Individual Chapter 11 Cases and the Absolute Priority Doctrine

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THE "ABSOLUTE PRIORITY" RULE IN INDIVIDUAL CHAPTER 11 CASES IN THE NINTH CIRCUIT AND IN RE FRIEDMAN, 466 B.R. 471 (9TH CIR. BAP 2012)

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Since the 2005 BAPCPA amendments of the Code, including 11 U.S.C. § 1115[1], there has been a substantial development in the law as it relates to the "absolute priority" rule as it applies to individual Chapter 11 cases, on whether or not the "absolute priority" rule survived BAPCPA. One recent opinion by District Court Judge Timothy J. Savage, in In re Brown, 2014 U.S. Dist. LEXIS

[1] 11 U.S.C. § 1115 provides,

> (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—
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> (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 to a case under chapter 7, 12, or 13, whichever occurs first; 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 to a case under chapter 7, 12, or 13, whichever occurs first.
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> (b) Except as provided in section 1104 or a confirmed plan or order confirming a plan, the debtor shall remain in possession of all property of the estate.

22891(E.D. Pa. February 24, 2014) identified the "broad" view as courts which conclude that the "absolute priority" rule was abrogated by the 2005 BAPCPA amendments and the absolute priority did not apply in individual Chapter 11 cases, thereby allowing the debtor to retain and receive both pre-petition and post-petition property without satisfying the claims of all dissenting unsecured creditors in full. Judge Savage noted that the leading proponent of that "broad" rule is the Ninth Circuit Bankruptcy Appellate Panel's decision in In re Friedman, 466 B.R. 471 (9th Cir. BAP 2012) (Jury J. Dissent) and then identifies the cases as following Friedman's "broad" rule, at *n.*13, to the effect that the "absolute priority" rule does not apply in individual Chapter 11 cases,

> 13. See In re Friedman, 466 B.R. 471 (BAP 9th Cir. 2012) (language not ambiguous and within the contextual statutory scheme and logic of plan confirmation requirements; "included" is not a word of limitation; plain reading of § 1129(b)(2)(B)(ii), and f 1115 together mandates that absolute priority rule is not applicable; Chapter 13 does not contain an absolute priority rule; BAPCPA amendments adopted provisions to individual Chapter 11s, which are similar, if not identical, to Chapter 13); In re O'Neal, 490 B.R. 837 (Bankr. W.D. Ark 2013); In re Tucker, 479 B.R. 873 (Bankr. D. Or. 2012) (vacating its prior order denying confirmation of the reorganization plan in light of intervening B.A.P. decision in In re Friedman, 466 B.R. 471); SPCP Group, LLC v. Biggins, 465 B.R. 316, 320-23 (M.D. Fla. 2011) (affirming an unpublished bankruptcy court decision that broad interpretation applied, based upon the plain meaning of the statute, thus allowing the debtors to retain prepetition property, despite contrary holding from another bankruptcy court

> in the same district — In re Gelin, 437 B.R. 435); In re Shat, 424 B.R. 854, 862-68 (Bankr. D. Nev. 2010) (narrow view "underscored 1*17] by other changes made at the same time" to make individual Chapter 11 cases more like Chapter 13 cases); In re Johnson, 402 B.R. 851, 852-53 (Bankr. N.D. Ind. 2009) (dicta that individual Chapter 11 debtor's plan need not satisfy the absolute priority rule of 11 U.S.C. § 1129(b)(2)(B)(ii)); In re Bullard, 358 B.R. 541, 544 (Bankr. D. Conn. 2007); In re Tegeder, 369 B.R. 477, 479-81 (Bankr. D. Neb. 2007) (court acknowledged absence of reported decisions, relied upon treatises and commentators, and found the statutorily language unambiguous); In re Roedemeier, 374 B.R. 264, 273-76 & nn. 16-19 (Bankr. D. Kan, 2007) (relying upon treatises and commentators, court noted that the changes made to make individual Chapter 11 cases function more like Chapter 13 cases indicated Congress intended to extend exemption to individual Chapter 11 debtors).

Judge Savage contrasts the "broad" approach of the Friedman line of cases with those which adopt the "narrow" view of the absolute priority rule that hold that only property and earnings acquired post-petition under § 1115 are excluded from the "fair and equitable" test, leaving the absolute priority rule in tact. Judge Savage cites In re Maharaj, 681 F.3d 558 (4th Cir. 2012) as an example of the "narrow" approach at the Court of Appeals level. After Judge Savage's opinion in Brown, the Sixth Circuit in Ice House America LLC v. Cardin, 2014 U.S. App LEXIS 58882 (6th Cir. May 13, 2014) held that only property acquired after the commencement of the case under § 1115, rather than property acquired

before the filing, could be retained if the debtor's unsecured creditors were not fully paid. The Ice House, court concluded,

> For the reason given, we think the best interpretation of the 2005 amendment to § 1129(b)(2)(B)(ii) is the one we adopt today. So does every other circuit court to have reached the issue. See In re Lively, 717 F.3d 406 at 410 (5th Cir. 2013); In re Stephens, 704 F.3d 1279, 1287 (10th Cir. 2013); In re Maharaj, 681 F.3d 558, 565 (4th Cir. 2012). We therefore hold that the absolute priority rule continues to apply to pre-petition property of individual Chapter 11 cases. The plan confirmed here did not comply with the rule, and thus the plan's confirmation was error.

