Sections 1115 and 1129(b)(2)(B): Possible Exceptions to the Application of the Absolute Priority Rule

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This article updates Balbus, Does the Absolute Priority Rule Apply to Individuals in Chapter 11?, 20 Norton J. Bankr. L. & Practice 79 (Jan. 2011) for a review of all relevant reported decisions during 2011.

I. Does the Absolute Priority Rule Apply to Individuals in Chapter 11?

A. Trend in 2011 Towards the Broad Interpretation

Prior to the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA),\(^1\) an individual debtor in Chapter 11 generally could not retain valuable, nonexempt, prepetition property by means of a plan of reorganization confirmed over the objection of a class of unsecured creditors. To be confirmed under §1129(b), among other requirements, a “cramdown” plan must have been “fair and equitable,” the primary component of which was satisfying §1129(b)(2)(B)(ii), the statutory codification of the absolute priority rule. Under the absolute priority rule, equity owners cannot retain any property unless senior classes of creditors have been paid in full. Prior to the enactment of BAPCPA, it was clear that, as a result of the absolute priority rule, unless their Chapter 11 plan provided for the payment of their creditors in full, individual debtors could not retain ownership of valuable business assets.

As part of BAPCPA, Congress amended §1129(b)(2)(B)(ii) by adding the following exception: “except that in the case in which the debtor is an individual, the debtor may retain property included in the estate under §1115” (emphasis added).

Under §1115(a), “in a case in which the debtor is an individual, property of the estate includes, in addition to the property specified in §541—(1) all property of the kind specified in §541 that the debtor acquires after the commencement of the case…; and (2) earnings from services performed by the debtor after the commencement of the case” (emphasis added).

The new exception language in §1129(b)(2)(B)(ii) is susceptible to two different interpretations. The first interpretation is that an individual debtor in Chapter 11 may retain all of the property that is defined as being included in the individual debtor’s estate under §1115.
The first interpretation thus reads the words “included in the estate under §1115” in §1129(b)(2)(B)(ii) broadly to mean all the individual’s property of the estate under §541 plus all of the property that is added to the individual’s estate under §1115. Under this interpretation, referred to as the “broad interpretation,” an individual debtor in Chapter 11 may retain prepetition assets (which are property of the estate under §541) as well as postpetition assets and earnings, all of which are “included” within the individual debtor’s estate pursuant to §1115.

The second interpretation of the new exception language in §1129(b)(2)(B)(ii) is that an individual debtor in Chapter 11 may retain only that property which is incorporated into the individual debtor’s estate by §1115 which has not already been incorporated into the individual debtor’s estate by §541. The second interpretation thus reads the words “included in the estate under §1115” in §1129(b)(2)(B)(ii) narrowly to mean only that property which is included in the estate under §1115 which would not otherwise be included in the estate under §541. Under this interpretation, referred to as the “narrow interpretation,” the maximum amount of property that an individual debtor in Chapter 11 may retain is postpetition assets and earnings. An individual debtor in Chapter 11 may not retain prepetition assets, because those assets are already included within the individual debtor’s property of the estate under §541 and are, therefore, not “included” within the individual debtor’s estate pursuant to §1115.

Initially, bankruptcy courts adopted the broad interpretation.3 The more recent trend, however, has been for bankruptcy courts in reported decisions to adopt the narrow interpretation.4 In 2011, bankruptcy courts almost exclusively adopted the narrow interpretation – that the absolute priority rule still applies with respect to individual Chapter 11 debtors and, as a result, such debtors may not retain prepetition assets.

B. In re Stephens

In re Stephens5 involved an individual debtor in Chapter 11 who owned an insurance agency, a mortgage brokerage and several parcels of real estate. Under his proposed plan of reorganization, the debtor was to retain two of the investment properties worth $396,1076 while paying unsecured creditors a total of $120,000 over five years.7 The class of unsecured creditors voted against the plan.8

After analyzing the relevant statutes and discussing the split in judicial opinions, the Bankruptcy Court for the Southern District of Texas followed the narrow interpretation, holding that the absolute priority rule was not abrogated for individuals in Chapter 11 for two reasons, both of which were based upon a textual analysis of §1115(a) and a determination that the narrow interpretation would have rendered portions of §1115(a) or §541 “surplusage.”

First, the Stephens court held that “[t]he language ‘in addition to the property specified in section 541’ in the preamble to §1115(a) would render surplusage the words ‘all property of the kind specified in section 541’ in §1115(a)(1), if §1115 is interpreted to include all property of the estate.”9

Second, the Stephens court held that “such a construction [the broad interpretation] would render Section 541 (which applies in Chapter 11 cases, including those of individuals, pursuant to Section 103(a)) itself surplusage.”10

Since the absolute priority rule still applied, the debtor’s proposed plan, which allowed him to retain $396,107 worth of real estate while failing to pay the unsecured creditors in full, could not be “crammed down” under §1129(b)(2)(B)(ii).11
C. In re Walsh

In re Walsh involved an individual debtor in Chapter 11 who owned 56 residential apartments in five locations, a home and a vacation property. Under his proposed plan of reorganization, the debtor was to retain an equity interest in some of the properties while paying unsecured creditors a 5% dividend over five years.

After reviewing the statutes, the broad view, as represented by Judge Markell in In re Shat and the narrow view, as represented by Judge Tchaikovsky in In re Gbadebo, the Bankruptcy Court for the District of Massachusetts adopted the broad view, holding that “because it deals with post-petition section 541(a) property (a most awkward construction), section 1115 does not include section 541(a) property as such.” The opinion went on to quote Judge Tchaikovsky’s language in Gbadebo:

If the clause referring to §541 had not been included in §1115 and if §1115 had merely stated that an individual chapter 11 debtor’s estate included post-petition property, the argument could have been made that an individual chapter 11 debtor’s estate did not include his pre-petition property.

