By Dana L. Robbins and Edward Comey

Examining the Absolute-Priority Rule in Individual Chapter 11 Cases

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Since the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), a split of authority has developed over whether § 1115 eliminates the absolute-priority rule in individual chapter 11 cases. However, another split of authority over the scope of the absolute-priority rule in individual chapter 11 cases dates back more than 30 years: Does an individual debtor violate the absolute-priority rule by retaining exempt property?

In *In re Joseffy*, Hon. **Peter D. Russin** of the U.S. Bankruptcy Court for the Southern District of Florida recently confronted both splits of authority and held that "the absolute-priority rule is alive and well in individual chapter 11 cases and that individual debtors may retain their exempt property without violating it."[1] This article examines the contours of the absolute-priority rule and its application in individual chapter 11 cases and the not-so-absolute nature of the rule in 21st century jurisprudence.

History of the Absolute-Priority Rule

The absolute-priority rule was originally a judicially created rule. Arising from a series of early 20th century railroad cases, including *Northern Pacific Railway Co. v. Boyd*,[2] the absolute-priority rule "provides that a dissenting class of unsecured creditors must be provided for in full before any junior class can receive or retain any property [under a reorganization] plan."[3] The U.S. Supreme Court created the absolute-priority rule to prevent senior creditors and equityholders from imposing unfair terms on unsecured creditors.[4]

In 1939, in *Case v. Los Angeles Lumber Products Co.*,[5] the Court explained that the "rule of full or absolute priority" had been "properly applied" throughout the history of equity reorganizations in "passing on objections made by various classes of creditors that junior interests were improperly permitted to participate in a plan."[6] However, when Congress amended the Bankruptcy Act 13 years later, it did away with the judicially created absolute-priority rule.[7]

Congress codified the absolute-priority rule when it passed the Bankruptcy Act of 1978. New § 1129(b)(2)(B)(ii) of the Bankruptcy Code provided that a plan could be confirmed without an impaired class's consent if "the plan [did] not discriminate unfairly, and [was] *fair and equitable*, with respect to each class of claims or interests that [were] impaired under, and [had] not accepted, the plan."[8]

As such, a plan was "fair and equitable" with respect to a class of unsecured creditors if the unsecured creditor class is paid in full, or any junior claim or an equity interest-holder does not receive or retain any property under the plan on account of such junior claim or interest.[9] "As codified," then, the absolute-priority rule made it clear that "every unsecured creditor must be paid in full before the debtor can retain 'any property' under a plan."[10]

Split No. 1: Post-BAPCPA, Does the Absolute-Priority Rule Apply in Individual Chapter 11 Cases?

In connection with BAPCPA, Congress made two changes to the Bankruptcy Code implicating the absolute-priority rule. First, Congress added § 1115, which expands the definition of "property of the estate" in individual chapter 11 cases. Section 1115 provides that in individual chapter 11 cases, property of the estate includes, "*in addition to the property specified in section 541*," "all property of the kind specified in section 541 that the debtor acquires after the commencement of the case" and "earnings from services performed by the debtor after the commencement of the case."[11]

Second, Congress amended the definition of "fair and equitable" in § 1129(b)(2)(B)(ii). Post-BAPCPA, a plan is "fair and equitable" with respect to an unsecured class as long as "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*."[12]

1 *In re Joseffy*, 654 B.R. 747, 748 (Bankr. S.D. Fla. 2023).
2 *N. Pac. R. Co. v. Boyd*, 228 U.S. 482, 508 (1913).
3 *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 202 (1988) (quoting *Ahlers v. Norwest Bank Worthington (In re Ahlers)*, 794 F.2d 388, 401 (8th Cir. 1986)).
4 *Zachary v. Cal. Bank & Trust*, 811 F.3d 1191, 1194 (9th Cir. 2016) (citing *In re Friedman*, 466 B.R. 471, 478 (B.A.P. 9th Cir. 2012)).
5 *Case v. Los Angeles Lumber Prod. Co.*, 308 U.S. 106, 116-18 (1939).
6 *Id.* at 118.
7 *Joseffy*, 654 B.R. at 750 (citing *In re Maharaj*, 681 F.3d 558, 560-61 (4th Cir. 2012)).
8 11 U.S.C. § 1129(b)(1) (1978) (emphasis added).
9 11 U.S.C. § 1129(b)(2)(B).
10 *Ice House Am. LLC v. Cardin*, 751 F.3d 734, 737 (6th Cir. 2014) (citing 11 U.S.C. § 1129(b)(2)(B)(ii) (1994)).
11 11 U.S.C. § 1115(a)(1)-(2) (2005) (emphasis added).
12 11 U.S.C. § 1129(b)(2)(B)(ii) (2005) (emphasis added).