Not only has the Sixth, Fourth, Tenth, and Fifth Circuits all adopted the "narrow view" of the absolute priority rule in individual Chapter 11 cases, Judge Savage in Brown identified the following cases as adopting the "narrow approach," at n.12,

> 12. See In re Maharaj, 681 F.3d 558 (4th Cir. 2012) (affirming the bankruptcy courts decision in 449 Bit. 484 (Bankr. E.D. Va. 2011)); In re Stephens, 704 F.3d 1279, 1284 (10th Cir. 2013); In re Lively, 717 F.3d 406, 409-10 (5th Cir. 2013); In re Gerard, 495 B.R. 850 (Bankr. E.D. Wis. 2013); In re Grasso, 497 B.R. 448, 461 n.13 (Bankr. E.D. Pa. 2013); In re Martin, 497 B.R. 349 (Bankr. M.D. Fla. 2013); In re Lively, 467 B.R. 884, 892-93 (Bankr. S.D. Tex. 2012); In re Arnold, 471 B.R. 578, 587-88 (Bankr. C.D. Cal. 2012); In re Lee Mn Ho Chen, 482 B.R. 473 (Bankr. D.P.R. 2012); In re Stephens, 445 B.R. 816, 820-21 (Bankr. S.D. Tex. 2011) (iff 1115 were interpreted to include all property of the estate, the language "in addition to the property specified in section 541" in the preamble to § 1115(a) would render the words "all property of the kind specified in

section 541" in § 1115(a)(1) surplusage; also, the broad interpretation would render section 541 itself surplusage); In re Walsh, 447 B.R. 45, 47-49 (Bankr. D. Mass. 2011) ("because it deals with postpetition section 541(a) property (a most awkward construction), section 1115 does not include section 541(a) property as such"); In re Draiman, 450 B.R. 717, 820-22 (Bankr. N.D. III. 2011) (courts "plain reading" of § 1115 was that it added property to the debtor's estate which had already been established by § 541 and that § 1115 did not absorb § 541, even though "it is generally true that the changes instituted by BAPCPA intended for individual Chapter 11 cases to more closely track Chapter 13 cases"); In re Kamell, 451 B.R. 505, 507-12 (Bankr. C.D. Cal. 2011) [*14] (no clear expression of Congressional intent to abrogate the absolute priority rule; the argument that Congress intended to treat individuals in Chapter 11 more like debtors in Chapter 13 was "rather convoluted and strained" particularly since the overall thrust of BAPCPA was punitive in nature); In re Lindsey, 453 B.R. 886 (Bankr. E.D. Tenn. 2011);

In re Borton, 09-BR-00196, 2011 Bankr. LEXIS 4310, 2011 WL 5439285, at *4 (Bankr. D. Idaho Nov. 9, 2011); In re Gbadebo, 431 B.R. 222, 227-30 (Bankr. N.D. Cal 2010) (court found the statutory language to be unambiguous; "included in the estate under section 1115" meant "added" to the estate by § 1115; BAPCPA amendments to make Chapter 11 more like Chapter 13 not "persuasive evidence"; BAPCPA not "designed to enhance the individual debtor's "fresh start"); In re Mullins, 435 B.R. 352, 359-61 (Bankr. W.D. Va. 2010) (statute not ambiguous; broad view "strained to find ambiguity"; had Congress intended to entirely eliminate absolute priority rule from individual Chapter 11 cases, there were clearer, easier and more direct ways to do it); In re Gelin, 437 B.R. 435, 440-43 (Bankr. M.D. Fla. 2010) (broad view was plausible given text's unquestionable ambiguity; since [*15] neither § 103(a) nor § 541 was amended by BAPCPA, "there is no reason

> for section 1115 to 'absorb' and 'supersede' § 541 to define property of the estate"; broad view was "an incredibly complicated and forced interpretation"; had Congress meant to exempt an individual debtor's entire estate, it would have referred to both § 541 and § 1115 in § 1129(b)(2)(B)(ii)); In re Karlovich, 456 B.R. 677, 679-82 (Bankr. S.D. Cal. 2010) (statutory language unambiguous; had Congress intended to abrogate the absolute priority rule for individuals, it "could easily have added 'except with respect to individuals' at the beginning of § 1129(b)(2)(B)(ii), or ;stated that an individual could retain all property"; had Congress intended to make individual Chapter 11 cases more like Chapter 13 cases, Congress could have raised or eliminated the statutory debt ceilings for Chapter 13 cases); In re Steedley, 09-BR-50654, 2010 Bankr. LEXIS 3113, 2010 WL 3528599, at *2-3 (Bankr. S.D. Ga. Aug. 27, 2010) (statutory language unambiguous; plain language of § 1115 does not subsume § 541; to the contrary, § 541 specifically applies in all Chapter 11 cases and § 1115 adds postpetition property to the individual debtor's estate); In re Friedman, 466 B.R. 471, 484-92 (B.A.P. 9th Cir. 2012) [*16] (Jury, J.).

Given the momentum for the "narrow" interpretation of the "absolute priority" rule in Chapter 11 individual cases, the Ninth Circuit's Friedman decision stands out as an outlier, although as indicated by Judge Savage's decision in Brown at n.13, other Ninth Circuit courts have followed the Friedman ruling, somewhat reluctantly.

Ninth Circuit Cases Pre-Friedman

Before the Ninth Circuit BAP opinion in Friedman, the Ninth Circuit bankruptcy court cases followed both the "narrow" and "broad" approach.

