Continued Disagreement Over the Application of the Absolute Priority Rule to Individuals in Chapter 11: *Friedman* and *Maharaj*

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The answer to a critical issue, on which many courts disagree, determines whether an individual choosing Chapter 11 to reorganize may retain valuable, nonexempt, prepetition business assets, an important if not the sole source of funds to make payments under a Chapter 11 plan of reorganization. The issue turns on whether the absolute priority rule applies in an individual's Chapter 11 case. If it does, the debtor will not be able to retain those business assets after confirmation of the plan, whereas, if that rule does not apply, as held by many courts, the debtor will be able to confirm a plan that provides for the retention of those assets.

Recently, the Ninth Circuit Bankruptcy Appellate Panel ("BAP") in *In re Friedman*[1] and the Fourth Circuit Court of Appeals in *In re Maharaj*[2] published sharply different opinions regarding whether the absolute priority rule applies to individual debtors in Chapter 11.[3] This article will discuss those opinions, identifying and explaining the arguments, reasoning and rationale behind the broad interpretation adopted by the Ninth Circuit BAP in *Friedman*, and the narrow interpretation adopted by the Fourth Circuit in *Maharaj*. The arguments considered in these two cases are representative of the arguments that have been advanced in most of the prior cases that have addressed whether the absolute priority rule applies to individual debtors in Chapter 11, an issue that ultimately will have to be decided by the Supreme Court.

I. Introduction

Prior to the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA),[4] 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 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*[5]—(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 Broad Interpretation

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 Narrow Interpretation

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 estate under § 541 and are, therefore, not "included" within the individual debtor's estate pursuant to § 1115.

Initially, bankruptcy courts adopted the broad interpretation.[6] The more recent trend, however, has been for bankruptcy courts in reported decisions to adopt the narrow interpretation[7]—that the absolute priority rule still applies to individual debtors in Chapter 11 and, as a result, such debtors may not retain valuable, nonexempt, prepetition business assets pursuant to a cram down plan, unless creditors are paid in full.

II. *In re Friedman*

The essential facts of the Friedmans' personal Chapter 11 filing are fairly straightforward.[8] The debts of Gregory Friedman and Judith Mercer-Friedman stemmed from their ownership of two internet service providers and investment real property located in Breckenridge, Colorado.[9] The Friedmans had substantial federal and state tax liabilities as well as other secured and unsecured debts.[10]

In Schedule B (Personal Property) of their Chapter 11 petition, among other items, the Friedmans listed ownership interests in three business entities: (1) AZCI Net, LLC ("AZCI"),

which was another internet service provider solely owned by the Friedmans; (2) Blue River Networks, Inc. ("Blue River"), a technology and management consulting corporation solely owned by the Friedmans; and (3) JGF Family LLP, a family trust, which provided resort rental management services. The petition ascribed no value to any of these business interests.[11]

The debtors' second amended plan of reorganization proposed to take all of the disposable income they derived from AZCI and Blue River, plus their pension and social security income, and to pay that income to unsecured creditors.[12] The proposed payments to unsecured creditors represented a dividend of less than 10%.[13] The plan also proposed that the debtors would retain their ownership interests in AZCI and Blue River,[14] which were the source of most of their proposed payments to unsecured creditors.

One unsecured creditor objected to the confirmation of the plan on three grounds.[15] First, the plan violated the absolute priority rule. Second, the plan violated the best interests of creditors test under § 1129(a)(7) because the true value of the Friedmans' business interests was not disclosed. An expert for the unsecured creditor valued the AZCI interest at over $600,000. The Friedmans did not ascribe any value to the AZCI interest. Third, the plan was proposed in bad faith.[16]

The bankruptcy court conducted a hearing on the confirmation of the second amended plan, but apparently only addressed the unsecured creditor's objection that the plan violated the absolute priority rule.[17] The bankruptcy court held that the absolute priority rule continued to apply, denied confirmation of the plan and ordered the Friedmans to submit a third amended plan of reorganization.[18] Instead, the Friedmans appealed the bankruptcy court's decision to the Ninth Circuit BAP. The bankruptcy court converted the case to Chapter 7, but stayed the conversion pending the appeal.[19]

Finding that the absolute priority rule did not apply to individuals in Chapter 11, the Ninth Circuit BAP reversed the orders of the bankruptcy court in *Friedman* denying confirmation and converting the case to Chapter 7 and remanded the matter to the bankruptcy court for further action consistent with its opinion.[20]

Absolute Priority Rule Not Very Absolute

The BAP began its opinion in *Friedman* with a brief historical perspective, noting that the absolute priority rule was a concept initially created by the U.S. Supreme Court to prevent deals between senior creditors and shareholders of large railroad corporations that allowed the shareholders to take advantage of unsecured creditors who were in the middle in terms of priority.[21]

The BAP noted that the absolute priority rule was never really absolute in terms of its application. For example, the Supreme Court recognized an exception to the absolute priority rule, called the "new value corollary," to allow an old equity holder to retain an equity interest in the reorganized debtor provided the old equity holder made a new, substantial, and necessary contribution.[22]

The BAP further noted that even after the absolute priority rule was codified in 1978 in § 1129(b)(2)(B)(ii) exceptions have been made. For example, the Ninth Circuit found the section inapplicable to organizations in which members held interests, which were not equity interests, despite the literal wording of the statute which applies to "interests" generally.[23]

The BAP drew two important conclusions from that historical perspective about the "absoluteness" of the absolute priority rule and how it should be applied by courts. First, courts have always reviewed the absolute priority rule "through the lens of common sense" and have

interpreted the rule in a way to facilitate its underlying goals, primarily preventing other parties from taking advantage of intermediate creditors. Second, ambiguities in statutory language do not necessarily arise simply because words may have alternative meanings. As in the case of determining the meaning of the word "interest" in § 1129(b)(2)(B)(ii), words may have different meanings (e.g., membership interest vs. equity interest), but no real reasonable ambiguity is created simply because of those different meanings.

The Language of the New Exception Language Is Plain

Like virtually every court that has considered the meaning of the new exception language in § 1129(b)(2)(B)(ii), the BAP began its statutory analysis by relying on the Supreme Court's plain meaning approach. [24] If the statutory language is plain and ambiguous, the statute should be enforced according to its terms, provided the result is not absurd. On the other hand, if the statutory language is not plain or is ambiguous, then further analysis, including a review of the legislative history and policy, is required.

Is the language of § 1129(b)(2)(B)(ii) plain and unambiguous? Section 1129(b)(2)(B)(ii) arises in the context of the confirmation of a "cram down" plan of reorganization.[25] The new exception language added to that provision by BAPCPA for individual debtors allows a plan that does not pay the unsecured creditor class in full nevertheless to be considered "fair and equitable" and be confirmed over the objection of the unsecured creditor class, provided that an individual debtor not retain property other than property included in the bankruptcy estate under § 1115.

The BAP in *Friedman* then considered what property is included in an individual debtor's bankruptcy estate under § 1115. It concluded that § 1115 "plainly identifies" an individual debtor's chapter 11 estate as being comprised of three types of property:

(1) Property specified in § 541 (i.e., "property of the estate includes, *in addition to the property specified in section 541* ") (emphasis added);

(2) All property of the kind specified in § 541 that the (individual) debtor acquires after the commencement (but before the closure, dismissal or conversion) of the case; and

(3) 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.[26]

Prepetition Property Is Included In The Absolute Priority Rule Exception

After concluding that § 1115 plainly included three types of property in an individual debtor's Chapter 11 estate, one type of which was valuable, nonexempt prepetition business assets (that is, property specified in § 541), the BAP went on to consider whether that conclusion was consistent with the statutory scheme and logic of Chapter 11 plan confirmation requirements. In other words, even though the court concluded that the plain language of the statute would allow an individual debtor to retain valuable, nonexempt prepetition property, the court wanted to make sure that that interpretation made sense given the overall requirements for the confirmation of a plan in Chapter 11.[27] The BAP concluded that it did for several reasons.

