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# Why Won't Anyone Just Follow The Rules:

## *Ninth Circuit Bankruptcy Appellate Panel overturns the absolute priority rule in individual bankruptcy cases*

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A fundamental principle of commercial lending holds that debt should be repaid prior to any return on equity. If a borrower cannot repay all of his or her creditors, the borrower's assets will be distributed first to the creditors with any remainder going back to the borrower if and only if all creditors are paid in full. This distribution scheme is consistent with the fundamental economics of most business transactions. An owner's return on his or her investment is potentially unlimited. On the other hand, a lender's return on its loan is capped at the repayment of principal together with a modicum of interest at an agreed upon rate. It would be expected, therefore, that the party who can earn the greater reward – the owner – will assume a higher degree of risk, and that the party whose return is limited – the lender – will be entitled to greater security. This principle is embedded in bankruptcy law under what is commonly called the "absolute priority rule." While the absolute priority rule has been under assault for decades, a recent case effectively nullified it at least where the borrower is an individual.

**What Is "Absolute Priority"?**

Interestingly, the term "absolute priority" does not appear in the United States Bankruptcy Code (11 U.S.C. section 101 *et seq.*). Despite such omission, the "absolute priority rule" has been observed by bankruptcy practitioners for over a century, notwithstanding several notable exceptions. Generally, there are two methods by which a Chapter 11 debtor may confirm a plan of reorganization. Under the first, the debtor must advance a plan that meets more than 16 requirements, including, notably, the consent of every class of creditors and interest holders in the debtor's estate. The second method, commonly known as "cramdown," permits confirmation over the dissent of creditor classes if, among other factors, the plan provides "fair and equitable" treatment to each non-consenting class.

Importantly, under section 1129(b)(2)(B)(ii) of the Bankruptcy Code, commonly considered the codification of the "absolute priority rule," a plan can be confirmed as "fair and equitable" – and thus confirmed over the dissent of unsecured creditor classes – if the holders of junior claims or interests (e.g., equity holders) will not "receive or retain under the plan on account of such junior claim or interest any property." Put simply, the "absolute priority rule" requires creditors to be paid the full present value of their claims if the debtor's equity holders are to retain any interest in the estate whatsoever.

**The *Friedman* Case Implications**

Concepts such as the "New Value Corollary" have been chipping away at the absolute priority rule for an extended period. But by and large, the absolute priority rule remained a fixture in the bankruptcy landscape until the adoption of amendments to the bankruptcy code in 2005. Those amendments spawned a split of authority nationwide over whether the absolute priority rule survived in individual Chapter 11 cases. In a very recent decision, the United States Bankruptcy Appellate Panel for the Ninth Circuit (the "BAP") took sides, and the absolute priority rule lost. *Friedman v. P+P, LLC (In re Friedman) (2012, B.A.P. Ninth Cir.)*

In *Friedman*, the BAP set out to determine whether the absolute priority rule of section 1129(b)(2)(B)(ii) applies to Chapter 11 individual debtors. *Friedman* involved the Chapter 11 proceedings of married, individual debtors who owned an equity interest in several businesses. The debtors proposed a series of plans for confirmation, the last of which called for the debtors to retain their assets, including post-petition assets and income and the equity interests in their businesses. The plan provided for payments to unsecured creditors in an amount which was acknowledged to be far less than the present value of the claims – i.e., a plan framework that would otherwise be non-confirmable by operation of the "absolute priority rule."

In the proceedings below, the Bankruptcy Court for the District of Arizona denied confirmation and converted the case to a Chapter 7 liquidation proceeding. But recognizing the split of authority on the absolute priority rule, the lower court issued a stay pending appeal to the BAP.

Over a vigorous dissent, the BAP overruled the lower court. Citing the provisions of section 1129(b)(2)(B)(ii), the majority held that the absolute priority rule does not apply in individual debtor Chapter 11 cases. The BAP based its decision, partly, on its interpretation of the plain language of section 1129(b)(2)(B)(ii), which it interpreted to mean that a plan may still be "fair and equitable" even if the debtor retains property included in the estate under section 1115:

"the holder of a 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 [...]"*

Crucially, under section 1115, property of the estate "includes, in addition to the property specified in section 541" property acquired and earnings received for services performed by the debtor ***after*** the commencement of the case. But under section 541, the estate consists of property owned by the debtor upon the commencement of the case. The BAP concluded that "section 1115's identification of estate property consists of the property contained in section 541 ***and*** […] post-petition acquired assets – newly acquired property and income." (Conversely, the dissent argued that the property "included" in the estate under section 1115 is limited to the newly acquired property and income.) Consequently, in light of this final provision of section 1129(b)(2)(B)(ii), the BAP held that an individual debtor is permitted to retain all pre-petition assets ***and*** post-petition acquired property and income.

The BAP also noted that its conclusion was supported by the legislative intent behind the 2005 changes to Section 1129(b)(2)(B)(ii), which was to align the policy and framework of individual debtor Chapter 11 cases more closely with those of Chapter 13 cases. The Court based this conclusion on the correlation derived from the 2005 changes to Section 1129(b)(2)(B)(ii) which enhanced the symmetry between Chapter 13 and individual debtor Chapter 11 cases.

**What Could This Mean For You?**

It will be interesting to see how the *Friedman* decision will affect the commercial lending market. Note that the *Friedman* decision only applies to individuals. Further, though many businesses are organized as corporations, limited liability companies or partnerships and are therefore unaffected by the *Friedman* decision, a significant number of small businesses are operated by individuals as sole proprietorships. So the question arises of whether lenders will be reluctant to lend to these individuals due to the greater likelihood of a cramdown under *Friedman*. Alternatively, will lenders require a sole proprietorship to be reorganized as a corporation or some other legal entity in order to qualify for credit?

On the other hand, many bankruptcy judges reject the majority analysis in *Friedman* – and many of those reject the notion that opinions of the BAP are binding authority. Still others, relying on the statutory, non-exclusive definition of the term "includes," may be willing to impose other, non-statutory requirements for the "fair and equitable" test, such as some good faith minimum distribution to unsecured creditors regardless of the *Friedman* decision.

In sum, the bankruptcy world just became a little less certain for lenders and debtors alike. This could easily lead to an uptick in individual Chapter 11 filings. One thing, however, is certain – whether you are a lender or a borrower, it is more important now than ever to know your local bankruptcy judge's views on this controversy.

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