The first of the major pre-Friedman cases in the Ninth Circuit was the opinion in In re Shat, 424 B.R. 854 (Bankr.D.Nev. 2010) (Markell, J), where the issue was whether the individual Chapter 11 debtors could keep their pre-petition dry cleaning business without paying unsecured creditors in full.

After Judge Markell's usual and thorough analysis of the legislative history of BAPCPA, he came to the conclusion that the post-2005 individual Chapter 11 was to "adopt and adapt" as much of the Chapter 13 analysis as possible.

Judge Markell cited three early post-2005 cases for support of the "broad" reading of § 1129(b)(2)(B)(ii); In re Bullard, 358 B.R. 541 (Bankr.D.Conn. 2007); In re Tegeder, 369 B.R. 477 (Bankr.D.Neb. 2007) and In re Roedemeier, 374 B.R. 264 (Bankr.D.Kan. 2007), all finding that the 2005 amendments eliminated the "absolute priority" rule in individual Chapter 11 cases.

In coming out for a "broad" reading of § 1129(b)(2)(B)(ii) Judge Markell concluded,

> While "the absolute priority rule has long been a feature of American bankruptcy law," Bank of New York Trust Co., NA v. Official Unsecured Creditors' Comm. (In re Pacific Lumber Co.), 584 F.3d 229, 244 (5th Cir. 2009), it is not sacrosanct. Chapter 13 has no absolute priority rule, and as noted above, most of the changes effected by BAPCPA to individual chapter 11 debtors were part of an overall design of adapting various chapter 13 provisions to fit in chapter 11. The broader view [that pre and post property are for the debtor] also saves

> Section 1129(b)(2)(B)(ii) from an almost trivial reading; if the narrow view is taken, the section protects only the value of aggregate postpetition earnings payable after the fifth anniversary of plan confirmation. This interpretation is thus consistent with the Ninth Circuit's 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)). As the Court said in a nonbankruptcy context, "statutory language cannot be construed in a vacuum. It is a fundamental canon of statutory construction that the words of a statute must be read in their context and with a view to their place in the overall statutory scheme." Davis v. Mich. Dep't of Treasury, 489 U.S. 803, 809, 109 S. Ct. 1500, 103 L. Ed. 2d 891 (1989). See also Florida Dep't of Revenue v. Piccadilly Cafeterias, Inc., 554 U.S. 33, 128 S.Ct. 2326, 2336, 171 L. Ed. 2d 203 (2008) (finding to placement and arrangement of statute to be informative of the proper interpretation).

After Judge Markell's opinion in Shat, the other pre-Friedman Ninth Circuit cases adopted the "narrow" view.

Judge Leslie Tchaikovsky's opinion in In re Gbadebo, 431 B.R. 222 (Bankr.N.D. Cal. 2010), contrary to Shat, concluded that the individual Chapter 11 debtor's plan could not be confirmed because it did not satisfy the "absolute priority" rule. Judge Tchaikovsky noted that BAPCPA modified the "absolute

priority" rule and decisions, like In re Shat, 424 B.R. 854 (Bankr. D.Nev. 2010), were incorrect.

Judge Tchaikovsky analyzed the Shat case as beginning with a detailed examination of BAPCPA's legislative history. Despite Shat's several references to Congressional intent to include an individual debtor's post-petition income in the bankruptcy estate, there was no references to Congressional intent to eliminate the "absolute priority" rule as applied to individuals. Judge Tchaikovsky then summarized the changes to chapter 11 made by BAPCPA that were designed to make an individual chapter 11 case more like a chapter 13 case.

Notwithstanding the analysis of BAPCPA by Judge Markell, Judge Tchaikovsky was unable to agree with his conclusion that BAPCPA abrogated the "absolute priority" rule.

Judge Tchaikovsky argued that the Shat cases' interpretation of BAPCPA that it was intended to eliminate the "absolute priority" rule as to individual Chapter 11 debtors, was incorrect. In opting for the "narrow" view, Judge Tchaikovsky wrote, as to the "absolute priority" rule in individual Chapter 11 cases, that each one of the new BAPCPA provisions appeared designed to impose greater burdens on individual Chapter 11 debtors so as to ensure a greater payout to creditors. This was a frequently expressed as an overall purpose of BAPCPA i.e., to ensure that debtors who can pay back a portion of their debts do

so. H.R. Rep. No. 109-31, pt 1, at 2 (2005). According to Judge Tchaikovsky, no one who read BAPCPA as a whole could reasonably conclude that it was designed to enhance the individual debtor's "fresh start," or the "broad" approach.

Although the Shat court asserted that the "absolute priority" rule made it virtually impossible for an individual chapter 11 debtor to confirm a plan that did not provide for payment in full to the holders of unsecured claims, to the contrary, Judge Tchaikovsky noted that the Chapter 11 plan may be confirmed if the holder of unsecured claims voted in favor of the plan. The creditors were likely to accept a plan if a reasonable dividend was proposed, and the unsecured creditors concluded that they would receive no dividend in a chapter 7 case.