First, the BAP observed that no other provisions of Chapter 11 conflicted with its interpretation or were inconsistent with its interpretation that the absolute priority rule no longer applied to individuals in Chapter 11. Second, and more importantly to the BAP, it

concluded that this plain language interpretation was consistent with several other confirmation requirements,[28] including the new requirement that all of the individual debtor's disposable income for a minimum of five years be devoted to the plan,[29] the new requirement that delayed the debtor's discharge until the completion of payments under the plan,[30] and the "straight-forward" best interest of creditors test.[31]

The BAP further concluded that it would be "illogical" to require individual debtors to devote five years of disposable income to their plans, but remove the debtors' means of producing that income, which would be the result if the application of the absolute priority rule were to prevent debtors from retaining valuable prepetition business assets.[32]

Section 103(a) makes § 541 applicable in Chapter 11 cases. However, under the broad interpretation, § 1115 supersedes and subsumes § 541 in individual Chapter 11 cases. The dissenting opinion in *Friedman*[33] argued against the broad interpretation because, by superseding and subsuming § 541, the broad interpretation rendered § 103(a) surplusage, which is disfavored as a matter of statutory interpretation. In response, the BAP in Friedman noted that the argument proved too much and was incongruent with the reality of the Bankruptcy Code. The BAP concluded that § 1115 mirrored § 1306, which was enacted as part of the 1978 Code concurrent with enactment of § 103(a), and that in the intervening 30+ years no one had raised a statutory interpretation argument against the validity of § 1306 because that section rendered § 103(a) surplusage.[34]

As a further element of statutory construction, the BAP noted that the word "included" as used in § 1129(b)(2)(B)(ii) and "includes" as used in § 1115 are not words of limitation. To limit the new exception language in § 1129(b)(2)(B)(ii) to exclude prepetition property, the court reasoned, would require the statute to be read as if it stated, "included, except for the property set out in Section 541" in the case of § 1129(b)(2)(B)(ii), and "in addition to, but not inclusive of the property described in Section 541" in the case of § 1115.[35]

Legislative History Is Unhelpful

Having determined that the plain meaning of the statutes mandated the abrogation of the absolute priority for individual debtors in Chapter 11 and that such conclusion did not produce an absurd result given the context of other confirmation requirements in Chapter 11, the BAP went on to explain that although "recourse to legislative history and spirited analytics is unnecessary in light of the plain meaning of this particular statute,"[36] it would do so anyway.

The BAP discounted the conclusions of earlier opinions and articles[37] that discerned some congressional intent from the sparse BAPCPA legislative history finding the opinions and articles to be result-oriented depending upon the narrow or broad interpretation favored by the jurist or author. The BAP concluded, "[w]hen decisions have gone further than exercising a plain reading of the statute, they have entered into speculative analyses that are fatally flawed."[38]

As an example, the BAP cited the bankruptcy court's opinion in *In re Gbadebo*.[39] The *Gbadebo* court claimed to discern a so-called "anomaly" under the broad interpretation that made "no sense," because debtors were required to send ballots to creditors whose votes could be ignored under that interpretation. The BAP pointed out that the *Gbadebo* court's analysis was incomplete. Creditors' votes were not ignored. All of the classes might vote yes, thereby satisfying § 1129(a)(8) and permitting confirmation on a consensual basis. At least one of the impaired classes must vote in favor of confirmation in order to satisfy § 1129(a)(10). If any class votes against confirmation, its vote is not ignored. The plan must still satisfy §

1129(a)(15)(B) (regarding disposable income payments) and § 1129(a)(7) (the best interest of creditors test).

Congress Intended To Make Chapter 11 For Individuals More Like Chapter 13

Despite the lack of help from the legislative history, the BAP did find support for its plain language reading of the statute in the Bankruptcy Code itself, in particular the incorporation by Congress of numerous provisions of Chapter 13 into Chapter 11 for individuals as part of BAPCPA. The Court stated:[40]

> Section 1123(a)(8) was added to the Bankruptcy Code, providing that, to be confirmable, an individual debtor's plan must provide for the payment to creditors of all or such portion of earnings from personal services or other future income of the debtor—resembling § 1322(a)(1). Section 1129(a)(15) was added, giving dissenting unsecured creditors who are not being fully paid under the plan absolute veto power over the plan unless the debtor contributes an amount equal to all of his projected disposable income over the longer of five years or the plan payment period-resembling § 1325(b). Section 1141(d)(5)(A) was added, delaying the discharge until completion of all plan payments—resembling § 1328(a). Section 1141(d)(5)(B) was added, permitting a discharge for cause before all payments are completed—resembling the hardship discharge of § 1328(b). And, Section 1127(e) was added, permitting modification of a plan even after substantial consummation—resembling § 1329(a).

Accordingly, the BAP concluded that a "plain reading of §§ 1129 and 1115," demonstrates that the exemption from the application of the absolute priority rule in Chapter 13 should extend to individual debtors in Chapter 11 as well.[41]

Interestingly, the *Friedman* decision of the Ninth Circuit BAP was not followed by a bankruptcy court in the Ninth Circuit. *In re Arnold*[42] adopted the narrow interpretation, despite the holding of the BAP in *Friedman*, finding that a BAP decision in the Ninth Circuit was not binding authority on a bankruptcy court.[43]

III. *In re Maharaj*

The relevant facts in *In re Maharaj*[44] are not particularly complicated. The debtors, husband and wife, owned the stock of an auto body repair business in which both worked. Their debts, which largely stemmed from an apparent fraud for which the debtors were not responsible, exceeded the debt limits under Chapter 13,[45] so the debtors filed a voluntary petition for relief under Chapter 11.[46]

The debtors' plan of reorganization included four classes of creditors. Class I was the secured claim of a home mortgage lender that was being refinanced and thus impaired. The unsecured portion of that claim was placed in Class IV. Class II was an unimpaired secured claim on an auto loan.[47] The holders of general unsecured claims were placed in Class III.[48] The bulk of that class consisted of the claims of the defrauded lenders totaling millions of dollars.[49] The unsecured class also included the $10,847 claim of Discover Bank, presumably an unpaid credit card debt.[50]

In their plan, the debtors proposed to retain ownership of and continue to operate their auto body business, which the debtors listed as having a small and indeterminate value.[51] The income from that business would go to paying the unsecured creditors.[52] In addition to their auto repair business, the debtors proposed to retain cars with an estimated value of $39,800,

jewelry with an estimated value of $20,000, a life insurance policy with an estimated value of $2,700, and an annuity with an estimated value of 26,371.[53]

The debtors' plan of reorganization proposed to pay unsecured creditors approximately $1,000/month for 60 months,[54] which represented a dividend of approximately 1.7 cents on the dollar.[55]

The sole holder of the claims in Class I and Class IV voted to approve the plan.[56] The Class II creditor was unimpaired and did not vote. Discover Bank, the holder of the relatively small $10,847 Class III claim, was the only unsecured creditor to return a ballot. The other unsecured creditors holding millions of dollars of claims did not vote. Discover Bank voted to reject the plan.[57]

The only objection filed against the plan was brought by one of the defrauded unsecured creditors who objected to the "strip off" of its subordinate mortgage lien pursuant to the plan without a determination of the validity of the lien. The bankruptcy court quickly overruled that objection holding that the lien was not supported by any value and the creditor's claim was thus unsecured, and further, that liens may be extinguished by Chapter 11 plan confirmation.[58] This ruling was not appealed and thus was not part of the Fourth Circuit's opinion in *Maharaj*.

Discover Bank did not file an objection to the plan,[59] but because it was the only unsecured creditor to vote, Discover Bank's sole negative vote meant that Class III rejected the plan. As a result of the negative class vote, in order to be confirmed, the plan had to satisfy the cram down requirements. Apparently, the bankruptcy court raised the question as to the applicability of the absolute priority rule on its own. The debtors argued that it did not apply, primarily because if it did, they would lose their business and with it the source of the disposable income with which they would make payments under the plan.[60] The United States Trustee supported the debtors' position that the absolute priority rule did not apply.[61]

The bankruptcy court adopted the narrow interpretation that Congress did not intend to abrogate the absolute priority rule.[62] The bankruptcy court expressed some reluctance about its conclusion, acknowledging that the debtors did not have enough income to contribute to a plan that might be accepted by unsecured creditors. The bankruptcy court further acknowledged that the debtor's proposed plan would have provided Discover Bank with a better recovery than it would have received in a liquidation under Chapter 7.[63]In essence, the bankruptcy court found the broad interpretation to be more illogical than allowing Discover Bank to reject a plan that would pay it more than it would receive upon the debtors' liquidation.

