

Absolute Priority Rule
Individual Chap 11 debtors
Fair and Equitable Standard
Good Faith
In re Friedman
11 U.S.C. § 1129(b)

Clinton and Delynn Tucker, Case No. 10-67281-fra11

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Debtors filed a Chapter 11 Plan, in which Debtors would retain pre-petition assets, which was rejected by the class consisting of unsecured creditors. The bankruptcy court ruled that the Absolute Priority Rule (11 U.S.C. § 1129(b)(2)(B)), applied in individual chapter 11 debtor cases and denied confirmation. The Absolute Priority Rule essentially requires that each claimant in the dissenting class be paid in full or that the debtor not retain any bankruptcy estate assets. Debtors filed an amended plan of reorganization which met the requirements of the Absolute Priority Rule by paying creditors over a longer period of time and providing income from a non-business source. The court ruled that the amended plan should be confirmed, but before a confirmation order was presented to the court for entry, the BAP issued its opinion in *In re Friedman*, 466 B.R. 471 (9th Cir. BAP 2012). The BAP held that the Absolute Priority Rule is not applicable in individual chapter 11 debtor cases.

Rather than “reinstate” and confirm the original plan of reorganization, as requested by Debtors, the court vacated its order denying confirmation of the original plan and scheduled another confirmation hearing. Debtors filed a second amended plan which was nearly identical to the original plan, but added a provision that was beneficial to unsecured creditors. An unsecured creditor objected that the plan should be rejected on two grounds: 1) The BAP opinion is not binding on the bankruptcy court and *Friedman* should be rejected, and 2) The plan was not proposed in good faith, as Debtors had shown they had the ability to pay unsecured creditors in full.

The bankruptcy court reiterated its holding made in an earlier opinion that Ninth Circuit BAP decisions are binding on bankruptcy courts in districts comprising the Ninth Circuit. Even though the Absolute Priority Rule no longer applies in individual debtor chapter 11 cases, Code § 1129(b)(1) still requires that the plan be “fair and equitable” with respect to the impaired, nonconsenting class. Citing to a 1994 California bankruptcy opinion, the court listed a number of criteria a court should consider in determining whether the fair and equitable standard has been met, and added a few additional nonexclusive criteria of its own.

Finding that the amended plan is fair and equitable with respect to the unsecured class of claimants and should be confirmed, the court rejected the creditor’s objection that it was not proposed in good faith. The fairness of a plan should not be measured, the court opined, against a standard that was erroneously applied.

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UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF OREGON

IN RE)
CLINTON SCOTT TUCKER and) Bankruptcy Case
DELYNN G. TUCKER,) No. 10-67281-fra11
Debtors.) MEMORANDUM OPINION

INTRODUCTION

The Debtors-in-Possession ask the Court to confirm their third amended plan of reorganization (Docket #193). A hearing on confirmation was convened on August 23, 2012. At the conclusion of the hearing, the Court took the matter under submission, and asked the parties to submit post-hearing memoranda on the application of Code § 1129(b) in light of recent developments in Ninth Circuit case law. After reviewing the testimony and evidence of the parties, and their legal memoranda, the Court concludes that the Debtors’ third amended plan satisfies the legal requirements set out in § 1129, and that the plan should be confirmed.

I. PROCEDURAL HISTORY

The Debtors are sole proprietors of a tanning salon business. In addition, Mr. Tucker is employed full-time by an unrelated company. Debtors filed their petition for relief on December 13, 2010. Their first plan was submitted on May 31, 2011 (#103). A first amended plan was filed on August 23, 2011 (#133). The first amended plan provided for payment of secured creditors, and payment of a dividend of

1 approximately 16% to unsecured creditors. The Debtors would retain all of their real and personal property,
2 including assets employed in the tanning salon business.