The court thus concluded that the absolute priority rule did apply and that the debtor would have to confirm her plan by satisfying §1129(b), presumably either by paying unsecured creditors in full or by offering some new value.

D. In re Draiman

The Bankruptcy Court for the Northern District of Illinois in In re Draiman also chose to follow Gbadebo and adopted the narrow view. After analyzing the language of the relevant statutes and the legislative history, the court found no evidence that Congress had intended to eliminate the absolute priority rule for individual Chapter 11 debtors, 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.” The court’s plain reading of §1115 was that it added property to the debtor’s estate which had already been established by §541; §1115 did not absorb §541. Consequently, prepetition property could not be retained.

The Debtor had interests in healthcare, real estate, and energy procurement (natural gas and electricity). His plan provided that he would retain assets including office equipment, furnishings, supplies, a residence, cars, household goods, interests in IRA accounts, certain management agreements and financial interests, other tangible personal property. The Draiman court held that although the absolute priority rule precluded debtor’s attempt to keep nonexempt assets of the bankruptcy estate, the debtor qualified for the new value exception to the absolute priority rule. The debtor’s contribution of $100,000, which was to be funded by a business associate, was held to be new money; necessary to the plan, because it was to fund a liquidation trust; reasonably equivalent to the value of the retained assets, based upon the value of the assets stated in the disclosure statement; and substantial.

E. In re Kamell

In re Kamell involved a personal injury lawyer with a home and two rental properties. In his plan, the debtor proposed to keep substantial prepetition property without paying the dissenting unsecured creditors in full.
The Bankruptcy Court for the Central District of California adopted the narrow view, finding that there was “no good reason” to conclude that Congress intended to abrogate the absolute priority rule, a “long-standing and important centerpiece of Chapter 11 jurisprudence based on the ambiguous language of the BAPCPA amendments” without Congress clearly expressing that intent.28

Although the “broad view” courts found Congressional intent to treat individuals in Chapter 11 more like debtors in Chapter 13, which has no absolute priority rule,29 the Kamell court considered that view to be “rather convoluted and strained” particularly since the overall thrust of BAPCPA was punitive in nature.30 Furthermore, had Congress intended to abrogate the absolute priority rule, there were simpler ways to accomplish that.31 “[I]t would have been easier and more logical to simply insert “except in individual cases” at the beginning of §1129(b)(2)(B).”32 The court concluded that the drafters’ intent was “to keep the absolute priority rule as pertains to pre-petition assets as a further barrier to cram down under §1129(b)(2)(B).”33

The Kamell court acknowledged that something was being excepted from the application of the absolute priority rule for individuals and found an “equally plausible” explanation for the new exception language. The court drew a distinction between the portion of postpetition earnings an individual Chapter 11 debtor facing objection must devote to the plan under §1129(a)(15)34 and all postpetition earnings which become property of the estate under §1115(a)35. Under §1129(a)(15)(B), the debtor must devote no less than his projected disposable income36 for the greater of five years or the term of the plan. The calculation of projected disposable income is made after deducting certain living and business expenses. In contrast, property of the estate under §1115(a) includes all post petition earnings, not limited by any deduction for any living or business expenses. The court concluded that the new exception language in §1129(b)(2)(B)(ii) effectively allows the debtor to keep the portion of postpetition earnings that are paid for the maintenance or support of the debtor and his family and, if the debtor is engaged in business, for the payment of expenditures necessary for the continuation, preservation, and operation of such business.37 The court stated:

[I]f the “absolute priority rule” persisted after BAPCPA it would have prevented the debtor from keeping any of his postpetition earnings as the price for cram down; thus enters the necessary amelioration in §1129(b)(2)(B)(ii). Obviously, forfeiting all postpetition income would have been at least difficult if not impossible in almost all individual cases. So, the “absolute priority rule” had to be amended to let the debtor keep enough of his post petition earnings to sustain his livelihood.38

In a footnote to its opinion, the Kamell court found another reason to reject the broad interpretation:39 the broad view makes §1129(b)(2)(B)(i)40 into a nullity because no debtor would choose to pay a class of unsecured claim holders the full allowed amount of their claims when, under the broad interpretation, the debtor could keep prepetition property and confirm a cram down plan by otherwise satisfying the requirements of §1129(b). Since the “harsh” result of §1129(b)(2)(B)(i) would never be chosen over the “lenient if not entirely inapplicable” result of §1129(b)(2)(B)(ii), the statutory alternative of (B)(i) or (B)(ii) is an “absurdity,” thereby rendering §1129(b)(2)(B)(i) a nullity, which as a matter of statutory interpretation is frowned upon.41

F. In re Maharaj
The debtors in *In re Maharaj* were a husband and wife who owned the stock of an auto body repair business in which both worked. In their plan, the debtors proposed to retain not just the stock, which had a small and indeterminate value, but also cars, jewelry an insurance policy and an annuity, while paying unsecured creditors approximately $1,000/month for 60 months.

Although the plan passed the good faith, the best interest of creditors and the feasibility tests of §§1129(a)(3), (7), and (11), the Bankruptcy Court for the Eastern District of Virginia adopted the narrow view that “the absolute priority rule continues to exist in individual chapter 11 cases with respect to non-exempt property that was owned by the debtor on the filing date of the petition.”