The debtors appealed the bankruptcy court's order, but didn't fare any better at the Fourth Circuit. The Fourth Circuit concluded that the statutory language was ambiguous because it was susceptible to more than one reasonable interpretation. Given the specific and broader context within which Congress enacted BAPCPA, i.e., to make it more difficult for debtors to discharge debts, and the canon of statutory construction which presumes that Congress does not repeal statutes without making that intention known, the Fourth Circuit held that Congress did not intend to alter longstanding bankruptcy practice by repealing the absolute priority rule for individual debtors in Chapter 11.[64]

Statutory Language Was Ambiguous, Not Plain

The Fourth Circuit began its analysis with a review of the statutory language to determine whether the language at issue had a plain and unambiguous meaning which, according to the court, was to be determined not just by reference to the statutory language itself, but by

reference also to the specific context in which that language was used and the broader context of the statute as a whole.[65]

The Court concluded that there were two competing constructions of the new exception language found in § 1129(b)(2)(B)(ii): a broad interpretation and a narrow interpretation, and thus the statutes did not have a "plain" meaning.[66] Similarly, the Court found that there were two competing constructions of the language "in addition to the property specified in section 541" found in § 1115: an additive interpretation and a subsuming interpretation. Given that both statutes were capable of multiple interpretations and given that courts had reached various differing conclusions regarding the interpretation of the statutes, the Fourth Circuit concluded that the statutes were anything but "plain;" the statutes were ambiguous.[67]

Congress Merely Gave Back What Congress Took Away

The Court then considered the specific context in which the new exception language was used, and the broader context of the new exception language as a whole, and ruled that the new exception language preserved the absolute priority rule. The Court supported its conclusion by quoting *Karlovich* for the context or purpose for the new exception language in § 1129(b)(2)(B)(ii), which was to give back to the individual debtor the postpetition property and earnings that the new language of § 1115 had included in the debtor's estate thereby making such property available to creditors of the individual debtor.[68] "Without a corresponding change to § 1129(b)(2)(B)(ii), individual debtors could no longer retain postpetition acquired property and earnings if they wished to "cram down" a plan."[69]

Before addressing the merits of the Court's conclusion, it is useful to flesh out this very abstract argument more concretely. For individuals in Chapter 11, § 1115(a), in relevant part, expands the definition of property of the estate to include all of their earnings from services performed postpetition, and all the property of the kind specified in § 541 they acquire postpetition, in both cases until the case is closed, dismissed or converted.[70] Future property acquisitions will rarely be important for the purpose of construing the new exception language in § 1129(b)(2)(B)(ii), because future property acquisitions will rarely be known with enough certainty to be included in a Chapter 11 plan. Accordingly, the focus should just be on postpetition earnings.

Note that under § 1115(a) future earnings are only included in the individual debtor's estate until the Chapter 11 case is closed (ignoring dismissal and conversion). Individual Chapter 11 cases can remain open for the duration of plan payments, which could be five years or longer. Individual Chapter 11 cases can also be closed following confirmation, in some jurisdictions very shortly after confirmation. Individual debtors have a strong incentive to close cases as soon as possible following confirmation in order to end their obligations to pay US Trustee fees and to file monthly operating reports.

According to the *Karlovich* court and, by adoption, the Fourth Circuit in *Maharaj*, since § 1115(a) captures all of the individual debtor's future earnings for some period of time that could be quite long, and since all of such future earnings would be subject to the absolute priority rule, no individual debtor could confirm a nonconsensual plan without giving up all of those future earnings to unsecured creditors unless there existed some exception to the absolute priority rule. These courts concluded that the purpose of the new exception language in § 1129(b)(2)(B)(ii) was to give back to individual debtors their future earnings that were in some sense "taken" by creditors under § 1115(a).

The first problem with this conclusion is that individual debtors in Chapter 11 do not get to keep their future earnings. In order to confirm a nonconsensual plan, § 1129(a)(15) requires that individual debtors devote all of their projected disposable income to their plans.[71] At best, the new exception language in § 1129(b)(2)(B)(ii) would allow individual debtors to keep only that portion of their future earnings that they were not compelled to devote to their plan. In other words, future earnings included in the individual debtor's estate under § 1115(a) encompasses all of the individual debtor's earnings. Some of those earnings will be devoted to the maintenance or support of the debtor or, if the debtor is engaged in business, for the payment of expenditures necessary for the operation of such business. That portion of future earnings necessary for support or operation of the business is subtracted in computing the projected disposable income the individual debtor must devote to the plan under § 1129(a)(15).[72] Accordingly, if the absolute priority rule were to be applied without exception, an individual debtor in Chapter 11 would not be able to "retain" that portion of future earnings that is necessarily spent on survival, including expenditures for food, clothing and shelter, as well as necessary business expenses. The *Karlovich* and *Maharaj* courts would have us believe that absent the new exception language, they would interpret the absolute priority rule so as to force debtors to give up 100% of their future earnings to creditors, including the portion necessary for survival, in order to confirm a nonconsensual plan. Obviously, under such an interpretation no nonconsensual plan could ever be confirmed. Furthermore, it strains credulity to consider payments made for survival to be "retained."

The second problem with the Fourth Circuit's conclusion is that the new exception language in § 1129(b)(2)(B)(ii) is overbroad to rectify the problem purportedly created by § 1115(a)'s inclusion of future earnings in the debtor's estate. Section 1129(a)(15) requires that individual debtors devote a minimum of five year's worth of projected disposable income to their plans. Yet § 1129(b)(2)(B)(ii) excludes from the application of the absolute priority rule all future earnings of the individual debtor. The five year's worth of projected disposable income is thus excluded from the application of the absolute priority rule along with the rest of the debtor's future earnings. If Congress had intended to retain the absolute priority rule, wouldn't Congress have intended that the absolute priority rule apply to at least the projected disposable income that individual debtors were required to devote to their plans? Why would Congress exclude from the application of the absolute priority rule the very earnings that Congress required individual debtors to devote to their plans?

Assuming that Congress would have wanted the absolute priority rule to apply to the earnings that individual debtors had to devote to their plans, there was a simple way to have accomplished that. Had Congress just included § 1129(a)(15) payments within the expanded definition of property of the estate for an individual in Chapter 11 in § 1115(a), instead of all of an individual debtor's earnings from services performed by the debtor after the commencement of the case, there would have been no need for any exception to the absolute priority rule in § 1129(b)(2)(B)(ii) and the § 1129(a)(15) payments would have been subject to the absolute priority rule. Excluding § 1129(a)(15) payments from the absolute priority rule only makes sense if Congress intended to abrogate the absolute priority rule in its entirety for individual debtors in Chapter 11.

A corollary to the Congress giveth, Congress taketh away justification for the new exception language in § 1129(b)(2)(B)(ii), adopted by the bankruptcy court in *In re Lively*,[73] is that the new exception language allows individual debtors to keep earnings in excess of what they are required to devote to their plans. For example, a debtor might get an unexpected raise in the

future that was not incorporated into the projected disposable income the debtor was devoting to his or her plan. According to the *Lively* court, the new exception language in § 1129(b)(2)(B)(ii) would allow the individual debtor to keep the excess earnings. This is plain wrong. Excess earnings arise post-confirmation. The absolute priority rule only applies in the context of a nonconsensual confirmation. Once the plan is confirmed, the absolute priority rule disappears. Nothing in § 1129(b)(2)(B)(ii) or § 1115(a) affects the ability of an individual debtor to keep excess earnings following confirmation. The resolution of that issue depends solely upon whether creditors can seek to modify plans following confirmation and closure.