After Shat and Gbadebo but before Friedman, Chief Judge Peter Bowie issued In re Karlovich, 456 B.R. 677 (Bankr. S.D. Ca. 2010), which disagreed with the Shat case, the so-called "broad" rule, and followed the "narrow" rule of Gbadebo, although the Karlovich court found itself writing on a "clean state," Judge Bowie concluded,

> The Court finds that there is a plain, unambiguous reading of the statutes. Section 1129(b)(2)(B)(ii) limits the application of the absolute priority rule by allowing an individual to retain only the "property included in the estate under § 1115." The property included under § 1115 is property "the debtor acquired after the commencement of the case.
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> The effect of the new provisions is § 1129(b)(2)(B)(ii) is not to abrogate the absolute priority

> rule, but to make it the same for individual and non-individual Chapter 11 debtors, as it was prior to BAPCPA. In fact, when read in conjunction with newly added § 1115, the absolute priority rule with respect to individuals is exactly the same as it was pre-BAPCPA. That is, prior to BAPCPA, property of the estate did not include post-petition acquired property and earnings for individuals and non-individuals alike. Hence, post-petition acquired property and earnings could be retained by a Chapter 11 debtor, individual and non-individual alike, without running afoul of the absolute priority rule. The addition of § 1115 potentially changed that by adding to the property of the estate of an individual post-petition acquired property and earnings. Without a corresponding change to § 1129(b) (2) (B) (ii), individual debtors could no longer retain post-petition acquired property and earnings if they wished to "cram down" a plan. By adding the language excepting the § 1115 property from the absolute priority rale of § 1129(b) (2) (B) (ii), Congress merely ensured that the absolute priority rule would be the same as it had been prior to BAPCPA and be the same for all Chapter 11 debtors. In other words, what Congress took from the individual debtor with its § 1115-hand, it returned for application of the absolute priority rule with its § 1129(b)(2) (B)(ii)-in hand.

In the Ninth Circuit prior to Friedman, like the courts generally, there was a split between the "broad" approach to the "absolute priority" rule in individual Chapter 11 cases, In re Shat as per Judge Markell's opinion, and several "narrow" cases, including Gbadebo and Karilousky, and In re Kamell 451 B.R. 505 (Bankr. CD. Cal. 2011), where the court recognized the trend from "broad" to "narrow." Judge Theodor Albert wrote,

> The first three courts to take up the issue as well as some of the commentators ascribe to the "broad view" that Congress intended to entirely abrogate the absolute priority rule in individual cases. See In re Tegeder, 369 B.R. 477 (Bankr. Neb. 2007); In re Roedemeier, 374 B.R. 264 (Bankr. D. Kan. 2007) and In re Shat, 424 B.R. 854 (Bankr.D.Nev. 2010). The "broad view" holds that the entirety of § 1129(b)(2)(B), including both subsections (i) and (ii) simply have no continued application at all in individual cases. Courts ascribing to the "broad view" infer a Congressional intent to make individual Chapter 11's parallel to Chapter 13, which has never contained any version of the "absolute priority rule." Some BAPCPA additions do who intent to make some aspects of individual Chapter 11's more parallel to Chapter 13. For example: post petition earnings and acquisition are now property of the estate under § 1115.

Judge Albert went on to note that the then current trend was to the "narrow" view:

> The more recent trend, and now the clear majority of courts, ascribe to the so-called "narrow view." See e.g. In re Gbadebo, 431 B.R. 222; In re Mullins, 435 B.R. 352 (Bankr. W.D. Va. 2010); In re Steedley, No. 09-50654, 2010 Bankr. LEXIS 3113, 2010 WL 3528599 (Bankr. S.D.Ga. Aug. 27, 2010); In re Gelin, 437 B.R. 435 (Bank. M.D. Fla. 2010); In re Karlovich, B.R. , 2010 Bankr. LEXIS 4014, 2010 WL 5418872 (Bankr. S.D.Cal. Nov. 16, 2010); [**9] In re Stephens, 445 B.R. 816, 2011 Bankr. LEXIS 593, 2011 WL 719485 (Bankr. S.D.Tex. Feb. 22, 2011); In re Walsh, 447 B.R. 45, 2011 Bankr. LEXIS 780, 2011 WL 867046 (Bankr. D. Mass. March 8, 2011). Many of the "narrow view" courts observe that had Congress intended to abrogate the absolute priority rule entirely, rather than only partly, they could scarcely have chosen a more convoluted and ambiguous way to go about it. As several "narrow view" courts have observed,

> it would have been easier and more logical to simply insert "except in individual cases" at the beginning of §11.29(b)(2)(B). Karlovich, 2010 Bankr. LEXIS 4014, 2010 WL 5418872 at *4.

In siding with the "narrow" view of the "absolute priority" rule, Judge Albert wrote,

> Moreover, the court is not impressed with the argument that continued application of the absolute priority rule makes Chapter 11 unworkable in most individual cases. The debtor may still negotiate plan acceptance from impaired unsecured classes, pay dissenting classes in full, contribute the pre-petition property and/or contribute "new value" in order to achieve confirmation in compliance with the absolute priority rule. Retention of these limitations is more consistent with general approach of BAPCPA, which is to make individual debtors pay more within their means toward debt, not less.
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> In sum, the court finds the "narrow view" more persuasive and holds that the absolute priority rule for individual Chapter 11 debtors was only modified, not fully abrogated, by BAPCPA. This court therefore adds its voice to the "narrow view" courts. Since in this plan debtor proposes to keep substantial prepetition property without paying the dissenting Class 5 unsecured creditors in full, the plan cannot be confirmed in its current form.

POST-FRIEDMAN CASES IN THE NINTH CIRCUIT

In In re Friedman, 466 B.R. 471 (9th Cir. BAP 2012), the 2 to 1 majority opinion, concluded that the "absolute priority" rule did not survive the

BAPCPA and no longer applied in individual Chapter 11 cases, contrary to the conclusion of the more recent circuit and bankruptcy court cases.

