

Mock Appellate Argument: Individual Chapter 11— Does the Absolute Priority Rule and the Preconfirmation Use of the Debtor’s Disposable Income Apply in Individual Chapter 11 Cases?

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INDIVIDUAL CHAPTER 11 DEBTOR FACT SCENARIO

John and Jane Smith are both employed as pharmacists by Feel Well Pharmacy. They are paid twice per month. Ten years ago they decided to invest in real estate, and have purchased five homes as rental properties. Each purchase was financed with a loan from Big Bank, which took a lien on each home to secure the purchase money loan. The loan documents in favor of Big Bank all provide the bank with a lien on rents generated by the property. Three of the properties have a current value in excess of the purchase money loan in favor of Big Bank, but two of the homes were purchased shortly before the downfall in the real estate market and are worth substantially less than the debt to Big Bank. All of the homes are leased to tenants. The three homes that have equity in them are self-sufficient, generating rentals in an amount in excess of operating expenses and debt service. The rental income on the last two, however, is insufficient to pay operating expenses and debt service, and prior to their bankruptcy filing the Smiths subsidized the deficiency through their employment income and the excess income from the first three homes. The loans on the five rental properties are cross-collateralized by the rental properties.

Jane Smith was involved in an auto accident, and her injuries required her to take a year off from her employment. While they have health insurance through Feel Well Pharmacy, it did not pay the full amount charged for Jane's hospitalization and other costs. The Smiths were not able to continue subsidizing the shortfalls on the last two homes they purchased, and allowed the loans on them to Big Bank to go into default. Because the loans are cross-collateralized by all the property, Big Bank commenced foreclosure proceedings against all five properties. The Smiths hired Mr. Fix It, Inc. to make repairs and renovations to several of their rental properties, but were unable to pay him after the loss of Jane's income. Mr. Fix It lost his patience on not being paid and filed a lawsuit seeking a judgment for the amounts owed him; however, he did not perfect a mechanics lien against the properties. The Smiths also fell behind on their credit card payments, which they used to a large extent to cover living and business expenses, and some medical expenses, following Jane's accident. The Smiths ended up on the receiving end of collection efforts by the credit card issuers. Several medical care providers also brought suit to collect the amounts charged for Jane's medical care which were not paid by their insurance carrier.

In order to resolve their debt challenges, the Smiths filed a chapter 11 bankruptcy petition in the United States Bankruptcy Court for the Western District of Missouri. During the case the Smiths used the income from their employment and from their rental homes to pay business and personal living expenses, but did not seek court approval for use of cash collateral until Big Bank filed a motion to prohibit use of cash collateral two months into the case. In response to Big Bank's motion, the Smiths sought the bankruptcy court's permission to use cash collateral under § 363 and submitted a budget for the operation of their rental business and for their personal living expenses. Shortly after the case was filed, Mrs. Smith completed her physical rehabilitation and returned to full time employment, allowing the Smiths' income to return to its

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pre-bankruptcy levels. The Smiths celebrated Mrs. Smith's recovery by taking a Caribbean cruise costing \$15,000, which they paid for with post-petition rents from their rental properties. The use of these funds for the cruise was not disclosed by the Smiths in their monthly reports or their disclosure statement, but was revealed during the course of the confirmation hearing. The Smiths did not offer to pay into their debtor-in-possession account the \$15,000 which was used to pay for their cruise.

The Smiths' schedules indicate the following values for their assets, along with the following debts:

Item	Value	Lien
Personal residence	\$600,000	\$400,000
Household Furnishings	\$50,000	\$0.00
Retirement Accounts	\$300,000	\$0.00
Rental Home #1	\$300,000	\$200,000
Rental Home #2	\$350,000	\$225,000
Rental Home #3	\$330,000	\$200,000
Rental Home #4	\$300,000	\$400,000
Rental Home #5	\$330,000	\$450,000

As of the date of their bankruptcy filing, the Smiths owed the following unsecured debts:

Creditor	Debt
Mr. Fix It	\$80,000
Medical bills (to various creditors)	\$350,000
Credit Cards	\$200,000

The Smiths' combined salaries at Feel Well Pharmacy is \$250,000 per year. Their disposable income from their employment and the operation of rental homes 1, 2 and 3 (and without any deduction or offset from the operating losses of rental homes 4 and 5) is \$20,000 per year. However, they have expensive tastes and could reasonably live more modestly and increase their disposable income to \$35,000 per year.

The Smiths proposed a plan of reorganization. The plan placed Big Bank's loans into one class, and proposed to pay Big Bank by replacing the five existing notes with one note secured by all five properties. The note will bear interest at 4.5% and is amortized over 30 years. The plan placed the claims of Mr. Fix It, the medical bills and the credit card debt into one class, which is to be paid in full without interest over a period of five years.

Big Bank voted to accept the plan, and did not raise any objection to confirmation or seek to change its vote when the debtors disclosed at the confirmation hearing their misuse of cash collateral. The class of unsecured creditors voted to reject the plan. Mr. Fix It filed an objection to the plan, contending the plan could not be confirmed for the following reasons because (1) it violates the Absolute Priority Rule of 11 U.S.C. § 1129(b)(2)(B) and could not be confirmed over the rejecting vote of the impaired class of unsecured creditors, and (2) because the Smiths

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had not submitted or obtained approval of a budget and used cash collateral without seeking authority to do so under § 363, the Smiths did not comply with applicable provisions of title 11, and so confirmation should be denied under § 1129(a)(2). At the confirmation hearing, Mr. Fix It specifically objected under § 1129(a)(2) based on the new evidence of the \$15,000 expenditure for the cruise. The bankruptcy court confirmed the plan, following the line of cases that hold that the Absolute Priority Rule does not apply in individual chapter 11 cases. The bankruptcy court also rejected Mr. Fix It's objections under 1129(a)(2) and found that the Smiths had adequately complied with the applicable provisions of title 11. Mr. Fix It has perfected an appeal to the Bankruptcy Appellate Panel for the Eighth Circuit.