After laying out the arguments of both interpretations, the *Maharaj* court concluded that “upon careful consideration, this court finds the [narrow] interpretation placed on §1129(b)(2)(B)(ii) … to be more consistent with the structure of the changes made by BAPCPA.” The court, following *Mullins*, concluded that had Congress intended to exempt individual debtors in Chapter 11 from the absolute priority rule, it would have been easier and more straightforward to have §1129(b)(2)(B)(ii) read: “except that in a case in which the debtor is an individual, this provision shall not apply” instead of adding the reference to §1115. In addition, the court, following *Karlovich*, concluded that had Congress intended to make Chapter 11 for individuals more like Chapter 13, it would have been easier and more straightforward for Congress to have raised or eliminated the debt limits in §109(e).

The *Maharaj* court expressed some reluctance about its conclusion. The court acknowledged that the debtors did not have enough income to contribute to a plan that might be accepted by unsecured creditors, and the court further recognized that the proposed plan would provide those rejecting unsecured creditors with a better recovery than they would receive in a liquidation under Chapter 7. The court noted that “a fundamental feature of chapter 11 is the right of creditors to vote on a plan that impairs their claims, and confirmation can be achieved over their rejection of the plan only in limited circumstances.”

### G. In re Lindsey

The debtor in *In re Lindsey* proposed to retain a lot of property, including: six parcels of real property, notes exceeding $500,000, shares of stock and LLC membership interests in real estate holding, leasing and other entities, a pistol, a car, a truck and office equipment.

The Bankruptcy Court for the Eastern District of Tennessee considered the arguments and prior judicial decisions in support of the broad and narrow interpretations in great detail. Given the split of authority interpreting §§1129(b)(2)(B)(ii) and 1115, the court found the language to be ambiguous and the sparse legislative history to be unhelpful in resolving the ambiguity. Relying on its own statutory analysis, the court concluded:

> [B]ecause §1115 is a supplement to [and does not supplant] §541 with respect to individual Chapter 11 debtors, the more logical reading of the phrase “included in the estate under section 1115” is the narrow one—that Congress intended for only post-petition wages and debtors’ after-acquired property to be excepted from the absolute priority rule.

Had Congress intended to completely exempt individual Chapter 11 debtors from the absolute priority rule, the *Lindsey* court concluded, Congress would have done so in a more explicit manner. The court also found the narrow interpretation more in line with the punitive
purpose of BAPCPA—to make debtors pay creditors as much as possible. “[B]ringing post-petition wages and property acquired by debtors postpetition into their estates better serves those purposes by offering trustees and debtors-in-possession additional assets with which to reorganize.”

H. In re Tucker

In re Tucker involved husband and wife debtors who owned a tanning salon business, which presumably was one of the assets the debtors were proposing to retain under a plan that also proposed to pay unsecured creditors a 16% dividend. The court refused to confirm the plan because it violated the absolute priority rule and because the unsecured promise of payments out of expected future salary did not constitute “new value” to meet the “new value exception” to the absolute priority rule.

After a quick review of the divide in cases between the broad and narrow interpretations, the Bankruptcy Court for the District of Oregon agreed with the narrow interpretation following the reasoning and holding in Karlovich:

The Absolute Priority Rule as applied to individual Chapter 11 debtors survived the changes made by BAPCPA to §1129(b)(2)(B)(ii) and the addition of §1115, and puts individual chapter 11 debtors in the same position as other chapter 11 debtors with respect to the Absolute Priority Rule.

Even though the debtors’ plan violated the absolute priority rule, the Tucker court found that the plan could still be confirmed on a cram down basis, pursuant to the “new value” exception to the absolute priority rule, provided the new value was: (1) new, (2) substantial, (3) money or money’s worth, (4) necessary for a successful reorganization, and (5) reasonably equivalent to the value or interest received. Further, the value had to be tangible, alienable, enforceable, and something of value to the creditors at the time the plan was confirmed.

The new value the debtors proposed to contribute was future salary earned by one of the debtors over the life of the plan. The Tucker court held that the unsecured promise of payments out of anticipated future salary did not meet the requirement that the new value given be in “money or money’s worth,” under Ahlers because “it cannot be exchanged in any market for something of value to the creditors at the time the plan is confirmed.”

I. In re Borton

In In re Borton, the Bankruptcy Court for the District of Idaho adopted the narrow view and denied confirmation of debtor’s plan for failure to satisfy the absolute priority rule. The debtor was a medical doctor, specializing in dermatology in California and Idaho. She operated her practice through a subchapter S corporation, which had not filed a petition. Her bankruptcy was primarily designed to deal with personal taxes owed the Internal Revenue Service and the Idaho State Tax Commission. Under the proposed plan, unsecured creditors were to receive an estimated .05% distribution with the debtor retaining all interests and property.

In a brief opinion, the court noted the split of authority among the nation’s bankruptcy courts and agreed with the court’s observation in Maharaj that “[s]o many able jurists have written so extensively on this issue that little purpose would be served by yet another analysis of the competing arguments.” The court adopted the narrow view, finding that the statutory language was unambiguous: §1129(b)(2)(B)(ii) left the absolute priority rule in place, except
for postpetition property and §1115 therefore supplements rather than supplants or subsumes §541.

J. SPCP Group v. Biggins

In SPCP Group, LLC v. Biggins, the District Court for the Middle District of Florida upheld the decision of the bankruptcy court in that district that the broad interpretation applied, thus allowing the debtors to retain prepetition property.

The case involved four individual Chapter 11 debtors who each owned a 25% interest in a corporation that owned an assisted living facility, and a 25% interest in the management company. Each personally guaranteed a $5 million secured debt incurred by the corporation to fund operations. The corporation defaulted on the debt. The corporation, the management company and the four individuals all filed petitions in Chapter 11.