Judge Jury in her Friedman dissent recognized the state of the law, as of the Friedman case,

> Before proceeding with the application of any interpretive rule, a brief review of the current state of the bankruptcy court caselaw in the Ninth Circuit is warranted. Two basic interpretations of §§ 1129(b)(2)(B)(0) and 1115 have emerged.
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> Under what is called the broad view, the bankruptcy court in In re Shat, 424 B.R. 854 (Bankr. D. Nev. 2010) construed the phrase "in addition to the property specified in section 541" contained in § 1115 to mean that "[s]ection 1115 absorbs and then supersedes [s]ection 541 for individual chapter 11 cases." Id. 865. In turn, the court reasoned that if § 1129(b) (2) (B)(ii) excepts from the operation of the absolute priority rule that property "included" in § 1115, then the "exception extends to all property of the estate." Id.21 Thus, in essence, In re Shat holds that the absolute priority rule does not apply in individual chapter 11 cases. Id. at 867. In reaching its decision, the Shat court relied upon the numerous revisions in BAPCPA which make individual chapter 11's more like Chapter 13 and also the few cases which had addressed the issue. Id. at 865-66. Nonetheless, the court acknowledged that its broad reading of § 1115 was "not without problems." Id. at 867.
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> These changes, also relied upon by the majority [in favor of the "Broad" rule], included: (1) redefining property under §1115 along the lines of property of the estate under § 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

> completion of all plan payments as in § 1328(a); (5) permitting 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). I
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> Other bankruptcy courts, in equally well-reasoned decisions, have narrowly interpreted § 1115 to supplement § 541 by adding only the debtor's postpetition earnings and other property acquired after the commencement of the case. See In re Tucker, 2011 Bankr. LEXIS 4701, 2011 WL 5926757 (Bankr. D. Or. 2011); In re Borton, 2011 Bankr. LEXIS 4310, 2011 WL 5439285 (Bankr. D. Idaho 2011); In re Kamell, 451 B.R. 505; In re Karlovich, 456 B.R. 677 (Bankr. S.D. Cal. 2010); In re Gbadebo, 431 B.R. 222. Under the narrow view, the absolute priority rule still applies to individual chapter 11 debtors with respect to their prepetition property, but postpetition property is not subject to its strictures. Notably, the Panel mentions only one of these well-reasoned decisions.

Judge Jury's dissent and the "narrow" approach to the "absolute priority" rule still had support in the Ninth Circuit, notwithstanding the majority's adoption on the "broad" approach in Friedman.

The first Ninth Circuit case, after the BAP ruling in Friedman, appears to be Judge Robert Kwan's opinion in In re Arnold, 471 B.R. 578 (Bankr.C.D.Cal. 2012). Judge Kwan describes the events, pre and post Friedman.

On August 24, 2011, Debtors David L. Arnold and Grace E. Arnold filed a Disclosure Statement and a proposed Chapter 11 Plan of Reorganization. A

hearing was held on approval of the Disclosure Statement on September 28, 2011. Issues regarding the confirmability of the Plan were raised by a creditor, U.S. Bank, arguing that the court should not approve the Disclosure Statement because the Plan violated the absolute priority rule. The hearing was continued, and the Debtors filed an Amended Disclosure Statement and proposed Chapter 11 Plan of Reorganization dated and filed on October 14, 2011. On November 16, 2011, the court held a hearing on the Amended Disclosure Statement, where U.S. Bank objected on the same grounds. That hearing was continued to January 18, 2012. Supplemental briefing was filed, and before that hearing, the court vacated the January 18 hearing and took the matter under submission.

While the matter was under submission, the Bankruptcy Appellate Panel ("BAP") of the Ninth Circuit, in a divided 2-1 decision, issued an opinion on March 19, 2012 in In re Friedman, 466 B.R. 471 (9th Cir. BAP 2012), which held that the absolute priority rule did not apply in Chapter 11 bankruptcy cases of individual debtors after the enactment of the BAPCPA, could retain both pre and post-petition property without paying creditors in full. On March 20, 2012, the Arnold court issued an order inviting further briefing from the parties in light of the BAP decision in Friedman. A final hearing on the Debtors' Disclosure Statement was held on April 25, 2012.

The Arnold court concluded that the "absolute priority" rule applied in an individual Chapter 11 bankruptcy cases, and the court found that the proposed Plan would violate the absolute priority rule. Therefore, the court denied approval of the Amended Disclosure Statement.

Notwithstanding that the BAP had just announced the Friedman case, Judge Kwan held that he would not be bound by Friedman, but he predicted what would happen if his decision requiring the "absolute priority" rule was appealed, post-Friedman.

> If an appeal is taken of this court's decision, [on the narrow approach] does not follow the BAP's holding in Friedman, to the BAP, most likely the BAP would reverse this court's decision in accordance with its policy stated in Windmill Farms that its decisions are binding on the bankruptcy courts of the circuit. However, if an appeal is taken and a party alternatively elects to have the district court hear the appeal, the BAP's decision in Friedman would not be binding on the district court under Bank of Maui. This situation presents a quandary for the court. In exercising its duty of independent inquiry to examine the law, the court could decide to be bound by BAP decisions under the principle of *stare decisis*, but then again, other bankruptcy courts not only in the circuit, but in this judicial district, have come to a different conclusion, equally principled, in exercising this same duty of independent judicial inquiry in the absence of definitive authority that BAP precedent is binding on them. Accordingly, in the absence of definitive guidance on the binding effect of BAP decisions from the Judicial Council of the Ninth Circuit in an amended order on BAP authority or by the Ninth Circuit itself in a precedential opinion, or other higher authority (i.e., the Supreme Court or Congress), and in light of the lack of

> uniformity in opinion on this issue among the bankruptcy courts in the circuit, the court adopts the analysis in Crain and will thus consider, but will not be bound by, the decision of the BAP in Friedman on the issue of whether the absolute priority rule applies in Chapter 11 bankruptcy cases of individual debtors. See In re Crain, 243 B.R. at 81 & n.6.