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IN THE UNITED STATES BANKRUPTCY APPELLATE PANEL
FOR THE EIGHTH CIRCUIT

In Re:)	
JOHN SMITH and JANE SMITH,)	BAP No. 12-123
)	
Debtors)	Bankr. No. 12-12345
_____)	
)	
MR. FIX IT, INC.)	APPEAL FROM ORDER
)	CONFIRMING DEBTORS' PLAN OF
Appellant)	REORGANIZATION
)	
v.)	
)	
JOHN SMITH and JANE SMITH,)	
)	
Appellees)	

APPELLANT'S OPENING BRIEF

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ISSUES ON APPEAL

1. Did the Bankruptcy Court err in confirming the Debtor’s plan of reorganization under § 1129(b) where the plan, which allowed the Debtors to retain property which was property of the estate under § 541, was rejected by an impaired class of unsecured creditors?

2. Did the Bankruptcy Court err in finding that the Debtors complied with applicable provisions of title 11 for purposes of § 1129(a)(2), where the Debtors used cash collateral post-petition without seeking court authority and also failed to propose a budget for their post-petition living expenses and used post-petition property to pay for a luxury cruise?

ARGUMENT

I. THE BANKRUPTCY ERRED IN CONFIRMING THE DEBTORS’ PLAN BECAUSE THE PLAN ALLOWED THE DEBTORS TO RETAIN PROPERTY WHICH WAS PROPERTY OF THE ESTATE UNDER § 541 BUT WAS REJECTED BY AN IMPAIRED CLASS OF UNSECURED CREDITORS

Section 1129(b)(2) contains what is commonly known as the Absolute Priority Rule for confirmation. When a debtor proposes a plan which has not been accepted by an impaired class of claims, the court may confirm the plan only if it meets the absolute priority rule. A debtor may “cram down” the plan—obtain confirmation—over a rejecting class of unsecured creditors only if the plan provides one of two treatments: (a) the plan provides that each holder of a claim in the rejecting class receive property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or (b) the plan provides that the holder of any claim or interest that is junior to the rejecting class will not receive or retain under the plan 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.*

The Bankruptcy Court interpreted the italicized language quoted above as rendering the absolute priority rule not applicable in individual chapter 11 cases, meaning that an individual

debtor's need not comply with the absolute priority rule in order to be confirmed. The Appellant respectfully suggests that the Bankruptcy Court erred in doing so.

Brief History of the Absolute Priority Rule

The absolute priority rule traces its origins to the latter half of the nineteenth century, when it was articulated by the Supreme Court in response to widespread collusion in the context of railroad bankruptcies. *See In re Maharaj*, 681 F.3d 558 (4th Cir. 2012). In order to reign in this collusion, the Court announced that “stockholders are not entitled to any share of the capital stock nor to any dividend of the profits until all debts of the corporation are paid.” *Id.* (citing *Chi. Rock Island & Pac. R. R. v. Howard*, 74 U.S. 392 (1868)). However, the absolute priority rule was never codified into the Bankruptcy Act, and in 1952 Congress enacted amendments to the Act prohibiting further judicial application of the rule on an absolute basis, providing instead that “confirmation of an arrangement shall not be refused solely because the interests of the debtor. . . or its stockholders. . . will be preserved.” *Id.*

In 1978 Congress enacted the Bankruptcy Code, including in it the absolute priority rule of § 1129(b)(2)(B)(ii). The rule remained unchanged until the passage of BAPCPA in 2005.

The Majority of Courts Have Correctly Ruled That BAPCPA did not Abrogate the Absolute Priority Rule in Individual Chapter 11 Cases

Section 541(a)(1) of the Code provides that a bankruptcy estate consists of “all legal or equitable interests of the debtor in property as of the commencement of the case.”

Section 1115, which was added by BAPCPA, provides in pertinent part:

(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. . . ; 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. . . .“

In those instances where an individual debtor seeks to confirm a plan over the rejecting vote of a dissenting impaired class of unsecured creditors, the plan must meet the requirements of § 1129(b)(2)(B)(ii), which following BAPCPA now provides that in order to be considered fair and equitable, a plan must provide that:

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.* . . . (emphasis added)

A minority of courts have interpreted § 1129(b)(2)(B)(ii) as abrogating the absolute priority rule in individual chapter 11 cases. These courts take a “broad view” of § 1129(b)(2)(B)(ii), interpreting the phrase “property included in the estate under section 1115” to also include property included in the estate under § 541. *See, for example, In re Friedman*, 466 B.R. 471 (9th Cir. BAP 2012); *In re Shat*, 424 B.R. 854 (Bankr. D. Nev. 2010). Several “broad view” courts also justify their interpretation based on their view that Congress intended individual chapter 11 cases to operate similarly to chapter 13 cases, noting similarities between what constitutes property of the estate under § 1306 and § 1115.. *In re Friedman, supra* at 482; *In re Shat, supra* at 862.