3 After the plan and disclosure statement were circulated, 57% of the holders of unsecured claims,
4 constituting 61% of the dollar amount, accepted the plan; this vote was insufficient to constitute acceptance
5 by the class. See Code § 1126(c). In addition, MBM Group, LLC, an unsecured creditor, objected to
6 confirmation, on the grounds that the Debtors had failed to satisfy the so-called “absolute priority rule” set
7 out in Code § 1129(b)(2)(B)(ii). The absolute priority rule provided, in essence, that a plan cannot be
8 confirmed over the objection of a dissenting class if the debtor-in-possession retains assets. In a
9 memorandum opinion, the court held that the absolute priority rule was applicable in cases where the debtors
10 were individuals, and denied confirmation. See Docket #150, published as In re Tucker, 2011 WL 5926757.

11 The Debtors-in-Possession filed their second amended plan on December 12, 2011 (#152). This plan
12 was substantially different, and designed to comply with the absolute priority rule. The plan provided for 10
13 years of payments to unsecured creditors, and a sale of the Debtors’ tanning business “in an amount not less
14 than what is necessary to pay off any remaining pre-petition creditors.” At the conclusion of the hearing on
15 confirmation of the second amended plan, the Court indicated that it would, if certain changes were made,
16 enter an order confirming the second amended plan.¹

17 Counsel for the Debtors-in-Possession were instructed to submit a form of order confirming the
18 second amended plan. Before an order was presented, the Bankruptcy Appellate Panel for the Ninth Circuit
19 issued its opinion in In re Friedman, 466 B.R. 471 (9th Cir. BAP 2012). As will be discussed below, a
20 majority of the Friedman panel held that the absolute priority rule was not applicable in Chapter 11 cases
21 filed by individuals, contrary to this Court’s prior holding in this case. The Debtors-in-Possession asked the
22 Court to “reinstate” the first amended plan, and confirm it on the theory that the Court’s sole rationale for
23 denying confirmation had been rejected by Friedman. The Court declined the invitation, reasoning that,
24 while it has previously held that Bankruptcy judges are bound by decisions of the BAP, the Court and the

25
26 ¹ Among other things, the Court required that a third party, whose participation was essential to the
plan, consent in writing to be liable to interested parties to the extent of his promised contribution.

1 parties had tried the first confirmation hearing on the assumption that the absolute priority rule controlled the
2 outcome. If the rule in fact had been abrogated, it was necessary to try the matter anew. The order denying
3 confirmation of the first amended plan was vacated, and a new confirmation hearing was ordered. Prior to
4 the hearing, Debtors filed their third amended plan (#193). The third amended plan was essentially the same
5 as the first, except that it added provisions providing for distribution of cash reserves at the conclusion of the
6 plan to unsecured creditors. As the plan stated, the section “is being included to ensure that the unsecured
7 creditors of the debtors obtain the financial benefit of any increased profitability of the business during the
8 life of the plan.” The third amended plan estimated an 18.24% dividend to holders of unsecured claims.

9 MBM Group, LLC renewed its objection to confirmation, asserting that the Court was not bound by,
10 and should not follow, the BAP’s Friedman decision. In addition, MBM argued that the third amended plan
11 could not be considered to have been filed in good faith given the Debtors’ demonstrated ability to confirm a
12 plan providing for payment in full of unsecured claims.

13 II. ANALYSIS

14 A. Developments Regarding Confirmation and Absolute Priority

15 Debtors’ first amended plan was rejected because it did not satisfy the requirements of Code
16 § 1129(b)(2), the so-called absolute priority rule. The Court found that the Debtors’ second amended plan
17 did comply with that provision. However, as noted, before an order confirming the second amended plan
18 could be entered, the Bankruptcy Appellate Panel held that the absolute priority rule does not apply in
19 individual debtor Chapter 11 cases. In re Friedman, 466 B.R. 471 (9th Cir. BAP 2012). Noting its prior
20 adherence to BAP decisions, the Court required that confirmation of the first amended plan be retried in light
21 of Friedman. At the subsequent confirmation hearing, the dissenting creditor argued that BAP decisions are
22 not binding on individual bankruptcy courts, and that the absolute priority rule be applied as it was after the
23 original hearing, Friedman notwithstanding. The Debtors urge an uncritical acceptance of the Friedman
24 decision. The appropriate approach lies somewhere in between.