After a careful and thorough review of the statutory language of § 541 and § 1115, including references to L. Rozakis, English Grammar for the Utterly Confused (2003), M. Shertzer, The Elements of Grammar (1986) and the classic W. Strunk & E.B. White, Elements of Style, Judge Kwan, with more standard bankruptcy references, came to the conclusion that the 2005 amendments for individual chapter 11 cases, resulted in a "narrow" form of the "absolute priority" rule, allowing the debtor to retain only the § 1115 post-petition property.

Here the debtors have retained their interest in their prepetition assets without paying unsecured creditors in full.

In In re Sample, 2013 Bankr LEXIS 2814 (Bankr. D. Ariz. July 15, 2013), the court followed Friedman, under the theory of precedent, if not with great legal conviction,

> Southwestern Business Finance (SBF) challenges Debtor's Chapter 11 Plan as violating the so-called absolute priority rule. SBF is, however, quick to point out that the Ninth Circuit Bankruptcy Appellate Panel's (BAP) Friedman, opinion held, in a 2-1 decision, that "the absolute priority rule does not apply in individual debtor chapter 11 cases." In re Friedman, 466 B.R. 471, 473 (9th Cir. BAP 2012) (Jury, J. dissenting). However,

SBF urges this Court to not consider itself bound by BAP decisions, contending the majority of decisions across the country hold contrary to Friedman. On the other hand, the Debtors point to the fact Friedman was an Arizona case and, under Bank of Maui v. Estate Analysis, Inc., 904 F.2d 470, 472 (9th Cir. 1990), the BAP's opinion is controlling authority within this district. Neither the Debtors nor SBF have cited any decisions from the U.S. District Court for the District of Arizona (District Court of Arizona) on the question of whether the absolute priority rule pertains to individual Chapter 11 debtor cases.

As to the precedential value of Friedman, Judge Daniel Collins wrote,

> The BAP notes that . . . (the Judicial Council of the Ninth Circuit established the BAP, among other things, to establish uniformity within Ninth Circuit bankruptcy courts and a consistent body of bankruptcy law throughout the circuit. See In re Windmill Farms, 70 B.R. 618. 622 (9th Cir. BAP 1987). In Windmill Farms, the panel held that, to achieve the desired bankruptcy low uniformity within Ninth Circuit, decisions of the BAP must be binding on all bankruptcy courts in the Ninth Circuit. The BAP reconfirmed this opinion in Philadelphia Life Ins. Co. v. Proudfoot, 144 B.R. 876 (9th Or. BAP 1992) holding that decisions of the Ninth Circuit BAP are binding on all bankruptcy courts in the Ninth Circuit unless contrary authority exists in the district court from the district in which the bankruptcy ease is heard.
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> Although there are no Ninth Circuit decisions mandating decisions of the BAP bind bankruptcy courts, this Court agrees with the rationale of Bankruptcy Judge Jaroslovsky from the Northern District of California when he held that a bankruptcy judge's ego should not get in the way of that judge following BAP decisions with which he or she may disagree. See In re Muskin, Inc., 151 B.R. 252 (Bankr. S.D. Ca. 1993). Judge

> Jaroslovsky pointed out that, among other things, opinions from the BAP are useful tools available to lawyers in plotting strategy for their client's cases and enabling lawyers to scale their bankruptcy Issues.

Based on the precedent of Friedman, the Sample court concluded,

> The BAP in the Friedman decision held that the absolute priority rule does not apply in an individual debtor's Chapter 11 case. The rationale for its 2-1 decision is set out in the extensive opinion penned in Friedman by Bankruptcy Judge Clarkson. Although this Court tends to favor the dissenting decision of Judge Jury in Friedman, for the reasons stated above, this Court feels duty bound to follow the majority's holding in Friedman. Accordingly, SBF's objection to the Debtor's chapter 11 plan based on absolute priority grounds is hereby overruled (emphasis supplied).

This same issue of Friedman and its precedential value are evident in In re Tucker 479 B.R. 873 (Bankr.D. Ore 2012), where the court started out by noting,

> The Bankruptcy Appellate Panel itself has held that decisions of the Panel are binding on each of the bankruptcy courts in the districts comprising the Ninth Circuit. In re Windmill Farms, 70 B.R. 618, 622 (9th Cir. BAP 1987); In re Proudfoot, 144 B.R. 876, 878 (9th Cir. BAP 1992), In re Gurr, 194 B.R. 474 (Bankr. D. Az. 1996). The rationale for these holdings is that Congress's purpose in establishing the BAP was to provide a uniform and consistent body of bankruptcy law throughout the circuit. In re Tong Seng Vue, 364 B.R. 767, 771 (Bankr. D.Or. 2007). In Tong Seng Vue, the undersigned expanded on this rationale, holding that
>
> > The Doctrine of Stare Decisis advances two important principles: the

> uniformity of case law throughout a jurisdiction, and the resulting predictability of results required in order to ensure fairness of the judicial process to litigants. As a [**7] matter of fundamental fairness to parties before it, a trial court must strive to apply the law as it is held by courts which may review its decisions. Otherwise, parties will often be forced to the trouble and expense of an appeal to achieve a lawful result whenever the trial court disagrees with the higher court's view of the law....