Do § 1129(b)(2)(B)(ii) And § 1115(a) Have Non-Trivial Meanings?

The Fourth Circuit's Congress giveth, Congress taketh away justification hardly explains the reason for the enactment of the new exception language in § 1129(b)(2)(B)(ii). It also fails to explain the reason for the enactment of new section § 1115(a). After all, without new § 1115(a), there would be no need for the new exception language in § 1129(b)(2)(B)(ii). So why did Congress enact new section § 1115(a)? As mentioned above, § 1129(b)(2)(B)(ii) applies until confirmation, while § 1115(a) ordinarily applies until the Chapter 11 case is closed, which could be long after confirmation. Why expand the definition of property of the estate for this longer period of time?

Arguably, one reason is to include within the property of the estate of the individual debtor the future earnings that the debtor will be devoting to the plan.[74] But, property that a debtor gives to creditors to satisfy nonconsensual plan confirmation requirements need not be part of the debtor's estate. For example, in order for entities to confirm plans that would otherwise violate the absolute priority rule, some new value must be contributed. That new value need not be property of the debtor's estate. Accordingly, there was no need for Congress to enact § 1115(a) in order for § 1129(a)(15) payments to be part of an individual debtor's plan.

Arguably, another reason for the enactment of § 1115(a) was to provide the protection of the automatic stay to future earnings that were going to be provided to creditors under § 1129(a)(15). The problem with that argument is that future earnings remain property of the debtor's estate under § 1115(a) only so long as the case is open. Given the incentives to close cases as soon as possible following confirmation, protection of the automatic stay may not be operable very long. [75] Furthermore, if the goal was to protect future earnings that were going to creditors under § 1129(a)(15), it would have made a lot more sense for Congress to have amended the automatic stay provision of § 362 to provide coverage for payments being made under § 1129(a)(15) for the life of the plan and not just for as long as the case is open.

Courts like *Karlovich*, *Lively*, and *Maharaj* are forced to reach their strained conclusions because they must find some justification for the new exception language in § 1129(b)(2)(B)(ii) and § 1115(a) that is non-trivial. Those courts cannot face the simple conclusion that as part of BAPCPA Congress attempted to make Chapter 11s for individuals more like Chapter 13s. Towards that goal, in BAPCPA Congress introduced five provisions of Chapter 13 into Chapter 11, some almost verbatim. Chapter 13 does not have the absolute priority rule[76] and there is no section that states the absolute priority rule does not apply in Chapter 13, thus there was no analogous provision for Congress to have written into in Chapter 11. Instead, Congress had to insert an exception to the absolute priority rule for individuals in Chapter 11 to produce the same result as in Chapter 13. That is precisely what the new exception language in § 1129(b)(2)(B)(ii) accomplishes.

The Fourth Circuit concluded that § 1115 did not have a trivial meaning because § 1115 "brings postpetition acquired property into the estate, thereby extending the automatic stay in Chapter 11 cases to an individual debtor's postpetition earnings and subject[s] those earnings to the various tests for confirmation of the Chapter 11 plan."[77] In addition, § 1129(b)(2)(B)(ii) did not have a trivial meaning, because it "permits the debtor to retain that property during the Chapter 11 proceeding and not put it at risk in a cram down analysis."[78] As explained above, this analysis is strained. The automatic stay in Chapter 11 cases may be extended to an individual debtor's postpetition earnings, but because § 1115 only applies until the case is closed, the automatic stay likely will expire long before the postpetition period in which the debtor has earnings expires. Futhermore, § 1129(b)(2)(B)(ii) does not keep future earnings from being at risk in a cram down analysis. The individual debtor in Chapter 11 does not get to keep future earnings. Future earnings either go to unsecured creditors or they go toward maintaining the debtor, the debtor's dependents or the debtor's business.

The Court's other determination that § 1115 subjects "those future earnings to the various tests for confirmation of the Chapter 11 plan" is intriguing. It suggest that § 1115 could affect how the best interests of creditor test under § 1129(a)(7) is calculated, because § 1129(a)(7) appears to be the only other cram down confirmation test that could involve future earnings. If § 1115 were read to include future earnings within the debtor's estate for purposes of the best interests of creditor test, then arguably, all of the debtor's future earnings during the plan would be included in what a creditor would receive in a liquidation in Chapter 7, which would then be compared to what the creditor would receive under the plan. That interpretation would make it even more difficult for individuals in Chapter 11 to confirm nonconsensual plans. Could that interpretation be correct? Could creditors argue that in a liquidation under Chapter 7 they would receive all of the debtor's future earnings? In the unlikely event that the Fourth Circuit actually approved that interpretation, the easy fix would be to have the plan provide for the closing of the case as soon as possible following confirmation, thereby dramatically restricting the future earnings that could be considered property of the debtor's estate.

Statutory Construction Canon Against Implied Repeal

The Fourth Circuit found further support for its conclusion that Congress did not intend to abrogate the absolute priority rule in the statutory construction canon against implied repeal, which is particularly strong in the bankruptcy context.[79] Given the ambiguous language of the statute and the sparse legislative history, the Fourth Circuit concluded that Congress made no clear statement of intention to abrogate the absolute priority rule. In contrast, the Court found that there were instances in the BAPCPA legislative history where Congress did manifest an intent to change other longstanding bankruptcy practices.[80]

While it is true the BAPCPA legislative history does not indicate that Congress intended to break with longstanding bankruptcy practice by abrogating the absolute priority rule,[81] the legislative history equally does not indicate that Congress intended to overturn a Supreme Court decision, *Norwest Bank Worthington v. Ahlers*,[82] without announcing it in the legislative history, another important canon of statutory construction. Under the Fourth Circuit's narrow interpretation, an individual debtor in Chapter 11 contributes future earnings to a plan under § 1129(a)(15) and retains future earnings, which are property of the estate as defined by § 1115. However, by retaining property of the estate through payments to creditors of postpetition earnings from personal services performed by the debtor, the narrow interpretation overrules the Supreme Court's decision in *Ahlers*, which stated that the new value exception to the

absolute priority rule, if it existed at all, could not be satisfied by the contribution of postpetition earnings from personal services ("sweat equity"). The canon of statutory construction against implied repeal of longstanding bankruptcy practice also applies to overruling Supreme Court precedents by implication. The new exception language in § 1129(b)(2)(B)(ii) must violate one canon against implied repeal. The narrow interpretation cannot be supported by an argument on the one hand that Congress would not have abolished the absolute priority rule without mentioning it in the BAPCPA legislative history, but, on the other hand, that Congress would have overruled the Supreme Court decision in *Ahlers* without mentioning it in the BAPCPA legislative history.

There Were Clearer, Easier And More Direct Ways For Congress To Have Drafted An Exception

For additional support that Congress did not intend to abrogate the absolute priority rule, the Fourth Circuit cited *Karlovich*[83] *and Mullins*[84] for the notion that had Congress intended to abrogate the absolute priority rule, there were "clearer, easier and more direct" ways to do it. For example, the Court found that Congress could have simply raised the Chapter 13 debt limits in § 109(e) or Congress could have drafted the new exception language in § 1129(b)(2)(B)(ii) to read 'except that in a case in which the debtor is an individual, this provision shall not apply'.

This conclusion proves too much. In retrospect, there are always "clearer, easier and more direct" ways for Congress to have drafted a statute. Should the existence of a "clearer, easier and more direct" way to have drafted a statute entitle a court to any interpretation of a statute it pleases?[85] 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.[86] Although the matter is not free from doubt, Congress also likely intended to further emphasize the Chapter 13 analogy by linking the new exemption in § 1129(b)(2)(B)(ii) to the provision requiring debtors to provide a minimum of five years worth of disposable income (another Chapter 13 analog), but due to a scrivener's error, the statute reads (a)(14) instead of (a)(15).[87] Viewed in context, these changes indicate that Congress intended to place an individual debtor in Chapter 11 in a similar position to an individual debtor in Chapter 13. Since there is no absolute priority rule in Chapter 13, it is plausible and reasonable to conclude that Congress intended to extend the exemption from the application of the absolute priority rule in Chapter 13 to individual debtors in Chapter 11 as well.

