM. BANKR. INST. J. 53, 54 (July, Aug. 2006). Generally, “there are many more opportunities for creditors to press their agenda in the chapter 11 process,” and therefore it is necessary to contemplate creditor intervention. Lassman, *supra*, at 66. However, this may not be the case in commonly arising disputes regarding payment terms to general unsecured creditors. *Id.* at 67. After an initial demonstration of the plan’s conformity with section 1129, a submission of a creditor voting affidavit, and the availability of witness testimony regarding the plan’s feasibility, “cram down” is possible under section 1129(b) when more than one class of creditors is impaired. *Id.* at 68. The absolute priority rule had given creditors leverage in

challenging individual chapter 11 debtors' plans, but it no longer applies to individual debtors attempting to retain property after plan confirmation. *Id.*

C. *Recent Interpretations of the BAPCPA Amendment to the Absolute Priority Rule*

Those courts having addressed the BAPCPA amendment of the absolute priority rule have concluded that the absolute priority rule no longer applies to individual chapter 11 debtors. This interpretation of the amendment is illustrated by the decisions of *In re Tegeder*, *In re Roedemeier*, and *In re Bullard*. To come to this conclusion, the bankruptcy courts addressed the interaction of sections 1129(b)(2)(B)(ii), 1115, and 541, as well as the congressional intent behind BAPCPA. *In re Tegeder* was the first decision to address the absolute priority rule amendment.

i. *In re Tegeder*

The bankruptcy court in *In re Tegeder* held that the addition of section 1115 to the Bankruptcy Code by the 2005 BAPCPA amendments created an exception to the absolute priority rule for individual chapter 11 debtors. 368 B.R. 477, 478 (Bankr. D. Neb. 2007). In *Tegeder*, the individual debtors filed a chapter 11 plan, confirmation of which was objected to by the U.S. Trustee. *Id.* The plan was accepted by all classes except the general unsecured creditor class. *Id.* As the general unsecured creditor class did not accept the proposed chapter 11 plan, the "cram down" provisions of 11 U.S.C. § 1129(b) were triggered. *Id.* at 478, 479. The debtors retained all of their property, which included both pre-petition and post-petition property and earnings. *Id.* at 479. Although all other requirements for plan confirmation under section 1129(a) were met, the U.S. Trustee argued that the debtor, as a holder of interests junior to the

dissenting class, could not retain any property pursuant to the absolute priority rule of section 1129(b)(2)(B)(ii). *Id.*

Addressing the effect of the cross-reference to section 1115 in section 1129(b)(2)(B)(ii), the *Tegeder* court held that the absolute priority rule did not prevent a plan's confirmation when both pre- and post-petition assets were retained by an individual debtor. *Id.* at 478. The court explained that the 2005 BAPCPA amendment and the addition of section 1115 created an exception to the rule, allowing an individual debtor to retain property included in the estate. *Id.* at 479–80. Section 1115 includes post-petition earnings, as well as property of the estate under section 541. *Id.* at 480. This property includes legal and equitable interests held pre-petition, as well as post-petition property. *Id.* Thus, the court reasoned that the debtor's retention of pre-petition property and post-petition property and earnings was permitted. *Id.* at 478. The court cautioned that the plan must still be fair and equitable. *Id.* at 480. The plan proposed had not been objected to on fairness grounds. *Id.* Therefore, as the plan treated unsecured creditors equitably, it was confirmed. *Id.* at 481.

In re Tegeder set forth the proposition that the absolute property rule is inapplicable to those individual debtors retaining property of estate under section 1115. *Id.* at 480. The courts in *In re Roedemeier* and *In re Bullard* have reached similar conclusions.

ii. In re Roedemeier

Building on the foundation of *In re Tegeder*, the bankruptcy court in *In re Roedemeier* held that sections 1115 and 1129(b)(2)(B)(ii) should be construed broadly to cover property brought into the estate by both sections 1115(a) and 541, as well as to explain the purpose of the BAPCPA amendment of the absolute priority rule. 374 B.R. 264, 275–76 (Bankr. D. Kan. 2007). In *Roedemeier*, an individual debtor operated a dental practice through a limited

liability company. *Id.* at 266. After being pursued for collection of a debt guarantee, the individual debtor filed a chapter 11 bankruptcy petition and proposed a simple reorganization plan. *Id.* at 266–67. The plan was not objected to, yet the court was required to make certain it conformed to the confirmation requirements of section 1129. *Id.* at 270. As section 1129(a)(8) had not been met, the debtor suggested that the class of unsecured creditors be treated as having objected to the plan. *Id.*

The *Roedemeier* court had to address the absolute priority rule in order to grant the debtor’s request for “cram down” under section 1129(b) and plan confirmation over the objections of the impaired general unsecured creditors. *Id.* at 271. The court found the plan to be nondiscriminatory, as required by section 1129(b), because the general unsecured creditors were within a single class and therefore treated uniformly. *Id.* at 273. In assessing whether the plan was fair and equitable, the plan had to conform to the absolute priority rule of section 1129(b)(2)(B)(ii), which was amended with the addition of the “except” clause. *Id.* at 274. The court reasoned that the addition of section 1115 should be interpreted broadly to cover both pre-petition property under section 541 and post-petition property and earnings under section 1115(a). *Id.* Therefore, the debtor could retain pre-petition property, including ownership of the limited liability company, despite a class of unsecured creditors not being paid in full. *Id.* at 276. The court’s expansive interpretation would not subject an individual chapter 11 debtor to the absolute priority rule. *Id.* Furthermore, the court’s interpretation allowed for chapter 11 to function more like chapter 13 for individual debtors, the underlying purpose of the BAPCPA amendment of the absolute priority rule. *Id.* at 275–76. If narrowly interpreted to apply only to post-petition property under section 1115(a), a debtor’s ability to reorganize under chapter 11

would be minimally affected. *Id.* at 275. The court explained that this would not carry out Congress' intent in ratifying BAPCPA. *Id.*