The bankruptcy court, relying on In re Shat, held that the absolute priority rule no longer applied to individual Chapter 11 debtors, and therefore the debtors’ proposed plans, which permitted the debtors to retain their interest in the corporation that owned the assisted living facility while the secured creditor was being paid less than its full claim, were “fair and equitable” to the secured creditor.

The secured creditor appealed the bankruptcy court decision granting plan confirmation arguing that the bankruptcy court should have adopted the narrow view, as did another bankruptcy court in the Middle District of Florida in In re Gelin.

The district court concluded that the broad interpretation was correct and affirmed the bankruptcy court’s ruling. The district court reached its conclusion by focusing on the statutes’ plain language:

The plain reading of this statute is that “property of the estate,” for purposes of Section 1115, includes property acquired and earnings earned after the debtor files his or her Chapter 11 petition, in addition to property specified in section 541. Property specified in section 541 includes property that the debtor holds an interest in at the time of the commencement of the bankruptcy case.

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 the bankruptcy case. The meaning of these statutes is clear, and therefore, the Court’s inquiry stops here. According to the plain meaning of the statutes, Debtors’ plans could be confirmed over SPCP’s objections 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. (Internal citations omitted).

II. Does it Matter Who Contributes the New Value?

A. In re Greenwood Point, LP

In In re Greenwood Point, LP, the Bankruptcy Court for the Southern District of Indiana held that absolute priority rule did not apply where 100% of the equity in a reorganized
Chapter 11 debtor was being received, not by debtor’s sole and current owner, but by his wife in exchange for a $100,000 cash infusion, where the record indicated that the wife, who owned numerous related businesses, had no prior legal relationship to the debtor, and was not a “straw person” who intended to later transfer the equity interest back to her husband.

The debtor was a limited partnership that owned a retail shopping center. All of the limited partnership interests and all of the shares of the corporate general partner were owned by one individual (“Husband”). The debtor had no employees of its own. Management was contracted out to a management company owned by Husband. Subsequent to filing, but prior to plan confirmation, ownership of the management company was transferred from Husband to his wife (“Wife”) for $50,000. Following that transfer, Husband remained President of the management company earning an annual salary of $600,000.

Under the proposed plan of reorganization, Husband’s ownership interests in the limited partnership would be cancelled. New equity in the reorganized debtor would be issued to a new limited partner and a new general partner both owned by Wife in exchange for a cash infusion of $100,000, which would not come from the debtor or Husband.

The secured lender objected to the plan, claiming, among other reasons, that the receipt by Wife, an insider, of equity of the debtor before all general unsecured claims were paid in full violated the absolute priority rule. The court disagreed.

Based upon a literal reading of §1129(b)(2)(B)(ii), which prohibits only current holders of equity interests from retaining any interests or property on account of their equity interests unless senior classes are paid in full, and three cases involving a similar issue, the court held that the absolute priority rule does not apply to individuals who are not current owners of the debtor, whether or not those individuals are insiders. However, the court noted, the new equity purchaser cannot be used by the current equity holder to retain its interest. Evidence presented at the confirmation hearing convinced the court that Wife was acting as a distinct arms-length purchaser and not as an agent or “straw man” for Husband, allowing him to indirectly retain his equity interest in the debtor.

The next issue addressed by the court was, assuming arguendo that the absolute priority rule did apply to an insider of old equity, whether the plan violated the new value exception to that rule because the value of the equity being issued to Wife was not market tested as required by the Supreme Court’s decision in LaSalle.

Although the Supreme Court suggested that “exposure to the market,” rather than a bankruptcy court valuation, is the proper way to value equity interests, the Greenwood Point court found that in this case there was no requirement to “market test” the $100,000 offer by Wife. Based upon the evidence, the court found the offer was equal to or better than any other offer anticipated and better in the long-term for the creditors of the bankruptcy estate. Additionally, the court found that the $100,000 cash contribution was “substantial,” despite being only 4.2% of unsecured claims, in light of the fact that it was the best that a potential buyer would offer and thus sufficient to satisfy the new value exception to the absolute priority rule.

**B. In re Multiut Corporation**

In In re Multiut Corporation, the bankruptcy court for the Northern District of Illinois addressed an issue similar to Greenwood Point: if the new value being contributed by the current equity holder is funded by a business associate of the current equity holder, is the absolute priority rule violated? The court held that it was not.
The debtor, a wholesale purchaser and resupplier of natural gas, proposed a plan under which the sole and current shareholder would retain 100% ownership by making a cash infusion of $100,000, which would be funded by an associate in a related business.\textsuperscript{102}

An objection to confirmation claimed the $100,000 contribution was suspect because there was potential for “collusion and mischief.” The court held that, “[t]he potential for ‘collusion and mischief’ has absolutely no bearing on the issue of whether [the sole shareholder] is offering ‘new value’ for his one hundred percent interest in the Debtor.”\textsuperscript{103}

The court sustained a second objection, that the $100,000 contribution was not reasonably equivalent to the value of 100% of the equity in the debtor, because the plan lacked a liquidation analysis and otherwise failed to value the debtor’s assets.\textsuperscript{104}

### III. With Debtors That Are Balance Sheet Insolvent, How is Reasonably Equivalent Value to be Determined?

#### A. In re Red Mountain Machinery Co.

Corporate debtors in Chapter 11 are frequently balance sheet insolvent and, therefore, have balance sheets with no equity. \textit{In re Red Mountain Machinery Co.}\textsuperscript{105} dealt with the issue of determining the value of a balance sheet insolvent debtor’s equity, so that the court could then determine whether the new value being contributed was reasonably equivalent to it.

