

Bankruptcy and Creditors' Rights Law Update

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The Absolute Priority Rule: *Zachary v. California Bank & Trust*

The Ninth Circuit Court of Appeals has now joined the Courts of Appeals from the Fourth, Fifth, Sixth and Tenth Circuits, and the Eighth Circuit Bankruptcy Appellate Panel (BAP) in holding that the absolute priority rule found in 11 U.S.C. § 1129(b)(2) (“the Absolute Priority Rule”) applies to limit individual debtors’ rights to retain prepetition property of their estate where their Chapter 11 plans propose to pay unsecured creditors less than the full amount of their allowed unsecured claims. *Zachary v. California Bank & Trust* (“*Zachary*”), — F.3d — (9th Cir. Jan. 28, 2016). In so holding, the Ninth Circuit overruled the Ninth Circuit BAP’s holding in *In re Friedman*, 466 B.R. 471 (9th Cir. B.A.P. 2012), which declined to apply the Absolute Priority Rule in an individual Chapter 11 case. *Friedman* has been followed by some bankruptcy courts within the Ninth Circuit and rejected by others.¹ The *Zachary* holding enhances the leverage of unsecured creditors in Chapter 11 cases to receive larger distributions on account of their unsecured claims which may affect a secured creditor’s strategic decision on whether or not to make the 1111(b) election to be paid the full amount of its secured claim and not receive distributions as an unsecured creditor.

Introduction

Since the 2005 amendments to the Bankruptcy Code, property of the estate of an individual Chapter 11 debtor includes the debtor’s interests in property held as of the petition date as set forth in 11 U.S.C. § 541; the debtor’s postpetition earnings; and the interests in property that the debtor acquires after the commencement of the case but before the case is closed, dismissed or converted (if those postpetition assets are of the type that would have been included in the estate under § 541 had they existed as of the petition date). 11 U.S.C. §§ 541 & 1115.

The Absolute Priority Rule requires that a dissenting class of unsecured creditors receive full payment of its allowed claims before a class of creditors or interests junior to the dissenting class (including the debtor) can receive or retain any assets of the estate if an unsecured creditor objects to the plan.

Factual Background and Procedural History

In *Zachary*, the individual debtors’ Chapter 11 plan proposed payment of only a small percentage of the unsecured creditors’ allowed claims while allowing the debtors to retain their home. The debtors’ largest unsecured creditor, California Bank & Trust, which was scheduled to receive only \$5,000 on its \$2 million claim, objected to this treatment. The bankruptcy court sustained the objection holding that the Absolute Priority Rule did apply to individual debtors’ Chapter 11 cases (thus rejecting the holding in *Friedman*) and denied confirmation of the plan. The debtors appealed the ruling and the bankruptcy court certified the question for a direct appeal to the Ninth Circuit (skipping an intermediary appeal to the Ninth Circuit BAP or district court).

¹ The Ninth Circuit refused to rule on whether decisions of the BAP should have binding precedential effect on bankruptcy courts within the Circuit. It again called on the Judicial Council to address this question of precedential value.

Summary of Analysis

The Ninth Circuit adopted much of the analysis from the Sixth Circuit, holding that the changes to the Absolute Priority Rule in 2005 did not eliminate the application of the Absolute Priority Rule as to debtors' property that existed on the petition date, but only as to the debtors' postpetition assets that became property of the bankruptcy estate under Section 1115. In its holding the Ninth Circuit relied on the language added to Section 1129(b)(2)(B)(ii) in 2005 as set forth in italics below:

[T]he condition that a plan be fair and equitable with respect to a class [of creditors] includes the following requirements: . . . (B) With respect to a class of unsecured claims . . . 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.*

11 U.S.C. § 1129(b)(2)(B)(ii) (emphasis added).

Practical Implications

The Ninth Circuit's holding has implications for both debtors and creditors. For debtors, the Ninth Circuit specifically acknowledges, "that retaining the absolute priority rule in chapter 11 cases works a 'double whammy' on a debtor" because individual debtors must now include postpetition assets in the payment of their creditors under the disposable income test set forth in 11 U.S.C. § 1129 (a)(15) and also must satisfy the Absolute Priority Rule if an unsecured creditor objects to the plan and the unsecured class does not consent to the plan (in contrast to Chapter 7, which does not include the debtor's postpetition assets, or Chapter 13, which does not have an Absolute Priority Rule). Thus, the 2005 amendments as interpreted in *Zachary* provides creditors with additional leverage to negotiate favorable plan treatment in exchange for their consent to confirmation of the plan. Additionally, it should give secured creditors more issues to consider as to whether to make an election to be paid in full under 11 U.S.C. § 1111(b), rather than having a bifurcated claim with a right to vote the unsecured portion of the claim and possibly force the application of the Absolute Priority Rule.

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