



## **ABSOLUTE PRIORITY RULE STILL APPLIES IN INDIVIDUAL CHAPTER 11 CASES – FIFTH CIRCUIT**

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### **The Headline:**

The United States Court of Appeals for the Fifth Circuit has recently held that the Absolute Priority Rule still applies to individual Chapter 11 bankruptcy debtors. *In re Lively*, 2013 Westlaw 2347045, 2013 U.S. App. LEXIS 10839 (5th Cir. 2013); affirming *In re Lively*, 466 B.R. 897 (Bankr. S.D. Tex. 2011)(Isgur, J.).

### **What is the Absolute Priority Rule?**

The Absolute Priority Rule provides that a Chapter 11 plan is “fair and equitable” regarding a dissenting class of unsecured claims if the plan provides that each holder of a claim in such class is effectively paid in full, or failing that, that *no holder of any claim or interest that is junior to the dissenting class will retain any property under the plan*. This applies in the so-called “cram-down” scenarios in which a class of unsecured creditors has voted to reject a Chapter 11 plan.

### **Why is this case significant?**

In the 2005 amendments to the Bankruptcy Code, under what is generally known as BAPCPA (Bankruptcy Abuse Prevention and Consumer Protection Act), new provisions regarding individual Chapter 11 cases were added, which led some courts and commentators to believe that the Absolute Priority Rule may no longer apply to individual debtors in Chapter 11. Many courts have struggled with this new language since 2005.

### **The Lively case.**

In *Lively*, the debtor filed a plan under which he would retain all of his non-exempt property, while paying unsecured creditors a small dividend. The dividend exceeded the liquidation value of his asset (thus, satisfying the “best interest of creditors test”). No objections were filed by any creditor, but the unsecured creditor class voted to reject the plan.

This left the bankruptcy court in a position where it would have to determine whether to apply the Absolute Priority Rule, in which event, *Lively’s* plan could not be confirmed.

The court reviewed the BAPCPA amendments to Sections 1129(b)(2)(B) and 1115(a) of the Code. Section 1129(b)(2)(B) is the cramdown provision, which now includes BAPCPA amendments providing that an individual Chapter 11 debtor may retain property included in the estate under (newly amended) Section 1115 if certain requirements are met. The property included under Section 1115 now includes property acquired by the debtor post-petition, including earnings from services rendered post-petition.

The Fifth Circuit applied a “narrow” interpretation of the amendments, which was to the effect that the Absolute Priority Rule exception provided in BAPCPA covered only the post-petition earnings and post-petition acquired property under Section 1115.

The Fifth Circuit reasoned that any broader application would in effect result in a repeal of the Absolute Priority Rule for individual debtors. Under its construction, repeal of a statute of this nature is “disfavored and will not be presumed unless the legislature’s intent is ‘clear and manifest.’” The court further noted that the Absolute Priority Rule “has been a cornerstone of equitable distribution for Chapter 11 creditors for over a century.” Thus, the Fifth Circuit was reluctant effectively to repeal such an important provision by implication.

### **What Do Other Courts Say?**

The Fifth Circuit’s decision in *Lively* affirmed the holding of Judge Marvin Isgur of the Southern District. *See, In re Lively*, 466, B.R., 897 (Bankr. S.D. Tex. 2011). It is also consistent with a recent ruling out of the Court of Appeals for the Fourth Circuit in *In re Maharaj*, 681 F.3d 558 (4th Cir. 2012). The Fourth Circuit also adopted a broad view of the BAPCPA amendments, also reasoning that had Congress intended to affect a repeal of the Absolute Priority Rule, it would have done so expressly. *Id.* *See also, In re Stephens*, 704 F.3d 1274 (10th Cir. 2013); *In re Texas Star Refreshments*, 2013 Bankr. LEXIS 1098 (Bankr. N.D. Tex. 2013)(Jones, J.) (“the better reasoned cases... conclude the absolute priority rule has not been abrogated.”).

### **To Whom Does This Apply?**

This ruling is only important in the context of Chapter 11 cases filed by individual debtors. These amendments do not affect Chapter 11s filed by corporate entities. The vast majority of individual debtors will continue to seek relief under Chapters 7 or 13, but because Chapter 13 contains statutory limits in terms of a maximum amount of secured and unsecured debt, individuals with a higher debt load who seek of reorganization will seek relief under Chapter 11.

In theory, under BAPCPA, Chapter 11 now takes on certain characteristics of Chapter 13, but unlike Chapter 13, creditors in Chapter 11 cases have the opportunity to vote on the plan, by class, which in turn implicates the Absolute Priority Rule when a class votes to reject a plan.

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