The majority of courts, however, have adopted a “narrow view” of § 1129(b)(2)(B)(ii), interpreting the phrase “property included in the estate under section 1115” to refer only to property acquired by the debtor after the case is filed and the debtor’s post-petition earnings. *See, for example, In re Maharaj, supra; In re Kamell*, 451 B.R. 505 (Bankr. C.D. Cal. 2011) (rejecting the 9th Circuit BAP’s reasoning in *In re Friedman*); *In re Gbadebo*, 431 B.R. 222

(Bankr. N.D. Cal. 2010). Appellant submits that the “narrow view” adopted by a majority of courts to have addressed the issue, is the appropriate view.

First, several of the “narrow view” courts have note that the language of § 1129(b)(2)(B)(ii) preserved the absolute priority rule in unambiguous terms. In re Tucker, 2011 WL 5926757 (Bankr.D.Or.2011); In re Gbadebo, *supra* at 229. Second, had Congress intended to abrogate the absolute priority rule for individuals, it could and likely would have done so in a much less convoluted way, such as by stating specifically that it does not. In re Kamell, 451 B.R. 505, 509 (Bankr.C.D.Cal.2011); In re Karlovich, 456 B.R. 677, 682 (Bankr.S.D.Cal.2010). Third, the “narrow view” cases correctly reject the argument that Congress intended to make individual chapter 11 proceedings to be more akin to chapter 13 bases. As noted by the court in Karlovich, had Congress intended that result, it would simply have amended the statutory debt ceilings for chapter 13. *Id.*

Finally, as noted by the court in In re Lindsey, 453 B.R. 886 (Bankr.E.D.Tenn.2011), “[T]he narrow interpretation [is] more in line with the primary purpose of BAPCPA to improve bankruptcy law and practice by restoring personal responsibility and integrity in the bankruptcy system and ensure that the system is fair for both debtors and creditors.” *Id.* at 904 (quoting H.R. Rep No. 109-31, pt. 1 at 2); *see also* Gbadebo, 431 B.R. at 229 (“No one who reads BAPCPA as a whole can reasonably conclude that it was designed to enhance the individual debtor's ‘fresh start.’ ”).

The only Circuit Court to address the issue so far is the United States Court of Appeals for the Fourth Circuit, which adopted the “narrow view” in its decision in Maharaj, 681 F.3d 558 (4th Cir. 2012). Appellant suggests that the reasoning of the Fourth Circuit in Maharaj is compelling and should be adopted by this court.

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The Fourth Circuit in *Maharaj* noted that prior to BAPCPA, property of the estate in an individual chapter 11 case did not include the debtor's post-petition earnings or assets acquired by the debtor after filing bankruptcy. *Id.* at 569. As a result, an individual debtor could retain his post-petition acquired property and earnings in a plan without running afoul of the absolute priority rule. *Id.* With the addition of § 1115, an individual debtor could no longer retain post-petition property and earnings and obtain confirmation of a plan under the Code's cram down provisions, unless a corresponding change was also made to § 1129(b)(2)(B)(ii). *Id.* By adding the language excepting property added by § 1115 from the absolute priority rule of § 1129(b)(2)(B)(ii), Congress merely incorporated and maintained the pre-BAPCPA absolute priority rule so that it remained the same for all chapter 11 debtors. *Id.* at 570. The *Maharaj* court stated that adherence to the narrow view results in bringing post-petition acquired property into the estate, thereby extending the automatic stay in chapter 11 cases to an individual debtor's post-petition earnings and assets and including them in the various tests for confirmation of the debtor's plan, while at the same time permitting the debtor to retain his post-petition earnings and assets and still obtain confirmation of his plan under the cram down provisions of § 1129. *Id.*

This analysis of the *Maharaj* court is consistent with the analysis of the Sixth Circuit in *In re Seafort*, 669 F.3d 662 (6th Cir.2012). The *Seafort* Court was faced with a similar question in connection with § 1306(a), the parallel chapter 13 provision to § 1115.¹ The Sixth Circuit

¹ 11 U.S.C. § 1306(a) provides:

Property of the estate includes, in addition to the property specified in section 541 of this title—

(1) all property of the kind specified in such section that the debtor acquires after the commencement of the case but before the case is closed, dismissed, or converted to a

interpreted the statute as follows: “Sections 1306(a) expressly incorporates § 541. Read together, § 541 fixes property of the estate as of the date of filing, while § 1306 adds to the ‘property of the estate’ property interests which arise post-petition.” *Seafort*, 669 F.3d at 667.

The Fourth Circuit refused to conclude that Congress intended to repeal the absolute priority rule through BAPCPA:

Strongly supporting our conclusion that the BAPCPA amendments did not abrogate the absolute priority rule is the Supreme Court's view, especially in the bankruptcy context, that implied repeal is strongly disfavored. Indeed, Debtors concede that adoption of their position would represent a significant departure from pre-BAPCPA bankruptcy practice.

As the Fourth Circuit noted, “repeals by implication are not favored and therefore, the intention of the legislature to repeal must be clear and manifest.” *The Last Best Beef, LLC v. Dudas*, 506 F.3d 333, 338 (4th Cir. 2007) (quoting *TVA V. Hill*, 437 U.S. 153, 189 (1978)). The canon against implied repeal is particularly strong in the field of bankruptcy law. In interpreting the Code, the Court was mindful that courts “will not read the Bankruptcy Code to erode past bankruptcy practice absent a clear indication that Congress intended such a departure.” *Hamilton v. Lanning*, 130 S. Ct. 2464 (2010); *see also Hall v. United States*, 132 S.Ct. 1882 (2012).