The debtor corporation was in the business of leasing large earth moving equipment.\textsuperscript{106} Under the proposed reorganization plan, the former shareholders would have their existing equity eliminated and would contribute $480,000 in cash in exchange for 100% of the equity of the reorganized debtor and would fund an exit loan facility in the amount of $1.25 million.\textsuperscript{107}

The debtor’s principal lender objected to the plan for, among other reasons, violating the absolute priority rule and its new value corollary.\textsuperscript{108}

The Bankruptcy Court for the District of Arizona found that four of the five requirements of the new value corollary were easily satisfied. The cash being contributed by the former shareholders was new, in money or money’s worth\textsuperscript{109}, substantial\textsuperscript{110} and necessary for a successful reorganization\textsuperscript{111}.

The fifth requirement, equivalence to the value of the interest received, was conceptually more difficult, according to the court, because when a debtor’s debts exceed its assets, the equity has no value, yet the Supreme Court has held the absolute priority rule to be violated even if old equity retains its interests “only for purposes of control.”\textsuperscript{112} The \textit{Red Mountain Machinery} court understood from the Supreme Court opinions that there is value to such retained equity interest, and the court is required to determine whether that value exceeds the amount of the new value contribution, “but the Supreme Court has never suggested any legal, accounting or economic analysis or methodology by which that determination could be made.”\textsuperscript{113}

The court found the solution in \textit{LaSalle}, which explained that the “equity value exists in the option value of the exclusive right to propose a new value plan.”\textsuperscript{114} Once the exclusive period has expired, however, the court reasoned that the option value expires and value of the interest being retained can be determined based upon either the balance sheet of the reorganized debtor or a capitalization of the reorganized debtor’s projected cash flow.\textsuperscript{115}

The \textit{Red Mountain Machinery} court found that the exclusive period had expired, so there was no option value. No evidence was admitted regarding the value of the reorganized debtor’s
equity on either a discounted cash flow or comparable company multiple basis. In the absence of such evidence, the court was left with a balance sheet on which liabilities substantially exceeded assets, including the new value being contributed. Accordingly, the court found that the value of the $480,000 cash being contributed was substantially greater than the reorganized debtor’s equity being received by the former shareholders.

Notes
2. Section 541 specifies that property of the estate includes “all legal and equitable interests of the debtor in property as of the commencement of the case.”
3. See In re Tegeder, 369 B.R. 477, 480, 48 Bankr. Ct. Dec. (CRR) 88 (Bankr. D. Neb. 2007) (court acknowledged absence of reported decisions, relied upon treatises and commentators, and found the statutory language unambiguous); In re Roedemeier, 374 B.R. 264, 275–76, 48 Bankr. Ct. Dec. (CRR) 196 (Bankr. D. Kan. 2007) (court relied upon treatises and commentators, 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); and In re Shat, 424 B.R. 854, 859–865, 63 Collier Bankr. Cas. 2d (MB) 748, Bankr. L. Rep. (CCH) P 81701 (Bankr. D. Nev. 2010) (narrow view “underscored by other changes made at the same time” to make individual Chapter 11 cases more like Chapter 13 cases, including §1129(a)(15), requiring a debtor to commit earnings to the plan; consequently, debtor can’t be said to ‘retain’ income).
4. See In re Gbadebo, 431 B.R. 222, 229, 63 Collier Bankr. Cas. 2d (MB) 1293, Bankr. L. Rep. (CCH) P 81753 (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 Gelin, 437 B.R. 435, 441, 64 Collier Bankr. Cas. 2d (MB) 435, Bankr. L. Rep. (CCH) P 81662 (Bankr. M.D. Fla. 2010) (broad view was plausible given text’s unquestionable ambiguity; since neither §103(a) nor §541 was amended by BAPCPA, “there is no reason for section 1115 to ‘absorb’ or ‘supersede’ section 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 Mullins, 435 B.R. 352, 360, (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 Karlovich, 456 B.R. 677, 682 (Bankr. S.D. Cal. 2010) (statutory language unambiguous; had Congress intended to abrogate the absolute priority rule for individuals, it could 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); and In re Steedley, Bankr. L. Rep. (CCH) P 81872, 2010 WL 3528599 (Bankr. S.D. Ga. 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).
6. The debtor presented no evidence as to the value of the two properties. The court found, for the purpose of considering confirmation of the plan, that the two properties were worth $396,107.
7. Stephens, 445 B.R. 819. It is unclear from the opinion, but presumably the debtor also proposed to retain his equity in the insurance agency and mortgage brokerage.
9. Stephens, 445 B.R. at 820-821. This appears to be an incorrect reading of the statute. The words “all property of the kind specified in section 541” in §1115(a)(1) are a qualitative description, identifying the type of property that a debtor acquires postpetition that would be included in the debtor’s estate. Section 541(b), for example, excludes numerous types of prepetition property from being included within a debtor’s estate. The same types of exclusions would apply to postpetition property under §1115(a)(1). The words “all property of the kind specified in section 541” in §1115(a)(1) would only be surplusage to the words “in addition to the property specified in section 541” in the “preamble” to §1115(a), if they were referring to the same property. If prepetition property were being included in §1115(a)(1), then the words “in addition to the property specified in section 541” in the “preamble” would be surplusage. There would be no reason to include prepetition property twice. But, neither the broad nor the narrow interpretation views §1115(a)(1) as including prepetition property.
10. Stephens, 445 B.R. at 821. This interpretation is also questionable. Under the broad interpretation, §1115(a) includes property specified in §541 in property of the estate of individuals in Chapter 11. It does not write §541 out of the Bankruptcy Code. Section 541 is still needed, for example, to determine what types of postpetition property are not included in the debtor’s estate.