BAPCPA's Purpose Was Punitive—"Debtor Always Loses" Rule.

The Fourth Circuit refused to see the analogy. The court cited *Gbadebo*[88] for the proposition that the incorporation of the Chapter 13 provisions into Chapter 11 was not to make Chapter 11 for individuals function in all respects more like Chapter 13, but to get individual debtors to pay more. "Each one of these new provisions appears designed to impose greater burdens on individual Chapter 11 debtors' rights so as to ensure a greater payout to creditors.…No one who reads BAPCPA as a whole can reasonably conclude that it was designed to enhance the individual debtor's 'fresh start.'"[89]

While it is true that the provisions adopted for individuals in Chapter 11 from Chapter 13 did expand the definition of property of the estate and did require debtors to pay more to creditors, it is unreasonable to conclude thereby that Congress intended to adopt only the punitive provisions from Chapter 13 and not the beneficial one. Will a court adopt a "debtor always loses" rule and hold against the debtor on every issue involving the construction of a BAPCPA statute merely because there are more BAPCPA provisions that force debtors to pay as much as they can, as opposed to BAPCPA provisions that help debtors get a fresh start? That approach to statutory construction is very troubling.

Nonconsensual Reorganizations Are Not Required

Based upon its statutory construction-based conclusion, the Fourth Circuit was not compelled to consider the debtor's policy arguments in favor of the broad interpretation, but it did so anyway. The debtors' policy argument was something to the effect that if they were not allowed to retain valuable prepetition business property, which the narrow interpretation would preclude, the debtors would lose their source of future earnings which are required to be paid into the plan under § 1129(a)(15). Without future earnings, debtors would be unable to satisfy the requirements to confirm a nonconsensual plan of reorganization.

The Fourth Circuit was nonplussed. Having already determined that Congress intended BAPCPA to be punitive, the fact that nonconsensual reorganizations for individuals were made more difficult or impossible to confirm by its holding was not surprising. Even though nonconsensual confirmation might not be possible under the absolute priority rule, the court concluded, debtors could still "negotiate a consensual plan, pay higher dividends, pay dissenting classes in full, or comply with the [absolute priority rule] by contributing prepetition property." [90]

Whether the Fourth Circuit has a point here depends upon whether one believes that individual debtors in Chapter 11 should be able to avail themselves of the nonconsensual confirmation provisions. If the purpose of BAPCPA is punitive, then perhaps Congress did intend to deny individual debtors the opportunity to cram down a plan. Courts that have adopted the narrow interpretation generally devote space to finding various evidences of surplusage if the broad interpretation were to be adopted.[91] Yet, the biggest surplusage in adopting the narrow interpretation is that it reads nonconsensual confirmation out of the Bankruptcy Code for individual debtors.

The Court conceded as much in citing the alternatives to a nonconsensual confirmation available to such debtors. Other than negotiating a consensual plan, those alternatives are illusory. Most individual debtors in Chapter 11, like the Maharajs and Friedmans, are performing services out of closely held businesses. All of their future disposable income must be devoted to their plans. Where exactly will the future earnings come from with which to pay higher dividends or to pay dissenting classes in full? If the narrow interpretation is correct, complying with the absolute priority rule by contributing prepetition property is not an alternative to a consensual plan, because all the prepetition property must be part of the plan to begin with. Under the narrow interpretation, all prepetition property is subject to the absolute priority rule and, therefore, may not be retained by the debtor. If the Maharajs were to contribute their prepetition business to the plan, the Maharajs would have no future earnings with which to satisfy § 1129(a)(15) and no business to reorganize.

Shouldn't Bankruptcy Policy Promote Reorganization?

Debtors can always negotiate consensual plans. If a debtor knows in advance that a creditor like Discover Bank has a minimum dividend threshold, of say a 20% recovery on a claim, below which it will always reject a plan, the debtor can provide for that level of payment in the plan, assuming such payments were possible. But, if the narrow interpretation of the Fourth Circuit is correct, individual debtors in Chapter 11 who are not aware of a particular unsecured creditor's dividend threshold in advance or who are unable to provide the requisite level of payments will be unable to confirm nonconsensual plans. If an unsecured creditor like Discover Bank decides to vote against confirmation of a proposed plan, because it does not meet the creditor's threshold for acceptance, or because the creditor believes it can hold out for more, or because the creditor is vengeful, or for any other reason, the reorganization fails. If the debtor is unable to afford multiple rounds of voting in which new plans are proposed that might satisfy the unsecured creditor, the case will be converted to Chapter 7 for liquidation. Debtors who anticipate the possibility that a single unsecured creditor might vote against confirmation and cannot afford multiple rounds of voting, will save money and proceed to Chapter 7 to begin with. As a result, fewer small businesses will be reorganized. More small businesses will be liquidated. And the small business liquidations will proceed despite the fact that, as in *Maharaj*, the recalcitrant creditor would have received more under the rejected plan than under a Chapter 7 liquidation.

This makes no sense. Can it be possible that by enacting a punitive BAPCPA Congress intended to deny individual debtors in Chapter 11 the ability to confirm a nonconsensual reorganization? The cram down provisions prevent a difficult or vindictive creditor from derailing a reorganization. The cram down provisions provide an alternative method of confirmation for debtors who lack the funds to satisfy the dividend threshold of a Discover Bank. The cram down provisions allow the confirmation of the plan, despite rejection by an unsecured creditor like Discover Bank, if, among other factors, Discover Bank gets more in Chapter 11 than it would in Chapter 7.

By adopting the narrow interpretation, the Fourth Circuit in effect concludes that Congress intended to expand the definition of property of the estate in § 1115(a) to include property it did not need to include and then to take that property out of the debtor's estate by amending § 1129(b)(2)(B)(ii), both of which provisions have trivial effect, for the punitive purpose thereby of making nonconsensual reorganizations impossible. Moreover, by adopting the narrow interpretation, the Fourth Circuit necessarily concludes that such interpretation is more logical than for Congress to have intended to enact a set of new provisions that make Chapter 11 more like Chapter 13 for individual debtors including abrogation of the absolute priority rule, which enhance the ability of individual debtors to confirm plans of reorganization.

Apply The Best Interests Of Creditors Test Instead Of The Absolute Priority Rule

The Maharajs apparently did have some nonexempt property in addition to their business that they were seeking to retain.[92] It is possible that the bankruptcy court and the appellate court were reacting to the perceived unfairness of allowing a debtor to retain valuable nonbusiness assets that are not the source of future earnings, which the absolute priority rule would preclude. If so, the courts have a more appropriate tool at their discretion to use than the absolute priority rule to prevent any perceived "unfairness."

The proper objection to raise is the failure to satisfy the best interests of creditors test under § 1129(a)(7). Under that test, a plan cannot be confirmed unless creditors receive more under the plan than they would in a liquidation of the debtor in Chapter 7. If the debtor is proposing

to retain valuable prepetition business or nonbusiness assets, the value of payments under the proposed plan of reorganization must exceed the value of the prepetition assets or the best interests of creditors test cannot be satisfied. The application of the best interests of creditors test is a more direct method of testing the "fairness" of what a debtor is proposing to retain than the absolute priority rule.

In *Maharaj*, the debtor most likely would have passed the best interests of creditors test. The business the debtors sought to retain was given a low and indeterminate value. The value of the other assets the debtors sought to retain was very likely less than the proposed dividend to unsecured creditors. Given that no creditor had objected to the Maharajs' plan (Discover Bank voted against the plan, but did not file an objection), the US Trustee had not objected to the plan, and the plan apparently satisfied the best interests of creditors test, there was no reason for the bankruptcy court to raise the absolute priority rule on its own.