After reviewing the language of both §§ 1129(b)(2)(B)(ii) and 1115, the Fourth Circuit in *Maharaj* found no clear indication that Congress intended to abrogate the longstanding absolute priority rule for individual chapter 11 debtor. The Fourth Circuit was unable to draw from it a clear Congressional intent to abrogate the rule. To the contrary, the Court agreed that, if Congress intended to abrogate such a well-established rule of bankruptcy jurisprudence, it could have done so in a far less convoluted manner. *Maharaj*, 681 F.3d at 571.

case under chapter 7, 11, or 12 of this title, whichever occurs first; and

(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, 11, or 12 of this title, whichever occurs first.

In addressing the argument by proponents of the “broad view” that BAPCPA abrogated the absolute priority rule in individual chapter 11 cases, the Fourth Circuit in *Maharaj* noted that Congress nowhere in BAPCPA expressed an intent to enact such a sea change in the application of the rule and, had it actually intended to do so, it could have in a much less convoluted way by simply increasing the debt limits for chapter 13 eligibility. *Id.* at 574.; *see also In re Karlovich*, 456 B.R. 677, 682 (Bankr. S.D. Cal. 2010).

As a result, Mr. Fix It respectfully submits that this Court should adopt the reasoning of those courts holding to the “narrow view” and conclude that BAPCPA did not abrogate the absolute priority rule in individual chapter 11 cases.

II. THE BANKRUPTCY ERRED IN CONFIRMING THE DEBTORS’ PLAN UNDER § 1129(a)(2) BECAUSE THE DEBTORS FAILED TO COMPLY WITH APPLICABLE PROVISIONS OF TITLE 11

One of the required elements a plan proponent must establish in order to obtain confirmation of a plan is that “the proponent of the plan complies with the applicable provisions of title 11. *11 U.S.C. § 1129(a)(2)*. In this particular case, the failure was the Smiths’ use of cash collateral for purposes that were not allowed by the Court as well as their failure to reimburse the estate for the use of the \$15,000 inappropriately spent on their cruise.²

Section 363(c)(2) of the Bankruptcy Code provides that a debtor in possession may not use cash collateral unless (1) each entity that has an interest in the cash collateral consents or (2) the court, after notice and hearing, authorizes such use. *11 U.S.C. § 362(c)(2)*. By using cash collateral without seeking prior court approval and by using cash collateral in violation of the court order approving such use, the Smiths failed to comply with an applicable provision of title 11, and the bankruptcy court erred in finding that the Smiths had complied with all applicable

² The Debtors never asserted that the expenditure for the cruise was an ordinary course transaction and cannot assert such.

provisions and in confirming their plan.

The elements of confirmation in § 1129 are there for a reason. A debtor seeking to change his obligations to his creditors, almost always to the creditors' detriment and the debtor's benefit, must satisfy certain standards to justify the benefits he seeks. One of those requirements is that the debtor must comply with all provisions of title 11 that are applicable to his case. Denial of confirmation is, and should be, the penalty for failing to do so.

“*Section 1129(a)(2)* conditions confirmation on the debtors' compliance with the applicable provisions of Chapter 11. To the extent that the administrative provisions of Chapter 3 apply to cases under Chapter 11, a debtor must also abide by Chapter 3 or risk non-confirmation.” *In re Cothran*, 45 B.R. 836, 838 (Bankr. S.D. Ga. 1984) (denying confirmation of a plan where the debtor used cash collateral without court permission). Even relatively minor failures to comply with title 11, if uncured, are grounds to deny confirmation under § 1129(a)(2). *In re Lapworth*, 1998 WL 767456 (Bankr. E.D. Pa. 1998) (denying confirmation where debtor has paid \$3,250 in post-petition interest to an unsecured creditor and did not cure the error prior to the confirmation hearing). In certain instances where the debtor's failure to comply with an applicable provision of title 11 is incurable, the bankruptcy court may have no choice but to dismiss the debtor's chapter 11 case. *In re Keiser*, 204 B.R. 697 (Bankr. W.D. Tex. 1996) (holding, dismissal appropriate as to one joint debtor where she failed to appear at the section 341 meeting of creditors).

In the present case, the debtors used rents generated by their rental properties for two months without seeking court permission for use of cash collateral. Only after Big Bank sought to prohibit use of cash collateral did the debtors seek to comply with § 363's requirements on such use. The debtors failed to disclose the use of cash collateral in a way that was not

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authorized by the court in either their operating reports or in their disclosure statement. Although these failures were likely curable, the debtors made no attempt to cure them. There is simply no basis on which to find that the debtors complied with applicable provisions of the Bankruptcy Code, and the bankruptcy court erred in confirming the plan.

CONCLUSION

For the foregoing reasons, Mr. Fix It respectfully submits that the Bankruptcy court erred in confirming the Debtors' plan. This Court should reverse the order of the Bankruptcy Court.

Dated: August 20, 2012.