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1 1. *Binding Effect of BAP Decisions*

2 The Bankruptcy Appellate Panel itself has held that decisions of the Panel are binding on each of the
3 bankruptcy courts in the districts comprising the Ninth Circuit. In re Windmill Farms, 70 B.R. 618, 622 (9th
4 Cir. BAP 1987); In re Proudfoot, 144 B.R. 876, 878 (9th Cir. BAP 1992); In re Gurr, 194 B.R. 474 (Bankr. D.
5 Az. 1996). The rationale for these holdings is that Congress’s purpose in establishing the BAP was to
6 provide a uniform and consistent body of bankruptcy law throughout the circuit. In re Tong Seng Vue, 364
7 B.R. 767, 771 (Bankr. D.Or. 2007). In Tong Seng Vue, the undersigned expanded on this rationale, holding
8 that

9 The Doctrine of *Stare Decisis* advances two important principles: the uniformity of case law
10 throughout a jurisdiction, and the resulting predictability of results required in order to ensure
11 fairness of the judicial process to litigants. As a matter of fundamental fairness to parties
12 before it, a trial court must strive to apply the law as it is held by courts which may review its
13 decisions. Otherwise, parties will often be forced to the trouble and expense of an appeal to
14 achieve a lawful result whenever the trial court disagrees with the higher court’s view of the
15 law....

16 In short, this court will follow the BAP’s decision respecting the absolute priority rule in individual
17 cases, as discussed blow.

18 2. *Absolute Priority and In re Friedman*

19 In order to confirm a plan of reorganization, the proponent must demonstrate that the plan satisfies
20 each of 16 provisions in 11 U.S.C. § 1129(a). Subsection (8) requires that each class of claims or interests
21 either accept the plan, or is not impaired by the plan. Section 1129(b), commonly referred to as the “cram
22 down” provision, provides an alternative to satisfying subsection (a)(8):

23 (b)(1) Notwithstanding section 510(a) of this title, if all of the applicable requirements of
24 subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court,
25 on request of the proponent of the plan, shall confirm the plan notwithstanding the
26 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.

(2) For the purpose of this subsection, the condition that a plan be fair and equitable with
respect to a class includes the following requirements:(B) With respect to a class of
unsecured claims –

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1 (i) the plan provides that each holder of a claim of such class receive or retain
2 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

3 (ii) the holder of any claim or interest that is junior to the claims of such class
4 will not receive or retain under the plan on account of such junior claim or
5 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 requirement of subsection (a)(14) of this section.

6 The last provision – that the holder of a claim or interest junior to that of a dissenting class will not
7 receive or retain property, is the so-called absolute priority rule. The language permitting individual debtors
8 to retain “property included in the estate under section 1115” is an exception added by the Congress in 2005.

9 Application of the absolute priority rule in individual cases has been the subject of considerable
10 debate since the 2005 amendment. The debate turns on whether the phrase “retain property included in the
11 estate under section 1115” means only the property obtained by the debtor post-petition, or includes virtually
12 all of the debtor-in-possession’s assets.² Courts interpreting §§ 1129(b)(2)(B) and 1115 as restricting the
13 property a debtor may retain over the objection of an impaired unsecured class to post-petition acquisitions
14 are said to have taken the “narrow” view. See In re Tucker, 2011 WL 5926757 (Bankr. D.Or. 2011); In re
15 Karlovich, 456 B.R. 677 (Bankr. S.D. Cal. 2010); In re Kamell, 451 B.R. 505 (Bankr. C.D. Cal. 2011); (In re
16 Gbadebo, 431 B.R. 222 (Bankr. N.D. Col. 2010); In re Maharaj, 681 F.3d 558, 571 (4th Cir. 2012). Other
17 courts take the so-called “broad” view, holding that the sections, construed together, permit a debtor-in-
18 possession to retain virtually all of its assets. See In re Friedman, 466 B.R. 471 (9th Cir. BAP 2012); In re
19 Tegeder, 369 B.R. 477 (Bankr. D.Neb. 2007); In re Roedemeier, 374 B.R. 264 (Bankr. D.Kan. 2007); In re
20 Shat, 424 B.R. 854 (Bankr. D.Nev. 2010).