Since BAPCPA, courts have disagreed over the effect of those two amendments. In particular, courts are split over what Congress meant when it amended § 1129(b)(2)(B)(ii) to permit individual chapter 11 debtors to "retain property *included in the estate under section 1115*."[13] The two conflicting views have been characterized as the "broad view" and the "narrow view."

Cases adopting the "broad view" have held that Congress effectively abrogated the absolute-priority rule in individual chapter 11 cases when it permitted individual chapter 11 debtors to "retain property included in the estate under section 1115."[14] Those courts read § 1115's inclusion of certain post-petition property in an individual chapter 11 debtor's estate *in addition to the property specified in § 541* to mean that Congress intended for § 1115 to subsume § 541. Put another way, "property included in the estate under section 1115" includes all § 541 property *plus* the post-petition property enumerated in § 1115.[15] "Under that 'broad view,' then, an individual chapter 11 debtor can retain — without paying unsecured creditors in full — *all* property of the estate, whether it is acquired pre-petition or post-petition."[16]

In contrast, "the narrow view holds that § 1115 merely adds to — but does not replace — § 541's definition of estate property for individual debtors."[17] Courts adopting the "narrow view" read § 1115 to "include" in the estate "only that property which was not already included by § 541," such as "post-petition property and earnings."[18] All courts of appeals that have considered the issue — the Fourth, Fifth, Sixth, Ninth and Tenth Circuits — have adopted the "narrow view."[19]

Split No. 2: Does an Individual Debtor Who Does Not Pay Unsecured Creditors Violate the Rule by Retaining Exempt Property?

Assuming that the absolute-priority rule still applies in individual chapter 11 cases, a less-well-known split has lingered for decades: Does an individual chapter 11 debtor who does not pay unsecured creditors in full violate the absolute-priority rule by retaining exempt property? While the split over whether Congress effectively repealed the absolute-priority rule in individual chapter 11 cases focuses on § 1129(b)'s reference to a debtor's right to "retain property included in the estate under section 1115," the split over a debtor's right to retain exempt property focuses on language preceding that phrase: A plan is "fair and equitable" with respect to a class of unsecured creditors if "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*."[20] Courts disagree over whether the prohibition against a debtor retaining "any property" bars a debtor from retaining exempt property.

For example, in *In re Gosman*, the court reasoned that "[h]ad Congress intended to exclude exempt property from the effect of the 'absolute-priority rule,' then the term 'property' would not have been used under Section 1129(b)(2)(B)(ii)."[21] Instead, "Congress would have used 'nonexempt property' or 'property of the estate.'"[22] Likewise, in *In re Fross*, the Bankruptcy Appellate Panel for the Tenth Circuit "read the fact that § 1129(b)(2)(B)(ii) does not expressly exclude exempt property to mean that the broad reference to 'any property' includes both exempt and nonexempt property."[23]

Courts holding otherwise focus on the caveat that the holder of a junior claim or interest cannot retain "any property" "*under the plan on account of such junior claim or interest*." For example, the Ninth Circuit Court of Appeals in *In re Juarez* explained that § 1129(b)(2)(B)(ii) has not been "implicated when a debtor retains exempt property" because "a debtor does not 'receive or retain' exempt property 'under the plan *on account of* [a] junior claim or interest.'"[24] Reasoning that a debtor "obtains exempt property from the bankruptcy estate by virtue of the right to exempt certain property under § 522, not 'under the plan on account of [a] junior claim or interest,"' the Ninth Circuit held that the absolute-priority rule does not prohibit a debtor from retaining exempt property.[25]

In re Joseffy

In *In re Joseffy*, the debtor owned certain real property, a truck and two watches.[26] The debtor claimed that the real property and the truck were exempt.[27] The debtor proposed a chapter 11 plan that paid a 3.99 percent dividend to unsecured creditors, who rejected the plan. The debtor thus attempted to cram down the plan under § 1129(b) over the dissenting unsecured class and the U.S. Trustee objected that the plan was not "fair and equitable" because it violated the absolute-priority rule.[28]

The bankruptcy court began by considering whether Congress abrogated the absolute-priority rule in individual chapter 11 cases. Although all the circuit courts of appeals that had considered the issue had adopted the "narrow view," the Eleventh Circuit never addressed the issue.[29] Not bound by Eleventh Circuit precedent, the bankruptcy court joined the circuit courts of appeals and adopted the "narrow view."