HOLLAND & HART LLP

By: Mona L. Burton
Counsel for Appellant

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IN THE UNITED STATES BANKRUPTCY APPELLATE PANEL
FOR THE EIGHTH CIRCUIT

In Re:)	
JOHN SMITH and JANE SMITH,)	BAP No. 12-123
)	
Debtors)	Bankr. No. 12-12345
_____)	
)	
MR. FIX IT, INC.,)	APPEAL FROM ORDER
)	CONFIRMING DEBTORS' PLAN OF
Appellant)	REORGANIZATION
)	
v.)	
)	
JOHN SMITH and JANE SMITH,)	
)	
Appellees)	

BRIEF FOR APPELLEES JOHN SMITH AND JANE SMITH

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ISSUES ON APPEAL

1. Did the Bankruptcy Court err in confirming the Debtors' plan of reorganization after determining that the absolute priority rule does not apply in chapter 11 cases filed by individuals?

2. Did the Bankruptcy Court err in finding that the Debtors complied with the provisions of title 11 for purposes of 11 U.S.C. § 1129(a)(2) when, *inter alia*, the Debtors' secured creditor did not object to the Debtors' use of cash collateral or plan of reorganization?

ARGUMENT

I. THE BANKRUPTCY CORRECTLY CONFIRMED THE DEBTORS' PLAN OF REORGANIZATION AFTER DETERMINING THAT THE ABSOLUTE PRIORITY RULE DOES NOT APPLY IN CHAPTER 11 CASES FILED BY INDIVIDUALS.

Chapter 11 of title 11 of the United States Code (the "Bankruptcy Code" or "Code") permits a debtor (or potentially another party interest) to file a plan to reorganize the debtor's finances. *See generally* 11 U.S.C. §§ 1121, 1123. Generally speaking, a plan can be confirmed in one of two ways: "If all sixteen paragraphs of Section 1129(a) are satisfied, a plan can be confirmed consensually under Section 1129(a). If, however, a plan proponent satisfied all paragraphs of Section 1129(a) other than the voting requirement of paragraph (8), then the court may still confirm the plan as long as the plan is, among other things, 'fair and equitable.' This second, nonconsensual method of confirmation is colloquially referred to as a 'cramdown.'" *In re Shat*, 424 B.R. 854, 857–58 (Bankr. D. Nev. 2010) (footnotes omitted).

Prior to the passage of The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"), the Bankruptcy Code provided that a plan was "fair and equitable" with respect to unsecured creditors if it met the following test:

{1067/000/00131312}

- (i) the plan provides that each holder of a claim of such [unsecured] class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or
- (ii) 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.

In re Shat, 424 B.R. at 858 (citing 11 U.S.C. § 1129(b)(2)(B) (before taking into account changes made to the Bankruptcy Code in 2005)). The second element of the test, that a junior claimholder not receive or retain property under a cramdown plan if general unsecured creditors are not paid in full, is commonly referred to as the "absolute priority rule." *See generally In re Tegeder*, 369 B.R. 477, 479 (Bankr. D. Neb. 2007).

Before the enactment of BAPCPA, bankruptcy courts applied the absolute priority rule equally to individual and non-individual chapter 11 debtors; "that is, courts held [the absolute priority rule] applied to humans and corporations alike." *In re Shat*, 424 B.R. at 858 (citations omitted). Although exceptions to the absolute priority rule exist for, *inter alia*, junior claimholders who contribute "new value" in exchange for receiving property under a plan, "this uniform application effectively meant that no individual debtor could ever confirm a chapter 11 plan." *In re Shat*, 424 B.R. at 858 (citing *In re Grosman*, 282 B.R. 45 (Bankr. S.D. Fla. 2002) (may not use homestead as "new value" contribution; exempt property must be devoted to creditors' claims in chapter 11 plan)); *see also In re Roedemeier*, 374 B.R. 264, 274–75 (Bankr. D. Kan. 2007) (noting that new value must be "in money or money's worth," and most individual debtors are only capable of contributing future labor or services as new value).

As part of BAPCPA, however, Congress amended the absolute priority rule with respect to individual chapter 11 debtors. *In re Shat*, 424 B.R. at 859. Section 1129(b)(2)(B)(ii) now reads as follows, with the provisions added by BAPCPA underlined:

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- (ii) 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 where 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.

In re Shat, 424 B.R. at 859 (citing 11 U.S.C. § 1129(b)(2)(B)(ii)). Put otherwise, an individual chapter 11 debtor may now receive or retain property under a plan while also retaining whatever property is included in the estate under 11 U.S.C. § 1115.

Section 1115 provides in relevant part:

- (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 —
 - (i) 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
 - (ii) 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.

11 U.S.C. § 1115(a).¹ "Section 1115 thus defines property of the estate for an individual chapter 11 debtor via a two-step process. Initially, Section 1115 creates a baseline estate of all property covered by Section 541. It then adds to that one class of property excluded for other chapter 11's by Section 541(a)(6): postpetition income from services." *In re Shat*, 424 B.R. at 863. Pursuant to §§ 1115(a) and 1129(b)(2)(B)(ii), this property is now exempted from the absolute priority rule in individual chapter 11 cases. *See In re Shat*, 424 B.R. at 868 (permitting individual chapter 11 debtors to cramdown plan on unsecured creditors while retaining property of the estate).

¹ Section 541 provides that the filing of a bankruptcy case creates an estate consisting of substantially all of the legal and equitable interests of the debtor in property as of the commencement of the case. *See* 11 U.S.C. § 541(a).