In *Friedman*, the debtors' largest unsecured creditor filed an objection to confirmation of the plan[93] on three grounds: (1) violation of the absolute priority rule; (2) violation of the best interests of creditors test; and (3) bad faith. In connection with its objection, the unsecured creditor offered an expert opinion that one of the debtors' business entities had a value of in excess of $600,000. The debtors had valued the entity at $0 on their petition. The bankruptcy court only addressed the absolute priority issue. Had the best interests of creditors test been applied, the court might have determined that the $600,000 value of the debtor's businesses, which the creditors would receive in a Chapter 7 liquidation if the creditor's valuation was correct, significantly exceeded the $634/month for 60 months ($38,040 total) that the debtor proposed to distribute to creditors under the plan. If the court had made that determination, the best interests of creditors test would have failed and confirmation been denied.

If a creditor is receiving at least as much under the plan as it would in a Chapter 7 liquidation and if the debtor's disposable income is being devoted to the plan for a minimum of five years, and all of the other requirements of a nonconsensual confirmation are met, including a vote in favor of the plan by at least one class of impaired creditors, then there is no reason for a court to apply the absolute priority rule. Creditors are getting all that they are entitled to receive. The fact that the debtor is retaining valuable property, which is the source from which the payments will be made, should be irrelevant. Where the objection from creditors or the perceived unfairness is that the debtor is retaining too much, the appropriate confirmation test to focus on is the best interests of creditors test, which directly addresses that issue, not the absolute priority rule, which makes nonconsensual confirmation impossible.

Notes

1. In re Friedman, 466 B.R. 471, 56 Bankr. Ct. Dec. (CRR) 57, 67 Collier Bankr. Cas. 2d (MB) 752, Bankr. L. Rep. (CCH) P 82232 (B.A.P. 9th Cir. 2012).
2. In re Maharaj, 681 F.3d 558, 56 Bankr. Ct. Dec. (CRR) 166, Bankr. L. Rep. (CCH) P 82289 (4th Cir. 2012).
3. The issue is currently pending in the Fifth Circuit, In re Lively, No. 12-90014, the Ninth Circuit, P + P, LLC v. Freidman, No. 12-60033, 12-60034, and the Tenth Circuit, In re Stephens, No. 11-6309.
4. Pub. L. No. 109-8, 119 Stat. 23 (April 28, 2005).
5. 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."
6. 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); 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); and SPCP Group, LLC v. Biggins, 465 B.R. 316, 322-23, 66 Collier Bankr. Cas. 2d (MB) 920, Bankr. L. Rep. (CCH) P 82079 (M.D. Fla. 2011) (upholding bankruptcy court decision that broad interpretation applied, based upon the plain meaning of the statutes, thus allowing the debtors to retain prepetition property, despite contrary holding from another bankruptcy court in the same district—*In re Gelin*).

7. 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 81862 (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); 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); In re Stephens, 445 B.R. 816, 820-821 (Bankr. S.D. Tex. 2011) (if § 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, 48 (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. 777, 820-822, 54 Bankr. Ct. Dec. (CRR) 175, 107 A.F.T.R.2d 2011-2180 (Bankr. N.D. Ill. 2011) (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; 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; new value exception to the absolute priority rule applied); In re Kamell, 451 B.R. 505, 506-508, 54 Bankr. Ct. Dec. (CRR) 197 (Bankr. C.D. Cal. 2011) (no clear expression of Congress 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; had Congress intended to abrogate the absolute priority rule there were simpler ways to accomplish 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; the broad view makes § 1129(b)(2)(B)(i) into a nullity because no debtor would choose to pay a class of unsecured claim holders the full allowed amount of their claims when the debtor could keep prepetition property and confirm a cram down plan by otherwise satisfying the requirements of § 1129(b)); In re Maharaj, 449 B.R. 484, 493 (Bankr. E.D. Va. 2011), aff'd, 681 F.3d 558, 56 Bankr. Ct. Dec. (CRR) 166, Bankr. L. Rep. (CCH) P 82289 (4th Cir. 2012) (following *Mullins*, had Congress intended to exempt individual debtors in Chapter 11 from the absolute priority rule, it would have been easier and more straight forward 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; following *Karlovich*, had Congress intended to make Chapter 11 for individuals more like Chapter 13, it would have been easier and more straight forward for Congress to have raised or eliminated the debt limits in § 109(e)); In re Lindsey, 453 B.R. 886, 903-05 (Bankr. E.D. Tenn. 2011), aff'd, 2012 WL 4854718 (E.D. Tenn. 2012) (statutory language ambiguous; sparse legislative history unhelpful in resolving the ambiguity; "[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; had Congress intended to completely exempt individual Chapter 11 debtors from the absolute priority rule, Congress would have done so in a more explicit manner; the narrow interpretation more in line with the punitive purpose of BAPCPA—to make debtors pay creditors as much as possible); In re Tucker, 2011 WL 5926757 (Bankr. D. Or. 2011) (adopted reasoning and holding of *Karlovich*; contribution of future salary was not "money or money's worth," under *Ahlers* and thus failed to satisfy the "new value" exception to the absolute priority rule); In re Borton, Bankr. L. Rep. (CCH) P 82112, 2011 WL 5439285 (Bankr. D. Idaho 2011) (statutory language 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); In re Lively, 467 B.R. 884, 56 Bankr. Ct. Dec. (CRR) 63 (Bankr. S.D. Tex. 2012) (statutory language unambiguous; it means property added to the estate by § 1115; the new exception language does not have a trivial meaning because it allows debtors to retain earnings by either economizing or increasing their actual earned income); and In re Arnold, 471 B.R. 578 (Bankr. C.D. Cal. 2012) (statutory language ambiguous; following grammatical exegesis, court concluded that § 1115 does not supplant, replace, absorb or supersede § 541; sparse legislative history indicates BAPCPA's purpose was punitive; Congress did not want to enhance an individual debtor's fresh start; new exception language allows the individual debtor to keep enough postpetition earnings to sustain his livelihood; under broad interpretation there is no need for an individual debtor to negotiate with creditors to solicit votes if the debtor can resort to cramdown and keep prepetition property regardless of the vote; interpretation that Congress intended to make Chapter 11 for individuals more like Chapter 13 is not supported by the structure of the statutory language or the legislative history of BAPCPA; had Congress meant to provide the protections of Chapter 13 to more debtors who are manager/owners of businesses, it could have simply raised the debt limits of Chapter 13; broad interpretation does violence to the delicate balance between creditors and debtors in Chapter 11).

8. The facts are complicated by the prior Chapter 11 filings of two internet service providers controlled by the Friedmans. The two cases were dismissed. Friedman, 466 B.R. at 473-74.

9. The investment real property was eventually foreclosed. Friedman, 466 B.R. at 475. The Friedman's primary residence was in Arizona. Friedman, 466 B.R. at 474, fn 3.

10. Friedman, 466 B.R. at 474-75.

11. Friedman, 466 B.R. at 474.

12. Friedman, 466 B.R. at 475-76.

13. It is impossible to calculate from the facts in the opinion how much less than 10% the dividend represented.

14. Friedman, 466 B.R. at 476.

15. The IRS and the US Trustee also objected to confirmation of the plan on various unstated grounds. Friedman, 466 B.R. at 476, fn 7. The opinion does not state whether violation of the absolute priority rule was one of them.

16. A footnote suggests that the bad faith may have been overstating expenses. Friedman, 466 B.R. at 476, fn 8.

17. The opinion does not state why the bankruptcy court failed to consider the objection based upon the violation the best interests of creditors test under § 1129(a)(7) or the objection based upon bad faith.

18. Friedman, 466 B.R. at 476.

19. Friedman, 466 B.R. at 476-77.

20. Friedman, 466 B.R. at 484.

21. The judicially created concept arose from a series of early twentieth century railroad cases including Northern Pac. R. Co. v. Boyd, 228 U.S. 482, 33 S. Ct. 554, 57 L. Ed. 931 (1913). Friedman, 466 B.R. at 478.

22. Citing Kansas City Terminal Ry. Co. v. Central Union Trust Co. of New York, 271 U.S. 445, 455, 46 S. Ct. 549, 70 L. Ed. 1028 (1926) and Case v. Los Angeles Lumber Products Co., 308 U.S. 106, 60 S. Ct. 1, 84 L. Ed. 110 (1939). Friedman, 466 B.R. at 478.