The *Roedemeier* court held the chapter 11 reorganization plan exempt from the absolute priority rule and meeting the "cram down" requirements. *Id.* at 276. Therefore, the plan was confirmed despite unsecured creditors receiving only three percent distribution on their claims. *Id.* To reach such a conclusion, *In re Roedemeier* relied on a broad construction of the absolute priority rule exception. *Id.* at 274.

iii. In re Bullard

The court in *In re Bullard* similarly held, based on section 1129(b)(2)(B)(ii), that a chapter 11 reorganization plan could be confirmed despite the debtor's retention of post-petition property and earnings. 358 B.R. 541, 544 (Bankr. D. Conn. 2007). The individual debtor's plan, to which no objections were filed, intended retention of post-petition property and earnings. *Id.* at 542–43. As the requirements of section 1129(a) were met, except paragraph eight, the court addressed whether the debtor could "cram down" the nonaccepting impaired classes. *Id.* at 543. The court, deferring to the BAPCPA amendment, explained confirmation would occur only if section 1129(b)(2)(B)(ii) was met. *Id.* *In re Bullard* acknowledged that the BAPCPA amendment altered the absolute priority rule, a fundamental principle of reorganization law. *Id.* (citing *Northwest Bank Worthington v. Albers*, 485 U.S. 197 (1988)). Nevertheless, based on the absolute priority rule exception, the court concluded that the debtor could retain post-petition property and earnings under section 1115. *Id.* at 544.

II. PROTECTION FOR CREDITORS

A. *The Exception to the Absolute Priority Rule and Its Effect on Creditors*

The current interpretation of section 1115, as illustrated by the bankruptcy courts in *In re Tegeder*, *In re Roedemeier*, and *In re Bullard*, has created an exception to the absolute priority rule for individual chapter 11 debtors and permitted the retention of pre-petition property and post-petition property and earnings even over the objections of unpaid unsecured creditors. *See* 358 B.R. at 544; 374 B.R. at 276; 368 B.R. at 480. Thus, a single phrase added to the end of section 1129(b)(2)(B)(ii) by the BAPCPA amendment appears to have eliminated a creditor's ability to challenge the reorganization plan of an individual chapter 11 debtor who seeks to retain property and earnings after confirmation. *See* Donald R. Lassman, *Individual Chapter 11s Really Do Work*, 27 AM. BANK. INST. J. 18, 68 (2008).

B. *Protection for Creditors Under the Disposable Income Requirement*

The protection once offered to a creditor in challenging the reorganization plan of a chapter 11 debtor who seeks to retain property and earnings after plan confirmation appears to have been replaced by the new disposable income confirmation requirement of section 1129(a)(15). *See* 11 U.S.C. § 1129(a)(15). This requirement, unlike "cram down," can only be invoked by a single unsecured creditor who objects to confirmation. *See In re Roedemeier*, 374 B.R. at 271; Bonapfel, *supra*, at 57. Under the disposable income requirement added by BAPCPA, the property distributed cannot be less than the unsecured claim's value. *Individual Chapter 11 Cases After BAPCPA: Can You Still Close the Case Early?*, <http://www.abiworld.org> (Aug. 1, 2006). Otherwise, section 1129(a)(15) requires a projected disposable income commitment from the debtor for five years or that time provided under the plan, whichever is

longer. Bonapfel, *supra*, at 57. The chapter 11 disposable income requirement of section 1129(a)(15) parallels the chapter 13 disposable income requirement of section 1325(b)(2). *Id.* Taken together with the absolute priority rule exception, the disposable income requirement was meant to align plan confirmation under chapter 11 with that under chapter 13. *See* Lassman, *supra*, at 68; *Individual Chapter 11 Cases After BAPCPA*. However, the congressional intent to incorporate the chapter 13 concept of disposable income may not have been successful. Bonapfel, *supra*, at 57. Although section 1129(a)(15) prohibits the distributed value from being less than the projected disposable income, it does not require payments to unsecured claim holders. *Id.* Still, the disposable income requirement is arguably a success in disciplining the debtor, post confirmation, in observance of plan terms during their disposable income commitment. Lassman, *supra*, at 67.

CONCLUSION

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 amended the absolute priority rule for individual chapter 11 debtors in order for chapter 11 to function more like chapter 13. This amendment has been interpreted by the bankruptcy courts in *In re Tegeder*, *In re Roedemeier*, and *In re Bullard*. Those courts have found that the absolute priority rule no longer applies individual chapter 11 debtors retaining property of the estate under section 1115. Therefore, unsecured creditors may have to look to the disposable income requirement of section 1129(a)(15) for protections once offered under section 1129(b)(2)(B)(ii). These recent developments are especially of weight as those chapter 11 filings under BAPCPA are likely to increase throughout the coming year. Michael D. Sousa, *Recent Developments in Chapter 11*, NORTON ANN. SURVEY OF BANKR. L. Part III § 18, 861 (Aug. 2008).