After reviewing the language of the foregoing statutes and applicable case law, the Bankruptcy Court correctly determined that the plan of reorganization (the "Plan") filed by John and Jane Smith (the "Appellees" or "Debtors") did not violate the absolute priority rule despite permitting the Debtors to retain property of the estate while not paying unsecured creditors the value of their claims as of the effective date of the Plan.² In so doing, the Bankruptcy Court agreed with the analyses of numerous courts that have held that the absolute priority rule no longer applies in individual chapter 11 cases. *See, e.g., SPCP Group, LLC v. Biggins*, 465 B.R. 316 (M.D. Fla. 2011) (holding that the absolute priority rule does not apply in chapter 11 cases filed by individuals following the enactment of BAPCPA); *Friedman v. P+P, LLC (In re Friedman)*, 466 B.R. 471 (9th Cir. B.A.P. 2012) (same); *In re Shat*, 424 B.R. at 868 (same); *In re Johnson*, 402 B.R. 851 (Bankr. N.D. Ind. 2009) (same); *In re Roedemeier*, 374 B.R. at 276 (same); *In re Tegeder*, 369 B.R. at 480 (same).

Notwithstanding the clear analysis of the Bankruptcy Court, Mr. Fix It, Inc. (the "Appellant") is urging this Bankruptcy Appellate Panel to adopt a so-called "narrow view" of § 1129(b)(2)(B)(ii), which only exempts a debtor's post-petition earnings from the absolute priority rule. *See* Appellant Br. 4–8. Specifically, the Appellant contends that the (1) plain language of § 1129(b)(2)(B)(ii) preserves the absolute priority rule in individual cases, and (2) preserving the absolute priority rule aligns with BAPCPA's goal of ensuring that the bankruptcy "system is fair for both debtors and creditors." *See id.* at 5. Neither argument withstands cursory scrutiny.

A. The Plain Language of §§ 1115 and 1129(b) Mandates that the Absolute Priority Rule Does Not Apply in Individual Chapter 11 Cases.

"The interpretation of the Bankruptcy Code first begins with the language itself...If the language is plain and unambiguous, then the Court must enforce the Bankruptcy Code according

² The Plan proposes to pay unsecured creditors in full without interest over a period of five years.

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to its terms." *In re Grosman*, 282 B.R. at 48 (citing *In re Griffith*, 206 F.3d 1389, 1393 (11th Cir. 2000); *United States v. Ron Pair Enters.*, 489 U.S. 235, 241, 109 S.Ct. 1026, 103 L.Ed.2d 290 (1989)). "In interpreting the Bankruptcy Code, the U.S. Supreme Court has held 'as long as the statutory scheme is coherent and consistent, there generally is no need for a court to inquire beyond the plain language of the statute.'" *In re Friedman*, 466 B.R. at 480 (quoting *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 566, 114 S.Ct. 1757, 128 L.Ed.2d 556 (1994)).

The Appellant cites *In re Tucker*, 2011 WL 5926757 (Bankr. D. Or., Nov. 28, 2011) in support of its argument that the language of § 1129(b) preserves the absolute priority rule in individual chapter 11 cases. Appellant Br. 5. In turn, the *Tucker* opinion states that the phrase "included in the estate under section 1115" in § 1129(b)(2)(B)(ii) actually means "added to the estate by § 1115." 2011 WL 5926757, at *2 (citations omitted). Under this interpretation, property acquired by the debtor after a bankruptcy case is filed, including post-petition earnings, is "added" to the estate by § 1115 and is exempt from the absolute priority rule; however, property of the estate set forth in § 541(a) remains subject to the absolute priority rule. *See Tucker*, 2011 WL 5926757, at *2.

The obvious flaw with this interpretation is that the word "include" is "not a word of limitation." *In re Friedman*, 466 B.R. at 482 (footnote omitted). Section 1115(a) unambiguously provides that "property of the estate includes, in addition to the property specified in section 541..." 11 U.S.C. § 1115(a) (emphasis added). Section 1129(b)(2)(B)(ii) provides that, "except that in a case where 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) (emphasis added). Read together, the statutes clearly hold that (1) property of the estate, as defined in § 541, is included in the definition of property of the estate set forth in § 1115(a), and (2) any

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property of the estate included in § 1115(a) is not subject to the absolute priority rule in an individual chapter 11 case. *See SPCP Group, LLC*, 465 B.R. at 322–23 ("Reading these statutes together, 'property of the estate' for purposes of Section 1115 includes property and earnings acquired both before and after the commencement of a bankruptcy case...According to the plain meanings of the statutes, Debtors' plans could be confirmed...because the absolute priority rule no longer applies to prevent individual Chapter 11 debtors from retaining pre- or post-petition property over an unsecured creditor's objection.").

As the *Friedman* court noted:

The so-called disputes over what "included" means in § 1129(b)(2)(B)(ii) and "in addition to" in § 1115 arise from misinterpretation of the words. "Included" is not a word of limitation. To limit the scope of estate property in §§ 1129 and 1115 would require the statute to read "included, except for the property set out in Section 541" (in the case of § 1129(b)(2)(B)(ii)), and "in addition to, but not inclusive of the property described in Section 541" (in the case of § 1115).