21 The practical distinction between these approaches is stark: under the narrow approach, it is difficult,

22 ² Code § 1115(a) provides in relevant part:

23 (a) In a case in which the debtor is an individual, property of the estate includes, in addition to
24 the property specified in section 541 –

25 (A) all property of the kind specified in section 541 that the debtor acquires after the
26 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....

1 if not impossible, for an individual debtor to confirm a plan over the objection of an impaired unsecured
2 class if the plan provides for the retention of any assets owned pre-petition. The individual debtor must
3 either persuade every unsecured class to accept the plan, pay every class in full (or a combination of the
4 two), “buy” assets it intends to retain by making a contribution of new value to the estate (*see In re Bonner*
5 *Mall Partnership*, 2 F.3d 899, 908-09 (9th Cir. 1993)), or forego retention of any pre-petition assets. Courts
6 adhering to the broad view permit the debtor-in-possession to retain pre-petition assets, effectively holding
7 that Congress has abrogated the absolute priority rule for individual debtors.

8 Friedman follows the broad rule, holding that “a plain reading of §§ 1129(b)(2)(B)(ii) and 1115
9 together mandate that the absolute priority rule is not applicable in individual chapter 11 debtor cases.” *In re*
10 *Friedman*, 466 B.R. at 482. The panel resolves the narrow versus broad dispute by holding that

11 Section 1115's identification of estate property consists of the property contained in § 541 *and*
12 the two post-petition acquired assets – newly acquired property and income. The so-called
13 disputes over what “included” means in § 1129(b)(2)(B)(ii) and “in addition to” in § 1115
14 arise from misinterpretation of the words. Included is not a word of limitation. To limit the
scope of estate property in §§ 1129 and 1115 would require the statute to read “included,
except for property set out in § 541” (in the case of § 1129(b)(2)(B)(ii)), and, “in addition to,
but not inclusive of the property described in § 541” (in the case of § 1115).

15 Id. Thus, a debtor may confirm a plan of reorganization that provides for retention of assets of the estate
16 (defined by § 541) and assets thereafter acquired, notwithstanding the objection of an impaired senior class
17 of unsecured creditors or interest holders.

18 3. *Application of the Friedman Rule*

19 As noted, a plan may be confirmed over the dissent of an impaired class if it provides fair and
20 equitable treatment to the class. The majority opinion in *Friedman* somewhat exuberantly states that

21 Simply put, a plan not paying an unsecured creditor in full is nevertheless “fair and equitable”
22 (and can be crammed down over the unsecured creditors’ objections), *so long as an individual*
23 *debtor does not retain property except property included in the bankruptcy estate under*
§ 1115.

24 *Friedman* at 480 [italics in original]. This misstates the law. The statute provides that “the condition that a
25 plan be fair and equitable with respect to a class *includes* the following requirements.” Code § 1129(b)(2)
26 [emphasis added]. The Code does not define what is fair and equitable, but provides a minimum requirement

1 that a fair and equitable plan not provide for retention of assets if senior classes are unsatisfied. Elimination
2 of the absolute priority rule in individual chapter 11 cases removes a significant barrier, but does not relieve
3 the plan proponent from its burden of proving fair and equitable treatment of dissenting classes. Friedman’s
4 assertion to the contrary was not essential to the holding that the absolute priority rule was not applicable in
5 individual cases, and was dictum, and not binding. See, e.g., In re Gurr, 194 B.R. 474 (Bankr. D.Az. 1996).