11. The court might have disposed of this case without addressing the applicability of the absolute priority rule, by finding that the proposed plan violated the best interests of creditors test under §1129(a)(7) as the debtor was retaining $396,107 worth of real estate while paying unsecured creditors only $120,000. For a recent case in which a court did not reach the absolute priority rule issue because it held that the debtor’s plan failed to satisfy the best interests of creditors test and the feasibility test, see In re Hockenberry, 457 B.R. 646, 660-661 (Bankr. S.D. Ohio 2011).


16. Walsh, 447 B.R. at 48. The opinion does not explain why the limitation on inclusion of postpetition property to the kind of property specified in §541 should thereby exclude prepetition property from being included as property of the estate under §1115, despite the wording “[i]n a case in which the debtor is an individual, property of the estate includes, in addition to the property specified in section 541” (emphasis added). The court also disagreed with Judge Markell because “Section 1115 deals with something more than post-petition income from services—it also brings in property described in section 541 but which is acquired post-petition.”

17. Walsh, 447 B.R. at 49. This argument is frequently cited in opinions upholding the narrow interpretation despite its irrelevance. Obviously if property specified in §541 had not been “included” in §1115, there would be no ambiguity. Only postpetition property and service income would be added to the property of the estate of an individual in Chapter 11. The very fact that the clause referring to §541 is included in §1115 is some indication that prepetition property is included in §1115 as the broad interpretation argues.

18. Walsh, 447 B.R. at 49 n15. Another option would be for the debtor to propose a consensual plan.


22. Draiman, 450 B.R. at 786.


27. Kamell, 451 B.R. at 507. There is no discussion in the case of the value of the practice, the residence or one rental property. The only asset discussed in the case is the second rental property. The secured debt was bifurcated into a secured claim valued by the court at $1.6 million and an unsecured claim of $1.3 million. The dissenting unsecured creditor’s claim was large enough to require the debtor to propose a “cram down” plan.

28. Kamell, 451 B.R. at 506, 508. The court went on to state, “It has long been held that major changes to existing practice will not be inferred unless clearly mandated” and “the ‘broad view’ effectively overrules Norwest Bank Worthington v. Ahlers in individual cases. The court agrees that such a momentous change should have at least merited a mention in the legislative history.” Kamell, 451 B.R. at 509-510.

29. For a description of the provisions of Chapter 13 that were adopted into Chapter 11 cases for individuals see Balbus, Does the Absolute Priority Rule Apply to Individuals in Chapter 11?, 20 Norton J. Bankr. L. & Practice 79 (Jan. 2011).

30. Kamell, 451 B.R. at 508. This argument, also known as the “Debtor always loses rule,” may prove too much. Will a court rule against the debtor on every issue involving construction of a BAPCPA statute because more BAPCPA provisions force debtors to pay as much as they can rather than help debtors get a fresh start? Arguably, one already has. In Baud v. Carroll, 634 F.3d 327, Bankr. L. Rep. (CCH) P 81930 (6th Cir. 2011), cert. denied, 132 S. Ct. 997, 181 L. Ed. 2d 732 (2012), the Sixth Circuit held against the debtor, partially relying on the Supreme Court’s language in Ransom v. FIA Card Services, N.A., 131 S. Ct. 716, 178 L. Ed. 2d 603, 54 Bankr. Ct. Dec. (CRR) 34, 64 Collier Bankr. Cas. 2d (MB) 1123, Bankr. L. Rep. (CCH) P 81914 (2011) that BAPCPA’s overall purpose was “ensuring that debtors repay creditors to the extent they can.”
Kamell, 451 B.R. at 509. Creditors beware: If the “My opponent’s proposed construction cannot be correct because there were easier ways for Congress to have drafted that” argument takes hold, how will the “hanging paragraph” of §1325(a) ever be enforced?

The problem with this argument is that had §1129(b)(2)(B)(ii) read “except in a case in which the debtor is an individual,” the ambiguity would have been shifted to what aspect of the absolute priority was being excepted. The additional language “the debtor may retain property included in the estate under section 1115” eliminates that ambiguity.

Kamell, 451 B.R. at 510. In another variation on the “there were easier ways for Congress to have drafted that” argument, the court concluded that had Congress intended individual Chapter 11’s to be like large Chapter 13’s, Congress could have just raised the debt limitations of §109(e).

Section 1129(a)(15) provides that:
In a case in which the debtor is an individual and in which the holder of an allowed unsecured claim objects to the confirmation of the plan—
(A) the value, as of the effective date of the plan, of the property to be distributed under the plan on account of such claim is not less than the amount of such claim; or
(B) the value of the property to be distributed under the plan is not less than the projected disposable income of the debtor (as defined in section 1325(b)(2)) to be received during the 5-year period beginning on the date that the first payment is due under the plan, or during the period for which the plan provides payments, whichever is longer.”

Section 1115(a) provides that:
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 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.

Section 1129(a)(15) cross references section 1325(b)(2) for the definition of “projected disposable income.” Section 1325(b)(2) provides:
For purposes of this subsection, the term “disposable income” means current monthly income received by the debtor (other than child support payments, foster care payments, or disability payments for a dependent child made in accordance with applicable nonbankruptcy law to the extent reasonably necessary to be expended for such child) less amounts reasonably necessary to be expended—
(A)(i) for the maintenance or support of the debtor or a dependent of the debtor, or for a domestic support obligation, that first becomes payable after the date the petition is filed; and
(ii) for charitable contributions (that meet the definition of “charitable contribution” under section 548(d)(3)) to a qualified religious or charitable entity or organization (as defined in section 548(d)(4)) in an amount not to exceed 15 percent of gross income of the debtor for the year in which the contributions are made; and
(B) if the debtor is engaged in business, for the payment of expenditures necessary for the continuation, preservation, and operation of such business.