466 B.R. at 482 (footnote omitted). The Code of course says no such thing. The definition of property of the estate set forth in § 1115(a) clearly incorporates that set forth in § 541(a). Section 1129(b) provides that property of the estate included in section 1115 is not subject to the absolute priority rule. Read together, the only reasonable interpretation of the statutes is that the absolute priority rule does not apply in individual chapter 11 cases and the order of the Bankruptcy Court should therefore be affirmed. *See SPCP Group, LLC*, 465 B.R. at 322–23; *Friedman*, 466 B.R. at 82.

B. The Removal of the Absolute Priority Rule From Individual Chapter 11 Cases Furthers the Policy Considerations of BAPCPA.

The Appellant next argues that preserving the absolute priority rule in individual cases aligns with the "primary purpose of BAPCPA" to ensure a fair bankruptcy system for both debtors and creditors. *See* Appellant Br. 5.

As a threshold matter, there is no need for this Panel to inquire beyond the plain language of the Code, which unambiguously provides that the absolute priority rule does not apply in individual chapter 11 cases. *See In re Friedman*, 466 B.R. at 480. Even assuming *arguendo* that such an analysis was relevant, however, not applying the absolute priority rule in chapter 11 cases in fact better aligns with the legislative intent and policy considerations of BAPCPA than applying the rule.

Multiple courts and treatises have noted that BAPCPA appears "to adopt and adapt as much of chapter 13 as possible with respect to individual debtors in chapter 11." *See In re Shat*, 424 B.R. at 862. These changes include:

1. Redefining property of the estate under § 1115 along the lines of property of the estate in § 1306;
2. Changing the mandatory contents of a plan pursuant to § 1123(a)(8) to resemble § 1322(a)(1);
3. Adding the disposable income test of § 1325(b) to § 1129(a)(15);
4. Delaying the discharge until the completion of all plan payments as in § 1328(a);
5. Permitting a discharge for cause before all payments are completed pursuant to § 1141(d)(5), similar to the hardship discharge of § 1328(b); and
6. The addition of § 1127(e) to permit the modification of a plan even after substantial consummation for purposes similar to § 1329(a).

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In re Shat, 424 B.R. at 862 (citing 5 KEITH M. LUNDIN, CHAPTER 13 BANKRUPTCY § 368.1 at pp. 368–1 to 368–5 (3d ed. 2000 & Supp.2006) (correlating new chapter 11 provisions with corresponding chapter 13 provisions)).

Critically, chapter 13 has no absolute priority rule. *See* 11 U.S.C. § 1325(b). Interpreting §§ 1115 and 1129(b) to differ from chapter 13 and preserve the absolute priority rule not only adopts a strained reading of the statutes, it runs counter to the obvious aim of BAPCPA to model individual chapter 11 cases after those in chapter 13. *See In re Shat*, 424 B.R. at 867–68. By contrast, a broad reading of the statute is consistent with the requirement that "the words of a statute must be read in their context and with a view to their place in the overall statutory scheme...Our goal in interpreting a statute is to understand the statute 'as a symmetrical and coherent regulatory scheme' and to 'fit, if possible, all parts into a...harmonious whole.'" *Am. Bankers Ass'n v. Gould*, 412 F.3d 1081, 1086 (9th Cir. 2005) (quoting *Food & Drug Admin. v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 133, 120 S.Ct. 1291, 146 L.Ed.2d 121 (2000)).

Moreover, as stated *supra*, individual chapter 11 debtors were rarely capable of satisfying the absolute priority rule prior to BAPCPA because they lacked "new value" in money or money's worth to contribute to the estate in exchange for receiving or retaining property under a cramdown plan. *In re Roedemeier*, 374 B.R. at 275. In light of the foregoing, it is unlikely that Congress intended to preserve the absolute priority rule and prevent plan confirmations in individual chapter 11 cases after amending chapter 11 in multiple sections to resemble chapter 13:

If the new exception in § 1129(b)(2)(B)(ii) is read narrowly, although it would mean the Debtor could keep his postpetition earnings and other property he acquired postpetition without violating the absolute priority rule, the exception would not help

him [satisfy the rule] because the new value he would be contributing to the plan would still be at least mostly his postpetition earnings, and he would be retaining his prepetition ownership of [property of the estate]. These considerations indicate the narrow reading of the new exception in § 1129(b)(2)(B)(ii) would have little impact on this Debtor's (and probably most other individual debtors') ability to reorganize in Chapter 11.

The broader view of the exception, on the other hand, helps to explain why a number of changes, including the exception, were made to Chapter 11, namely, so that it could function for individual debtors much like Chapter 13 does.

In re Roedemeier, 374 B.R. at 275 (footnotes omitted).

Given the above, preserving the absolute priority rule in individual chapter 11 cases (1) contravenes the obvious intent of BAPCPA to model such cases after chapter 13, and (2) fails to increase the likelihood that individual debtors will satisfy the absolute priority rule by somehow contributing new value to their bankruptcy estates. Congressional intent, as well as the plain language of the statute, thus indicates that the absolute priority rule no longer applies in individual chapter 11 cases. Accordingly, the order of the Bankruptcy Court should be affirmed.

II. THE BANKRUPTCY COURT CORRECTLY DETERMINED THAT THE DEBTORS COMPLIED WITH THE PROVISIONS OF TITLE 11 FOR PURPOSES OF 11 U.S.C. § 1129(a)(2).

