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The Absolute Priority Rule in Individual Chapter 11 Cases – The Eastern District of Wisconsin Offers Guidance

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) is the most recent significant amendment to the United States Bankruptcy Code. Many issues have arisen since its enactment. Of particular interest to those practicing in the Chapter 11 arena involves the absolute priority rule in individual Chapter 11 cases. Courts have split over whether an individual Chapter 11 debtor can confirm a plan of reorganization over the objections of unsecured creditors without regard to the absolute priority rule set forth in section 1129 of the Bankruptcy Code (Code). Recently, Judge Susan Kelley of the United States Bankruptcy Court for the Eastern District of Wisconsin decided the first case in that district that addresses this issue. In *In re Gerard*, 496 B.R. 850 (Bankr. E.D. Wis. 2013), Judge Kelley adopted the "narrow view," holding that an individual debtor's Chapter 11 plan must comply with the absolute priority rule. In that case, relying on section 1115(b) of the Code, the individual debtors sought to confirm a plan over the objection of unsecured creditors and retain their property without regard to the absolute priority rule.

Section 1129(b)(1) of the Code provides that to be confirmed, a plan of reorganization must be "fair and equitable." With respect to a class of unsecured creditors that votes against a plan, section 1129(b)(2)(B) defines "fair and equitable" as follows:

1. (B) With respect to a class of unsecured claims —

    1. the plan provides that each holder of a claim of such 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 of such claim; or

    2. 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....

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(emphasis added.)

Section 1115 of the Code provides:

1. In a case in which the debtor is an individual, property of the estate includes, in addition to the property specified in section 541 [which defines property of the estate] —

    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

    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.

2. 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.

Thus, the fair and equitable test requires that in order for subordinate classes of claims or interests to receive anything from the plan on account of their claims or interests, all senior classes of creditors must be paid in full or consent to the proposed treatment in the plan. This is known as the absolute priority rule.

While there is little dispute about the application of the rule to corporate Chapter 11 debtors, the language of the BAPCPA amendments has engendered a plethora of litigation in individual Chapter 11 cases. Although the United States Supreme Court held in a pre-BAPCPA case that the absolute priority rule applies to individual debtors. (*see Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988)), the ambiguity arising after BAPCPA created by the reference to section 1115 in section 1129(b)(2)(B)(ii) has spawned two opposing views.

The proponents of what is known as the "broad view" conclude that section 1115 and many of the other BAPCPA amendments are modeled after concepts contained in Chapter 13, which addresses adjustments of debts of wage earners. Chapter 13 does not include an absolute priority rule requirement for confirmation of a Chapter 13 plan. This, the "broad view" proponents suggest, is evidence that Congress intended to write the absolute priority rule out of individual cases, including individual Chapter 11 cases. See, e.g., *In re O'Neal*, 490

B.R. 837 (Bankr. W.D. Ark. 2013).

The opposite position is taken by the proponents of the "narrow view," who, like Judge Kelley in *Gerard*, find that the absolute priority rule is applicable in individual Chapter 11 cases. These courts rely on the long history of the application of the absolute priority rule in Chapter 11 cases and the absence of any provision of the Code or legislative history that clearly indicates that Congress intended to abrogate the absolute priority rule. These courts conclude that the application of absolute priority rule in individual cases previously approved by the Supreme Court should not be repealed by implication. Judge Kelley noted that the narrow view is the majority view and has been followed by three Circuit Courts of Appeal. *See Dill Oil Co. v. Stephens (In re Stephens)*, 704 F. 3d 1279 (10th Cir. 2013); *In re Lively* 717 F. 3d 406 (5th Cir. 2013); and *Maharaj v. Stubbs & Perdue, P.A (In re Maharaj)*, 681 F.3d 558 (4th Cir. 2012).

The debate is far from over and the issue perhaps won't be finally clarified unless another Circuit adopts the broad view and the matter is decided by the United States Supreme Court, or Congress further amends the Code to clarify its intention with respect to this issue. While it is only one opinion by one of four sitting bankruptcy judges in the district, In re *Gerard* provides at least a measure of guidance for debtors and creditors involved in individual Chapter 11 cases in the Eastern District of Wisconsin.