6 B. Fair and Equitable Treatment

7 With the elimination of the absolute priority rule set out in § 1129(b)(2)(B)(ii) in individual chapter
8 11 cases, the Court must analyze whether the plan is “fair and equitable” with respect to the class of
9 unsecured creditors which has withheld its acceptance. Given the widespread application of the absolute
10 priority rule, there is a paucity of case law providing criteria for a “fair and equitable” analysis, apart from
11 the retention of assets. One case that does provide extensive discussion of this issue is In re Dollar
12 Associates, 172 B.R. 945 (Bankr. N.D. Ca. 1994). The court in Dollar Associates observed that

13 The absolute priority rule is only a minimum requirement for confirmation. Compliance with
14 that rule via the new value exception does not guarantee that a plan is confirmable. Section
15 1129(b)(2) states: ‘*the condition that a plan be fair and equitable with respect to a class*
16 *includes the following requirements.*’ Thus the Code plainly provides that a plan may not be
fair and equitable, even though it satisfies the absolute priority rule or the new value
exception to the absolute priority rule.

17 Id. at 949 [emphasis added]. The same reasoning applies here: where the absolute priority rule is not to be
18 applied, the proponent must nevertheless demonstrate that the plan satisfies the fair and equitable
19 requirements of Code § 1129(b)(2). Dollar Associates sets out a number of criteria to be considered in
20 determining whether the fair and equitable standard is satisfied, including:

- 21 – Whether the plan furthers the reorganization goal of preserving equity of the debtor;
- 22 – Whether the plan preserves jobs and going concern value;
- 23 – Whether the plan significantly furthers the goal of maximizing distribution to creditors; and
- 24 – Whether the plan has been rejected by the overwhelming majority of claims.

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1 In addition, three other criteria (at least) should be considered with respect to an individual debtor's plan:

2 – Whether the plan provides for equal treatment of the creditors in the dissenting class;

3 – Whether the net value of the assets retained is small relative to the amount to be paid out to
4 unsecured creditors over the life of the plan; and

5 – Whether the assets retained are used to generate funds to be paid to creditors under the plan.

6 C. The Debtor's Plan Does Provide Fair and Equitable Treatment

7 Applying the foregoing considerations (which, it should be said, are neither exclusive nor
8 exhaustive), the Court finds that the proposed plan is fair and equitable in its treatment of the Debtors'
9 unsecured creditors. The plan preserves equity of the estate, and specifically the Debtor's business assets. It
10 commits the Debtors' personal income and the revenues generated by the business assets to the payment of
11 unsecured claims for a period of five years. The distribution provided is clearly superior to the treatment
12 unsecured creditors would receive in the event of a liquidation. It is true, as the dissenting creditor points
13 out, that the dividend under this plan is considerably less than the payout proposed by the second amended
14 plan. However, that plan was proposed under duress: namely the application of the absolute priority rule,
15 which the Bankruptcy Appellate Panel has now deemed to be inapplicable. The fairness of a plan should not
16 be measured against a standard which was erroneously applied.

17 III. CONCLUSION

18 The proposed plan of reorganization satisfies all of the criteria set out in Code § 1129(a), other than
19 § 1129(a)(8). Class 6, the unsecured creditors, has failed to accept the plan by a narrow margin.

20 Notwithstanding the failure of the unsecured creditors to accept the plan, the plan may be approved under
21 § 1129(b)(1), since the Court finds that the plan's treatment of the unsecured creditors is in fact fair and
22 equitable.

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1 The foregoing memorandum constitutes the Court's findings of fact and conclusions of law. Counsel
2 for the Debtor-in-Possession shall submit to the Court a form of order consistent with this ruling.

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5 FRANK R. ALLEY, III
6 Chief Bankruptcy Judge
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