In short, this court will follow the BAP's decision respecting the absolute priority rule in individual chapter 11 cases, as discussed below.

The Tucker Court went on to note,

> Application of the absolute priority rule in individual cases has been the subject of considerable debate since the 2005 amendment. The debate turns on whether the phrase "retain property included in the estate under section 1115" means only the property obtained by the debtor post-petition, or includes virtually all of the debtor-in-possession's assets. Courts interpreting §§ 1129(b)(2)(B) and 1115 as restricting the property a debtor may retain over the objection of an impaired unsecured class to post-petition acquisitions are said to have taken the "narrow" view. See In re Tucker, 2011 Bankr. LEXIS 4701, 2011 WL 5926757 (Bankr. D.Or. 2011); In re Karlovich, 456 B.R. 677 (Bankr. S.D. Cat. 2010) , In re Kamell, 451 B.R. 505 (Bankr. C.D. Cal. 2011) (In re Gbadebo, 431 B.R. 222 (Bankr. N.D. Col. 2010); In re Maharaj, 681 F.3d 558, 571 (4th Cir. 2012). Other courts take the so-called "broad" view, holding that the sections, construed together, permit a debtor-in-possession to retain virtually all of its assets. See In re Friedman, 466 B.R. 471 (9th Cir. BAP 2012); In re Tegeder, 369 B.R. 477 (Bankr. D.Neb. 2007); In re

> Roedemeier, 374 B.R. 264 (Bankr. D.Kan. 2007); [**10] In re Shat, 424 B.R. 854 (Bankr. D.Nev. 2010).

But even under the Friedman rule, the elimination of the absolute priority rule, these were still other § 1129(b)(2)(B) requirements that had to satisfied.

> As noted, a plan may be confirmed over the dissent of an impaired class if it provides fair and equitable treatment to the class. The majority opinion in Friedman states that,
>
> > Simply put, a plan not paying an unsecured creditor in full is nevertheless "fair and equitable" (and can be crammed down over the unsecured creditors' objections), so long as an individual debtor does not retain property except property included in the bankruptcy estate under § 1115.
>
> Friedman at 480. This misstates the law. The statute provides that "the condition that a plan be fair and equitable with respect to a class includes the following requirements." Code § 1129(b)(2). The Code does not define what is fair and equitable, but provides a minimum requirement that a fair and equitable plan not provide for retention of assets if senior classes are unsatisfied. Elimination of the absolute priority rule in individual chapter 11 cases removes a significant barrier, but does not relieve the plan proponent from its burden of proving fair and equitable treatment of dissenting classes. Friedman's assertion to the contrary was not essential to the holding that the absolute priority rule was not applicable in individual cases, and was dictum, and not binding. See, e.g., In re Gurr, 194 B.R. 474 (Bankr. D.Az. 1996).

The Court found that even if Friedman abrogated the "absolute priority" rule, it did not do away with the "fair and equitable" requirement.

> In order to confirm a plan of reorganization, the proponent must demonstrate that the plan satisfies each of 16 provisions in 11 U.S.C. § 1129(a). Subsection (8) requires that each class of claims or interests either accept the plan, or is not impaired by the plan. Section 1129(b), commonly referred to the "cram down."
>
> > and equitable with respect to a class includes the following requirements.' Thus the Code plainly provides that a plan may not be fair and equitable, even though it satisfies the absolute priority rule or the new value exception to the absolute priority rule.
>
> Id. at 949 [emphasis added]. The same reasoning applies here: where the absolute priority rule is not to be applied, the proponent must nevertheless demonstrate that the plan satisfies the fair and equitable requirements of Code § 1129(b)(2). Dollar Associates sets out a number of criteria to be considered in determining whether the fair and equitable standard is satisfied, including:
>
> — Whether the plan furthers the reorganization goal of preserving equity of the debtor;
>
> — Whether the plan preserves jobs and going concern value;
>
> — Whether the plan significantly furthers the goal of maximizing distribution to creditors; and
>
> — Whether the plan has been rejected by the overwhelming majority of claims.

> In addition, three other criteria (at least) should be considered with respect to an individual debtor's plan:
>
> — Whether the plan provides for equal treatment of the creditors in the dissenting class;
>
> — Whether the net value of the assets retained is small relative to the amount to be paid out to unsecured creditors over the life of the plan; and
>
> — Whether the assets retained are used to generate funds to be paid to creditors under the plan.

In confirming a plan notwithstanding the elimination of the "absolute priority" rule, Judge Frank Alley noted,

> The distribution provided is clearly superior to treatment unsecured creditors would receive in the event of a liquidation. It is true, as the dissenting creditor points out, that the dividend under this plan is considerably less than the payout proposed by the second amended plan. However, that plan was proposed under duress: namely the application of the absolute priority rule, which the Bankruptcy Appellate Panel has now deemed to be inapplicable. The fairness of a plan should not be measured against a standard which was erroneously applied.

Without the absolute priority rule, the plan was confirmed under the "fair and equitable" provision of § 1129(b)(2)(B), even though the distribution under the "narrow" view would yielded more for the dissenting unsecured creditors, the plan provided more than a liquidation under Chapter 7.