The final argument raised by the Appellant is that the Bankruptcy Court should have denied confirmation of the Plan as a result of the Debtors' alleged violations of title 11. *See* Appellant Br. 8–10. Specifically, Appellant argues that the Debtors violated § 1129(a)(2) of the Code in that they used \$15,000 of Big Bank's cash collateral to take a Caribbean cruise postpetition without Big Bank's authorization. Likewise, Appellant argues a similar violation because the Debtors failed to reimburse the estate for the \$15,000 spent on their cruise.

Section 1129(a)(2) of the Code requires a plan proponent to comply with the applicable provisions of title 11 in order for a plan to be confirmed. 11 U.S.C. § 1129(a)(2). The primary

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purpose of this requirement is to ensure that a plan proponent complies with the disclosure requirements set forth in 11 U.S.C. § 1125. *In re Trans World Airlines, Inc.*, 185 B.R. 302, 313–14 (Bankr. E.D. Mo. 1995).

Although substantive violations of the Code may prohibit plan confirmation under § 1129(a)(2), "[c]ourts should be cautious...in applying this remedy where confirmation of the plan might be in the best interests of creditors even though the proponent has transgressed the Code." 6 Norton Bankr. L. & Prac. 3d § 112:9. Indeed, a literal, "slavish" interpretation of § 1129(a)(2), in which any infraction will prohibit plan confirmation, "can lead to draconian results not intended by Congress." *In re The Landing Associates, Ltd.*, 157 B.R. 791, 811 (Bankr. W.D. Tex. 1993). As the *Landing Associates* court elaborated:

When interpreting a statute, "[t]he judge should try to think his way as best he can into the minds of the enacting legislators and imagine how they would have wanted the statute to be applied to the case at bar." Contrary to [the secured creditor's] interpretation of § 1129(a), Congress did not intend to fashion a minefield out of the provisions of the Bankruptcy Code. In fact, the legislative history mentions the provision only in passing, offering as an example of compliance that the debtor meet the disclosure requirements of § 1125 to satisfy § 1129(a)(2). Certainly, if Congress had meant that any infraction, no matter how early on in the case, no matter how minor the breach, and regardless of whether the court has remedied the violations, should result in a denial of confirmation, Congress would have given some clearer indication in the legislative history or made the statutory provision far more express.

157 B.R. at 811 (citations omitted) (emphasis in original).

In the instant case, the Appellant is seeking to reverse confirmation of the Plan by alleging the Debtors misused cash collateral during the pendency of their bankruptcy case.

As an initial matter, the Appellant, an unsecured creditor of the Debtors' estate, lacks standing to object to the Debtors' use of cash collateral. Section 363(c)(2) of the Code expressly

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provides that a chapter 11 debtor in possession may not use, sell, or lease cash collateral unless (1) the entity that has an interest in the collateral consents, or (2) the court authorizes such use, sale or lease. 11 U.S.C. § 363(c). The entity holding a security interest in the Debtors' cash collateral is Big Bank. Although Big Bank filed a motion to prohibit cash collateral use early in the bankruptcy case, the Debtors subsequently filed a motion to permit the use of cash collateral and submitted a budget to the Bankruptcy Court detailing such use. Additionally, Big Bank did not raise any objection to confirmation or seek to change its vote accepting the Plan when the Debtors disclosed their modest use of cash collateral for vacationing purposes. As a result, Big Bank consented to the cash collateral use and such use was permitted under § 363(c). Absent a security interest in cash collateral, the Appellant may not object to this use.³

Additionally, the cash in question was used by the Debtors within the ordinary course. Pursuant to Section 363(b)(1) of the Code, a debtor in possession only needs to seek the court's authorization for uses of estate property that are not within the ordinary course of its business. 11 U.S.C. § 363(b)(1). Here, it is clear as the ocean beneath them that the Debtors enjoyed cruising before their bankruptcy filing. Accordingly, it was within the ordinary course for the Debtors to continue cruising post bankruptcy filing and is thus not a violation of the Code as Appellant alleges.

Finally, as stated *supra*, courts should be cautious in utilizing § 1129(a)(2) "where confirmation of the plan might be in the best interests of creditors even though the proponent has transgressed the Code." *See* 6 Norton Bankr. L. & Prac. 3d § 112:9. The Plan identifies two classes of creditors: Big Bank and unsecured creditors. Big Bank voted to accept the Plan and

³ Even assuming *arguendo* that the Debtors' use of cash collateral prior to filing a motion and budget was prohibited, "that wrong has since been righted" by the Debtors' filing the motion and budget, and obtaining the consent of Big Bank to use cash collateral. *See In re Landing Associates*, 157 B.R. at 810 (rejecting argument that prior misuse of cash collateral, which had subsequently been righted, should prohibit plan confirmation under § 1129(a)(2)).

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did not object to confirmation. Although the Appellant opposes confirmation, it, like all other unsecured creditors, will be paid the face value of its claim over five years under the Plan. Given this, it is obvious that the confirmation of the Plan is in fact in the best interests of all creditors, irrespective of whether the Appellees violated title 11 in an isolated instance.

The Bankruptcy Court was correct in declining to use § 1129(a)(2) to prohibit confirmation of a plan that manifestly benefits the Debtors' creditors, and the order of the Bankruptcy Court should be affirmed.

CONCLUSION

For the foregoing reasons, the Appellees respectfully submit that the Bankruptcy Court correctly applied applicable statutory and case law in confirming the Plan. This Panel should affirm the order of the Bankruptcy Court.

Dated: August 23, 2012.

SHRAIBERG, FERRARA & LANDAU, P.A.

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