Kamell, 451 B.R. at 511. One of the problems of the narrow interpretation is that if the new exception language in §1129(b)(2)(B)(ii) is not excepting prepetition property from the absolute priority rule, what is being excepted? The Kamell court suggests that the purpose of the exception in §1129(b)(2)(B)(ii) is to protect postpetition earnings and property from becoming subject to the absolute priority rule. It explains why, if BAPCPA was designed to be merely punitive, Congress would have introduced any exception at all into §1129(b)(2)(B). The more fully articulated argument is that §541 covers all property of the estate as of the commencement of the case and §1115(a) adds to property of the estate postcommencement earnings and property, so that without an exception in §1129(b)(2)(B)(ii) an unsecured creditor who was not paid in full might claim that an individual debtor in Chapter 11 could not receive any earnings or property in the future because such future earnings and property are property of the debtor’s estate, receipt of which would violate the absolute priority rule and, therefore, the creditor should be entitled to such future earnings and property. Courts, like Kamell and Karlovich that have raised this explanation for the new exception language in §1129(b)(2)(B)(ii), have limited the exception to protecting just that portion of the debtor’s future earnings that are not required to be distributed to creditors under §1129(a)(15)(B), which requires the individual debtor in Chapter 11 to distribute not less than the debtor’s projected disposable income for five years or the length of the plan, whichever is longer. Without the new
exception language in §1129(b)(2)(B)(ii), reason those courts, the debtor would be unable to pay living expenses and expenditures necessary for the continuation, preservation, and operation of the debtor’s business. That income would instead have to go to unsecured creditors. The “protection” justification for the new exception language in §1129(b)(2)(B)(ii) could even go further. For example, assume the debtor wins a lottery or gets an unexpected bonus (and projected disposable income was not modifiable) in year two of the debtor’s plan. In the absence of an exception in §1129(b)(2)(B)(ii), arguably §1115(a) would force the debtor to turn the bonus or lottery winnings over to an unsecured creditor who claimed the absolute priority rule did not allow the debtor to receive that property of the estate until the creditor had been paid in full. There are several statutory construction issues that call into question this explanation for the new exception language in §1129(b)(2)(B)(ii). First, for the absolute priority rule of §1129(b)(2)(B)(ii) to be implicated, the debtor would have to receive future earnings or property under the plan. Plans do not normally provide for the debtor to receive future earnings or property. Plans generally provide for the revesting of estate property in the debtor at the time of confirmation, but it is not clear that such revesting would re vest earnings and property to be received in the future. The property that normally is revested is that property which is in existence at the time of confirmation. Second, for the absolute priority rule of §1129(b)(2)(B)(ii) to be implicated, the plan would have to provide for the debtor to receive future earnings or property on account of an interest that the debtor held. Does a debtor have an equity interest in himself? Can a debtor hold an interest in his own ability to earn income, particularly bonus income? Can a debtor hold an interest in his possible future lottery winnings? Such a construction is quite awkward. Consequently, the exception in §1129(b)(2)(B)(ii) does not appear to except anything under the broad interpretation. Note that §1115(b) allows the debtor to remain in possession of all property of the estate, except as provided in §1104 (regarding the appointment of a trustee or examiner) or a confirmed plan or order confirming a plan, just as §1306(b), the Chapter 13 analog of §1115(b), allows retention of postpetition earnings for a debtor in Chapter 13.