23. Citing In re General Teamsters, Warehousemen and Helpers Union, Local 890, 265 F.3d 869, 874, 38 Bankr. Ct. Dec. (CRR) 117, 168 L.R.R.M. (BNA) 2161, Bankr. L. Rep. (CCH) P 78501, 175 A.L.R. Fed. 775 (9th Cir. 2001) which agreed with the Seventh Circuit in Matter of Wabash Valley Power Ass'n, Inc., 72 F.3d 1305, 1315, 34 Collier Bankr. Cas. 2d (MB) 877, Bankr. L. Rep. (CCH) P 76739 (7th Cir. 1995) that the term "interest" in § 1129(b)(2)(B)(ii) meant equity interest in a for-profit corporation. Friedman, 466 B.R. at 479.

24. Citing U.S. v. Ron Pair Enterprises, Inc., 489 U.S. 235, 241, 109 S. Ct. 1026, 103 L. Ed. 2d 290, 18 Bankr. Ct. Dec. (CRR) 1150, Bankr. L. Rep. (CCH) P 72575, 89-1 U.S. Tax Cas. (CCH) P 9179, 63 A.F.T.R.2d 89-652 (1989); Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A., 530 U.S. 1, 6, 120 S. Ct. 1942, 147 L. Ed. 2d 1, 36 Bankr. Ct. Dec. (CRR) 38, 43 Collier Bankr. Cas. 2d (MB) 861, Bankr. L. Rep. (CCH) P 78183

(2000); and Lamie v. U.S. Trustee, 540 U.S. 526, 534, 124 S. Ct. 1023, 157 L. Ed. 2d 1024, 42 Bankr. Ct. Dec. (CRR) 122, 50 Collier Bankr. Cas. 2d (MB) 1299, Bankr. L. Rep. (CCH) P 80038 (2004). Friedman, 466 B.R. at 479-480.

25. Section 1129(b)(1) deals with the requirements for the confirmation of a plan of reorganization over the objection of an impaired class of creditors, also known as a "cram down":

Notwithstanding section 510(a) of this title, if all of the applicable requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of such paragraph if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.

With respect to a class of unsecured claims, the condition that a plan be "fair and equitable" may be satisfied under either of the following two alternative requirements set forth in §1129(b)(2)(B):

(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

(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.

Subsection (i) essentially requires that unsecured creditors be paid in full in cash or other property. That requirement will almost never be satisfied. Subsection (ii) provides an alternative that more plans can satisfy. Subsection (a)(14) deals with the payment of postpetition domestic support obligations and does not bear on the meaning of §1129(b)(2)(B)(ii).

26. Friedman, 466 B.R. at 481.

27. This was another way of asking whether the result of applying the plain language produced an absurd result.

28. Friedman, 466 B.R. at 481.

29. Section 1129(a)(15), added as part of BAPCPA, states:

(a) The court shall confirm a plan only if all of the following requirements are met:

(15) 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 §1325 (b)(2)) to be received during the five-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 1129(a)(15) thus permits the confirmation of an individual debtor's plan notwithstanding the objection of a holder of an allowed unsecured claim, provided the debtor either pays the unsecured claim in full, or distributes under the plan property of a value that is not less than the "projected disposable income" to be received during the five-year period beginning on the date the first payment is due or during the plan payment period, whichever is longer. This confirmation requirement is triggered not by the election of an objecting class of unsecured creditors, but by the objection of any single holder of an allowed unsecured claim. The language of §1129(a)(15) is very similar to the language of §1325(b)(1). Section 1123(a)(8), also enacted as part of BAPCPA, introduced a new plan requirement for an individual debtor in Chapter 11. The plan must provide for the payment of creditors through postpetition service income or other future income of the debtor to the extent necessary for the execution of the plan.

30. Section 1141(d)(5) ordinarily delays the entry of the debtor's discharge until completion of all payments under the plan just as in Chapter 13 under §1328.

31. Under the "best interest of creditors" test of §1129(a)(7), each holder of an impaired claim must receive or retain under the plan at least as much as the claim holder would receive if the debtor were liquidated under Chapter 7.

32. Friedman, 466 B.R. at 482.

33. Friedman, 466 B.R. at 488 (Jury, J., dissenting).

34. Friedman, 466 B.R. at 482.

35. Citing § 102(3) and American Sur. Co. of New York v. Marotta, 287 U.S. 513, 517, 53 S. Ct. 260, 77 L. Ed. 466 (1933). Friedman, 466 B.R. at 482, fn 20.

36. Friedman, 466 B.R. at 484.
37. See, for example, Balbus, Does the Absolute Priority Rule Apply to Individuals in Chapter 11?, 20 Norton J. Bankr. L. & Practice 79 (Jan. 2011); Ahart, The Absolute Abolition of the Absolute Priority Rule in Individual Chapter 11 Cases, 31 Cal. Bankr. J. 731 (2011); and Balbus, Sections 1115 and 1129(b)(2)(B): Possible Exceptions to the Application of the Absolute Priority Rule, 21 Norton J. Bankr. L. & Prac. 309 (May 2012).
38. Friedman, 466 B.R. at 483-484.
39. Gbadebo, 431 B.R. at 230.
40. Friedman, 466 B.R. at 483.
41. Friedman, 466 B.R. at 483. The BAP further noted that the lack of uniformity in the treatment of individuals in Chapter 11 and Chapter 13 should not preclude the abrogation of the absolute priority rule in both chapters. For example, in Chapter 13, unsecured creditors do not get to vote on the debtor's plan. They can only object to confirmation under § 1325(b)(1). In Chapter 11, creditors holding impaired claims have the right to vote on the plan and also to object to confirmation. Friedman, 466 B.R. at 484.
42. Arnold, 471 B.R. 578.
43. Arnold, 471 B.R. at 589-90.
44. Maharaj, 681 F.3d 558. The description of the facts of the case in this article also relies upon the facts reported in the bankruptcy court's decision as reported in In re Maharaj, 449 B.R. 484 (Bankr. E.D. Va. 2011), aff'd, 681 F.3d 558, 56 Bankr. Ct. Dec. (CRR) 166, Bankr. L. Rep. (CCH) P 82289 (4th Cir. 2012).
45. As of August, 2012, the §109(e) debt limits were $360,475 for unsecured debt and $1,081,400 for secured debt.
46. Maharaj, 681 F.3d at 567.
47. The claim was to be paid by the debtors' daughter pursuant to the terms of the loan agreement.
48. Maharaj, 681 F.3d at 567.
49. Maharaj, 449 B.R. at 487. The exact amount of the defrauded lenders' claim is unreported, but at least three fraudulent notes in the amount of $613,600 and two fraudulent notes in the amount of $115,050 were executed by the debtors.
50. Maharaj, 449 B.R. at 488.
51. Maharaj, 449 B.R. at 489.
52. Maharaj, 681 F.3d at 567.
53. Maharaj, 449 B.R. at 489. It is unclear from the opinions whether any of these assets were exempt, although presumably some, but not all, were exempt.
54. Maharaj, 449 B.R. at 489.
55. Maharaj, 681 F.3d at 567.
56. Maharaj, 681 F.3d at 567.
57. Maharaj, 681 F.3d at 567.
58. Maharaj, 449 B.R. at 491.
59. It is relatively expensive to file an objection to confirmation and argue it in court. It costs nearly nothing to vote against confirmation of a plan.
60. Maharaj, 681 F.3d at 567.
61. Maharaj, 449 B.R. at 485.
62. After laying out the arguments of both interpretations, the bankruptcy 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." Maharaj, 449 B.R. at 493. The court, following *Mullins*, 435 B.R. at 360, concluded that had Congress intended to exempt individual debtors in Chapter 11 from the absolute priority rule, it would have been easier and more straight forward 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. Maharaj, 449 B.R. at at 493. In addition, the court, following Karlovich, 456 B.R. at 682, concluded that had Congress intended to make Chapter 11 for individuals more like Chapter 13, it would have been easier and more straight forward for Congress to have raised or eliminated the debt limits in § 109(e). Maharaj, 449 B.R. at 493.
63. Maharaj, 449 B.R. at 494. The bankruptcy 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."
64. Maharaj, 681 F.3d at 568.
65. Citing U.S. v. Thompson-Riviere, 561 F.3d 345, 354-55 (4th Cir. 2009). *Maharaj*, 681 F.3d at 568.
66. Maharaj, 681 F.3d at 569.