After Friedman, even though Ninth Circuit courts on the basis of precedent and stare decisis follow the BAP's "broad" approach, it was followed without any conviction and some judge's deprived of the "absolute priority" rule to block confirmation of an individual Chapter 11 debtor's plan, can, as did the Court in Tucker, look to the "fair and equitable" standard of § 1129(b)(2)(B) to block confirmation of a Chapter 11 plan, which allows the individual debtor to keep too much property for its "fresh start," even though the confirmed Chapter 11 plan did not satisfy the "narrow" interpretation of the absolute priority rule, it could still be confirmed by satisfying the "fair and equitable" standard and which would yield more than the distribution in a Chapter 7 liquidation.

INDIVIDUAL CHAPTER 11 CASES
DISCUSSION QUESTIONS
ABI Hawaii Conference
August 2014

Eligibility/Comparison to Chapter 13

1. An individual with primarily business (non-consumer) debt needs to file a Chapter 11 case. Does the individual need to obtain a credit-counseling certificate before she can file her petition?

2. Can an individual debtor's Ch.11 case qualify as a single asset real estate ("SARE") case or a small business case, and how does that affect the case?

3. Is each of the following true in comparing an individual Chapter 11 with a Chapter 13?

   A. Individual Chapter 11's can be filed involuntarily;

   B. The individual in Chapter 11 does not have to have regular income;

   C. A trustee can be appointed in Chapter 11 case;

   D. Chapter 11 Debtors have the same debt limits as Chapter 13 Debtors;

   E. The filing fees in Chapter 11 and Chapter 13 are the same;

   F. Both types of cases require payment of quarterly fees to the US Trustee;

   G. A Creditors committee can be appointed in a Chapter 11 case

Absolute Priority Rule

4. To what extent must an individual chapter 11 debtor comply with the absolute priority rule as to a dissenting class of unsecured creditors with respect to the following?

- 1000 shares of publicly traded stock held as of the petition date
- 100% of the Debtor's closely held company that only employs the Debtor.
- 1000 shares of publicly traded stock inherited by the Debtor after the filing of her case
- $150,000 of equity in a homestead that is exempt under state law

Assuming that the absolute priority rule applies, what does this mean and what can you do to help get your plan confirmed?

Post-Petition Revenues/1115

5. An individual with a salary of $10,000 per month files a Chapter 11 case. Is the individual's post-petition salary property of the bankruptcy estate?

6. Must an individual chapter 11 debtor obtain court approval to pay personal expenses pre-confirmation?

A. Does it matter if a portion of the debtor's postpetition wages would be exempt under nonbankruptcy state or federal law?

B. Should the debtor seek court approval of a budget at any early stage of the case?

7. A Chapter 11 individual debtor may use his/her post petition wages and income for which of the following ?

A. Pay $1200/month rent for an apartment

B. Pay $1200/month for her vacation villa

C. Pay $1200/month for her Mercedes lease

D. Pay her $100 monthly car insurance

E. Pay $125/month for phone bills

F. Pay $250/week for house cleaning

G. Pay $250/month for pool maintenance

H. Pay $1750 to take a cruise.

Individual Ch. 11 Plan Issues

8. Is each of the following true in connection with a Chapter 11 plan for an individual?

A. Creditor voting is required

B. The plan must be accepted by at least one class of impaired, non-insider creditors

C. Like a Chapter 13 case, the Debtor must commence plan payments immediately

D. The standard for valuation of assets is "retail price"

E. In a Chapter 11 case, plans may not modify debts beyond a five year plan term

F. In a Chapter 11 case, the Debtor is discharged as soon as she substantially consummates her plan.

G. Creditors can obtain the right to file creditor plans that call for the liquidation of all of the Debtors non-exempt assets.

9. If an unsecured creditor objects to an individual chapter 11 debtor's plan, how is the value of the required projected disposable income under section 1129(a)(15) calculated?

A. What amount of post-confirmation wages has to be devoted to the plan if the wages would otherwise be exempt under nonbankruptcy law?

10. Is there a difference between voting against a plan and objecting to confirmation? If so, should the individual's disclosure statement disclose the difference?

Plan Payments

11. Is there a minimum or maximum period of time during which payments under section 1129(a)(15) have to be made under an individual chapter 11 debtor's plan?

A. Does it matter if the debtor has long term debt like a 30-year mortgage?

Retention of Professionals/Ethical Issues

12. What types of professionals can the individual debtor retain at the expense of the estate in a Chapter 11?

A. Bankruptcy counsel; Divorce counsel; Criminal counsel? If so, is court approval required?

B. Can the debtor pay for defense of challenges to exemptions, discharge or dischargeability from property of her estate?

C. Can the debtor's bankruptcy counsel represent the debtor in such challenges

Which of the following creates a difficult ethical dilemma for a Chapter 11 individual debtor's attorney? Can the attorney charge the estate to defend these?

D. The appointment of a Trustee;

E. An objection to claimed exemptions by a creditor;

F. The defense of several discharge ability proceedings.

Discharge

13. An individual debtor is in year 4 of her 5 year plan and looking forward to a discharge. The individual receives an unexpected royalty from a gas lease on land that was property of the estate. Can a creditor request a modification of the plan to require the debtor to use the inheritance to increase the amount that will be paid to creditors under the confirmed plan?

A. If so, under what standard is the court to consider the request?

B. Does it matter if the recovery is unexpected?

C. What if the creditors are only getting 10% of their claims over 5 years? What if they are scheduled to get 80%?

D. What if the creditor instead requests that the Debtor's plan be extended another 3 years?

14. Is it possible to deny a discharge to an individual chapter 11 debtor that otherwise could complete his or her plan? Does section 727 apply?