40. Section 1129(b)(2)(B)(i) provides: With respect to a class of unsecured claims—
   (i) 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 amount of such claim; or
41. Kamell, 451 B.R. at 508, n3 (citations omitted). The counter to this argument would be that the Bankruptcy Code is replete with provisions that are stated in the alternative, but, as a practical matter, one or more alternatives are virtually never chosen.
43. Maharaj, 449 B.R. at 489.
44. Maharaj, 449 B.R. at 493. The United States Trustee supported the debtors’ position that the absolute priority rule did not apply. Maharaj, 449 B.R. at 487.
47. Maharaj, 449 B.R. at 493.
49. Maharaj, 449 B.R. at 493. While raising the debt limits might have been an alternative to making Chapter 11 for individuals more like Chapter 13, Congress clearly evidenced an intent to make Chapter 11 for individuals more like Chapter 13 while still preserving most of the aspects of Chapter 11, by enacting six specific changes to the Bankruptcy Code that make Chapter 11 function for individuals the way Chapter 13 functions. See Balbus, Does the Absolute Priority Rule Apply to Individuals in Chapter 11?, 20 Norton J. Bankr. L. & Practice 79 (Jan. 2011).
52. Maharaj, 449 B.R. at 494. In essence, the Maharaj court found Congress’ drafting of the new exception language in §1129(b)(2)(B)(ii) to be more illogical than allowing unsecured creditors to reject a plan that would pay them more than liquidation value.
53. In re Lindsey, 453 B.R. 886 (Bankr. E.D. Tenn. 2011). This case is unusual in that the objection to confirmation for violation of the absolute priority rule arose in a Motion for Summary Judgment, not in a confirmation hearing.
54. Lindsey, 453 B.R. at 888-89. Given the substantial value of the property the debtor sought to retain, it is hard to see how a plan could have satisfied the best interests of creditors test under §1129(a)(7).
55. Lindsey, 453 B.R. at 903.
56. Lindsey, 453 B.R. at 903.
57. Lindsey, 453 B.R. at 903-04. “For instance, it could simply have added the phrase “except in a case in which the debtor is an individual” to the beginning of subsection (ii) without reference to §1115 at all.”
58. Lindsey, 453 B.R. at 904, citing legislative history, citations omitted.
59. Lindsey, 453 B.R. at 905. Bringing postpetition wages and property into a debtor’s estate is accomplished by §1115(a).
66. Tucker, 2011 WL 5926757 at *2. The opinion suggests that this future salary was “additional personal money.” It is not clear from the opinion why that postpetition salary would not be included in the debtor’s projected disposable income to be distributed under the plan for the greater of five years or the length of the plan under §1129(a)(15).
76. SPCP Group, 2011 WL 4389841 at *1.
77. The secured creditor brought a state court action to enforce the personal guarantees and the individual guarantors subsequently filed Chapter 13 petitions, which were later converted to Chapter 11 cases.
78. SPCP Group, 2011 WL 4389841 at *1.
80. The proposed plans called for the individuals to retain their ownership in the corporation that owned the assisted living facility while not paying any money to the secured creditor because monthly payments were to be made to the secured creditor under the corporation’s confirmed plan, but the secured creditor retained the right to enforce the guarantees if those payments stopped.
82. SPCP Group, 2011 WL 4389841 at *4.
84. SPCP Group, 2011 WL 4389841 at *5. In footnote 6, the court noted that Gelin was factually distinguishable because the debtors in Gelin proposed to pay their unsecured creditors less than 1% of their claims, while the creditor in SPCP Group would be repaid 118% of its claim. Furthermore, the Gelin court expressed “significant doubt” over the feasibility of the debtors’ plan, whereas the bankruptcy court in SPCP Group found that the plans of the corporation and the management company, the entities that were to make payments to the secured creditor, were feasible, a ruling which was upheld on appeal.
85. SPCP Group, 2011 WL 4389841 at *5.
88. Husband testified that the $50,000 paid to him by Wife was the full value of the company. Greenwood Point, 445 B.R. at 891.
89. Greenwood Point, 445 B.R. at 891.
90. Greenwood Point, 445 B.R. at 909.
92. The section is misidentified as §1129(a)(2)(B)(i) in the opinion. Greenwood Point, 445 B.R. at 910. Section 1129(b)(2)(B)(ii) provides:
With respect to a class of unsecured claims—

(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 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.


94. The court noted that the application of the absolute priority rule was extended to a nonowner insider in In re Global Ocean Carriers Ltd., 251 B.R. 31, 49 (Bankr. D. Del. 2000) (the exclusive opportunity to determine who will be the owner of the reorganized debtor is a property interest that must be marketed, even when the proposed owner is neither a creditor nor current owner of the debtor). Greenwood Point, 445 B.R. at 910.

95. Greenwood Point, 445 B.R. at 911.

96. Evidence at the confirmation hearing revealed that during the month in which the bankruptcy petition was filed and for several months thereafter, Wife was either deeded for estate planning reasons, or purchased with her own funds 14 other shopping centers from Husband, which enabled Wife to diversify her portfolio and Husband to raise capital. Wife testified that although she had never been an owner, partner, employee or otherwise involved in the operations of the shopping centers, she had a vested interest in acquiring the shopping centers because she also bought the entity that managed the shopping centers from Husband and had no intention of reconveying her interests in any of those entities to Husband. Greenwood Point, 445 B.R. at 911.


99. The evidence included testimony that there was no marketplace for the sale of the debtor, that no shopping centers in the area had recently been sold and that ownership of the debtor was not worth $100,000 in light of the current vacancy rate of 21% and the required debt service imposed by the plan.

100. Greenwood Point, 445 B.R. at 913.

101. Oddly, the current equity holder testified that he did not know if the money from his associate was a loan or a gift. While the court found that whether the contribution was a loan or a gift to the current equity holder was of no consequence to the debtor, as to which the contribution would be new regardless, the current equity holder was himself a debtor in a separate Chapter 11 proceeding. Multiut Corp., 449 B.R. at 354.

102. Multiut Corp., 449 B.R. at 354. No authority was cited by the objector to support its argument.

103. A substantial claim against a former law firm was not valued as an asset of the debtor. The plan otherwise satisfied the five LaSalle factors comprising the new value exception to the absolute priority rule recognized in the Seventh Circuit. The $100,000 contribution was new, in the form of money, substantial, and necessary (without the contribution, there likely would not be enough funds to pay administrative claimants in full on the effective date). Multiut Corp., 449 B.R. at 354.

104. Red Mountain Machinery, 448 B.R. at 1. The company’s business model was to buy older, cheaper equipment, maintain the equipment well, service it quickly when it broke down and charge less than competitors leasing new equipment.

105. Red Mountain Machinery, 448 B.R. at 1. The reorganized debtor would then have more than enough funds to pay all administrative claims, including the claims of former shareholders, and to fund a capital reserve.

106. Red Mountain Machinery, 448 B.R. at 15-16. The $480,000 contribution was characterized as both a waiver of administrative claims and a cash contribution.
The court noted that the contribution was neither “nominal or de minimis.” It was more than three times the annual gross salary of a U.S. Bankruptcy Judge, approximately 3% of the unsecured debt being discharged, and in line with other cases in the circuit. Red Mountain Machinery, 448 B.R. at 16.

The contribution was necessary to pay the administrative claims, without which the reorganization could not occur.


Red Mountain Machinery, 448 B.R. at 17. The court suggested that a discounted cash flow or a comparable company multiple analysis, presumably after deducting remaining debt, were better methods of determining value than the debtor’s reorganized balance sheet.

Apparantly, the secured creditor’s §1111(b) election resulted in a nominal debt on the balance sheet that was much higher than the value of the collateral.

Red Mountain Machinery, 448 B.R. at 19.