67. Citing Friedman, 466 B.R. at 485 (Jury, J., dissenting) ("[T]he meaning of the words is not plain. There can be more than one cogent interpretation of their meaning and intent[.]"). Maharaj, 681 F.3d at 569.
68. Maharaj, 681 F.3d at 569 -70.
69. Karlovich, 456 B.R. 677, 681.
70. Section 1115(a) 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—
(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.
71. Technically, an unsecured creditor would not receive disposable income from the individual debtor under § 1129(a)(15) unless the unsecured creditor objected to confirmation of the plan. However, individual debtors wishing to avoid multiple confirmation rounds and to secure the affirmative votes of unsecured creditors will provide for the payment of disposable income in their plans. Moreover, an individual debtor in Chapter 11 who did not devote all of its disposable income to the plan, but proposed to retain valuable prepetition property, would very likely receive an objection from the U.S. Trustee and unsecured creditors.
72. Section 1129(a)(15) provides:
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 1325(b)(2) provides, in relevant part:
For purposes of this subsection, the term "disposable income" means current monthly income received by the debtor...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
...
(B) if the debtor is engaged in business, for the payment of expenditures necessary for the continuation, preservation, and operation of such business.
73. In re Lively, 467 B.R. 884, 56 Bankr. Ct. Dec. (CRR) 63 (Bankr. S.D. Tex. 2012).
74. The only reason that future earnings could not be contributed to a plan would be *Ahlers*. This suggests that the purpose of § 1115 was to overrule *Ahlers*, but a principal rule of statutory construction is that Congress does not overrule the Supreme Court without mentioning it in the legislative history.
75. What are we to make of § 1115(b) which provides that the debtor shall remain in possession of all property of the estate until confirmation (or a trustee is assigned). Future earnings are property of the estate until the case is closed, which will always be after confirmation, sometimes shortly after confirmation, sometimes a long time after confirmation. If the case is not closed, future earnings are property of the estate. Do postpetition creditors have any right to them? After confirmation, the debtor does not even remain in possession of future earnings (unless such property reverts to the debtor under the plan).
76. See Lundin, Chapter 13 Bankruptcy, 3d Ed., § 368.1 at pp. 368-1 to 368-5 (2000 & Supp.2006); and In re Roedemeier, 374 B.R. 264, 276, 48 Bankr. Ct. Dec. (CRR) 196 (Bankr. D. Kan. 2007) (the absolute priority rule should not be read into post-BAPCPA Chapter 11 because there is absolute priority rule in Chapter 13).
77. Citing Gelin, 437 B.R. at 442 (Bankr. M.D. Fla. 2010). Maharaj, 681 F.3d at 570.
78. Maharaj, 681 F.3d at 570.
79. Maharaj, 681 F.3d at 570-71.
80. Citing H.R. Rep. 109-31(I) at *97. Maharaj, 681 F.3d at 572.
81. There have been significant periods of time in the past when the absolute priority rule did not apply to individuals. In 1952, provisions were added to Chapters XI through XIII of the Bankruptcy Act specifically stating that the absolute priority rule no longer applied. Act of July 7, 1952, Pub. L. No. 82-456, § 35, 66 Stat. 420, 433 (1952). Following those amendments, the absolute priority rule ceased to be a factor in confirmation

proceedings, except for publicly held corporations reorganizing under Chapter X, until 1978 when Congress replaced chapters X and XI with Chapter 11 and re-instated the absolute priority rule in 1129(b)(2). See Shat, 424 B.R. at 867 n.45; and In re Fross, 233 B.R. 176 (B.A.P. 10th Cir. 1999) (The fair and equitable rule of Boyd and Case "cannot realistically be applied in a chapter XI, XII, or XIII proceeding. Were it so applied, no individual debtor and, under chapter XI, no corporate debtor where the stock ownership is substantially identical with management could effectuate an arrangement except by payment of the claims of all creditors in full."). See also Ayer, Rethinking Absolute Priority After Ahlers, 87 Mich. L. Rev. 963 (April 1989); and Peeples, Staying in: Chapter 11, Close Corporations and the Absolute Priority Rule, 63 Amer. Bankr. L.J. 65, 103-04 (Winter 1989).

82. Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 108 S. Ct. 963, 99 L. Ed. 2d 169, 17 Bankr. Ct. Dec. (CRR) 201, 18 Collier Bankr. Cas. 2d (MB) 262, Bankr. L. Rep. (CCH) P 72186 (1988).

83. Karlovich, 456 B.R. at 682.

84. Mullins, 435 B.R. at 360-61.

85. 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?

86. Six specific changes to the Code that make Chapter 11 function for individuals the way Chapter 13 functions are as follows:

Section 1115 brings property the debtor acquires postpetition into the estate just as in Chapter 13 under §1306(a);

Section 1123(a)(8) requires the debtor's plan to provide for payment to creditors from postpetition earnings from services or other future income just as Chapter 13 under §1322(a)(1) calls for the debtor's plan to "provide for the submission of all or such portion of future earnings or other future income of the debtor... as is necessary for the execution of the plan";

The exception in §1129(b)(2)(B)(ii) allowing the debtor to retain property included in the estate under §1115 without paying in full senior objecting creditors effectively repeals the absolute priority rule just as it is not present in Chapter 13;

Section 1129(a)(15) authorizes the debtor to overcome an objection to the plan made by a single unsecured creditor by proposing to distribute under the plan property worth at least as much as the debtor's projected disposable income for a five-year period. Chapter 13 authorizes the debtor to overcome an objection to the plan made by a single unsecured creditor by proposing to distribute under the plan all of the debtor's projected disposable income for the three to five year period of the plan under §1325(b)(1)(B);

Section 1141(d)(5) ordinarily delays the entry of the debtor's discharge until completion of all payments under the plan just as in Chapter 13 under §1328; and

Section 1127(e) permits modification of a confirmed plan even after substantial consummation for certain purposes just as in Chapter 13 under §1329.

87. See Norton Bankruptcy Law and Practice 3d § 106:1. See also Shat, 424 B.R. at 860 n.21 (tracing the legislative history of the reference to subsection (a)(14), which apparently began as a reference to subsection (a)(15)). The consequence of this possible drafting error is not important, however, because (a)(14), which requires the debtor to pay postpetition domestic support obligations, and (a)(15), which, in relevant part, requires the debtor to pay projected disposable income for at least five years, are both mandatory confirmation requirements of §1129(a) anyway.

88. Gbadebo, 431 B.R. at 229-30.

89. Maharaj, 681 F.3d at 573.

90. Citing Friedman, 466 B.R. at 491 (Jury, J., dissenting) (citing Kamell, 451 B.R. at 512; Gbadebo, 431 B.R. at 229-30). Maharaj, 681 F.3d at 574.

91. See, for example, In re Stephens, 445 B.R. 816, 820-821 (Bankr. S.D. Tex. 2011) (if § 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); and Kamell, 451 B.R. at 506-508 (the broad view makes § 1129(b)(2)(B)(i) into a nullity because no debtor would choose to pay a class of unsecured claim holders the full allowed amount of their claims when the debtor could keep prepetition property and confirm a cram down plan by otherwise satisfying the requirements of § 1129(b)).

92. In addition to their auto repair business, the Maharajs proposed to retain cars with an estimated value of $39,800, jewelry with an estimated value of $20,000, a life insurance policy with an estimated value of $2,700, and an annuity with an estimated value of $26,371. It is unclear to what extent those assets were claimed as exempt.

93. The US Trustee did not object to confirmation or raise the absolute priority issue.