In doing so, the court began with the text of §§ 1115 and 1129 and concluded that the language of those sections was plain and unambiguous: Section 1129 permits an individual chapter 11 debtor to retain property "included" in the estate under § 1115.[30] The court noted that the term "included" was a transitive verb meaning to "take in or compromise as a part of a whole or group."[31] Applying the dictionary definition, the

13 *In re Joseffy*, 654 B.R. 747, 752 (emphasis added; collecting cases).
14 *Id.* at 753.
15 *Id.*
16 *Id.*
17 *In re Stephens*, 704 F.3d 1279, 1285 (10th Cir. 2013) (citing *In re Draiman*, 450 B.R. 777, 821 (Bankr. N.D. Ill. 2011)).
18 *Id.*
19 *Joseffy*, 654 B.R. at 754.
20 11 U.S.C. § 1129(b)(2)(B)(ii) (emphasis added).
21 *In re Gosman*, 282 B.R. 45, 49 (Bankr. S.D. Fla. 2002).
22 *Id.*
23 *In re Fross*, 233 B.R. 176 (B.A.P. 10th Cir. 1999).
24 *Todeschi v. Juarez (In re Juarez)*, 836 F. App'x 557, 561 (9th Cir. 2020) (quoting 11 U.S.C. § 1129(b)(2)(B)(ii); emphasis added)).
25 *Id.*
26 *Joseffy*, 654 B.R. at 748-49.
27 *Id.* at 749.
28 *Id.*
29 *Id.* at 754.
30 *Id.* at 754-55.
31 *Id.* at 755 (citing "Include," *Merriam-Webster Online Dictionary*, *available at* merriam-webster.com/dictionary/include; last visited Jan. 2, 2024).

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court concluded that the property § 1115 "takes in[to]" the estate is certain post-petition property. Section 1115 does not include § 541 property, the court reasoned, because it is already in the estate.[32] Thus, the court concluded that a debtor could not retain pre-petition property under § 1129(b)(2)(B)(ii), and therefore, the absolute-priority rule had not been abrogated.[33]

The bankruptcy court also concluded that the outcome would be the same even if §§ 1115 and 1129 were ambiguous. As such, "[f]or most of the past 100 years, the absolute-priority rule has been 'central to the bankruptcy bargain.'"[34] Given this, if Congress had intended to abrogate the absolute-priority rule, the court concluded that it would have mentioned its intention in the legislative history. In fact, when Congress repealed the judicially created absolute-priority rule in 1952, it did exactly that,[35] yet BAPCPA's legislative history is silent about any repeal of the absolute-priority rule. That "silence would be an 'odd occurrence for such a significant change.'"[36]

The bankruptcy court noted that the Supreme Court has reaffirmed that it "will not read the Bankruptcy Code to erode past bankruptcy practice absent a clear indication that Congress intended such a departure."[37] Moreover, the bankruptcy court noted that had Congress intended to abrogate the absolute-priority rule, it could have done so in a more straightforward way "by adding the words 'except with respect to individuals' at the beginning of § 1129(b)(2)(B)(ii)."[38]

After deducing that the absolute-priority rule applied in individual chapter 11 cases, the bankruptcy court concluded that debtors would not violate it by retaining exempt property: The court's chief complaint with cases holding that a debtor could not retain exempt property was that "[i]n focusing on the words [that] Congress did not include in § 1129(b) (*i.e.*, 'nonexempt property' or 'property of the estate')," those courts "ignore[d] the words [that] Congress did include."[39] As such, "Congress did not simply say that unless unsecured creditors are paid in full, the debtor cannot 'receive or retain *any property*.'"[40] Rather, the *Joseffy* court noted, Congress said that debtors could not retain "any property" "*under the plan on account of such junior claim or interest*."[41]

According to the bankruptcy court, debtors do not retain exempt property *under the plan*, nor do they retain it *on account of their claim or interest*. Thus, debtors retain exempt property under § 522, and the court concluded that the plain language of § 1129(b)(2)(B)(ii) permits a debtor to retain exempt property, which made sense in the court's view:

> The idea behind property being exempt and passing through bankruptcy unmolested is to allow debtors to retain property that state or federal law deems essential for daily living, such as a primary residence, tools of a trade, retirement savings, or a car. That property is no less essential in an individual chapter 11 than it is in an individual chapter 7.[42]

Conclusion

For more than two decades, there has been some doubt about an individual chapter 11 debtor's ability to retain both exempt and nonexempt property without paying unsecured creditors in full. Relying on the plain language of §§ 1115 and 1129, the *Joseffy* court concluded that the absolute-priority rule is alive and well, and that an individual chapter 11 debtor "may only retain three categories of property under § 1129(b) if unsecured creditors are not paid in full: (1) exempt property; (2) property of a kind specified in § 541 that [has been] acquired post-petition; and (3) earnings from post-petition services." abi

32 *Id.*
33 *Id.*
34 *Id.* at 756.
35 *Id.*
36 *Id.* (quoting *In re Maharaj*, 681 F.3d 558, 572).
37 *Id.* (quoting *Hamilton v. Lanning*, 560 U.S. 505, 517 (2010)).
38 *Id.* at 757.
39 *Id.* at 759.
40 *Id.* (emphasis added).
41 *Id.* (quoting 11 U.S.C. § 1129(b)(2)(B)(ii); emphasis added)).
42 *Id.* at 760.