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Problems in the Code

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The New Value Corollary to the Absolute-Priority Rule Codified for Individuals in Chapter 11

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The absolute-priority rule has always prevented individuals from reorganizing under chapter 11. The absolute-priority rule is a chapter 11 plan-confirmation standard requiring that the debtor, in order to keep anything of value, must either pay all claims in full, or obtain creditor consents to paying something less.[1] Creditors rarely consent to something less.

On two occasions, the U.S. Supreme Court considered whether a "new value corollary" would allow a chapter 11 debtor to confirm a plan over creditor objections without paying all claims in full. Both times, the Court suggested that such a corollary might exist but determined that it did not help the debtor.

Congress has codified new value corollary schemes to help farmers (chapter 12) and small businesses (subchapter V) reorganize, but neither one helps middle-class consumers. Instead, Congress expressed its intention to similarly help middle-class consumers in chapter 11 through the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA). BAPCPA was both good and bad for individual debtors.

The bad is that BAPCPA took chapter 7 relief away from middle-class consumers. The good is that BAPCPA tried to make up for that take-away by codifying a new value corollary for individual debtors in chapter 11, through an amendment to the absolute-priority rule that (1) identifies post-petition earnings as a source of new value,[2] and (2) quantifies the amount of new value at five years of projected disposable income.[3] This new value corollary would finally make chapter 11 viable for individual debtors.

Here is a problem: Bankruptcy courts have failed to even consider the possibility of a new value corollary in BAPCPA to help middle-class consumers in chapter 11. The courts have focused on a different and preparatory question: whether BAPCPA "abrogated" the absolute-priority rule for individuals.[4]

However, the absolute-priority rule is *not* "abrogated" in BAPCPA (that is what all the circuit courts of appeals that have considered the issue say — *i.e.*, the Fourth, Fifth, Sixth, Ninth and Tenth Circuits[5]). This means that chapter 11 remains ineffective and unavailing for middle-class consumers. The "abrogated" question is only preparatory because the new value corollary becomes relevant only if the absolute-priority rule has not been abrogated, as a new value corollary would allow individuals to find, at long last, effective relief in chapter 11.

Before BAPCPA

Middle-class consumers had three bankruptcy options before BAPCPA. First, chapter 7 provided a

1 11 U.S.C. § 1129(b)(2)(B)(ii) contains the chapter 11 plan-confirmation standard known as the "absolute-priority rule." It provides that "[w]ith respect to a class of unsecured claims — (i) ... each holder of a claim of such class [will] receive ... the allowed amount of such claim; or (ii) the holder of any claim or interest that is junior ... will not receive or retain ... on account of such junior claim or interest any property."

2 BAPCPA added the following language to the absolute-priority rule statute (11 U.S.C. § 1129(b)(2)(B)(ii)): "[E]xcept that in a case in which the debtor is an individual, the debtor *may retain* property included in the estate under section 1115," (emphasis added) — and § 1115 states that the debtor's post-petition earnings are included in the bankruptcy estate.

3 BAPCPA added this language in 11 U.S.C. § 1129(a)(15)(B): "[T]he value of the property to be distributed under the plan is not less than the projected disposable income of the debtor (as defined in section 1325(b)(2)) to be received during the five-year [plan] period."

4 *See In re Joseffy*, 654 B.R. 747, 752-53 (Bankr. S.D. Fla. 2023).

5 *Id.*

quick path to a fresh financial start, with a typical case lasting less than six months from petition to entry of discharge for a no-asset case in which discharge is not challenged under § 523 or 727, and debtors could keep assets through a combination of exemptions and reaffirmations. Second, chapter 13 required a three-year plan under which debtors could (1) keep exempt assets, (2) make payments over time to keep nonexempt assets, and (3) receive a discharge at the end of all plan payments, including a "super discharge" of certain types of claims identified in § 523(a).[6] Third, chapter 11 provided a discharge immediately upon confirmation and had no minimum plan term, but it also had the absolute-priority rule, which meant that an individual debtor could not keep any exempt or nonexempt assets, even when the debtor's plan provided for payment of the value of such assets. In other words, before BAPCPA, both chapters 7 and 13 were viable options for a middle-class consumer, but chapter 11 did not work because of the absolute-priority rule.

BAPCPA Changes

Two decades ago, Congress enacted BAPCPA to reduce the number of middle-class consumers in bankruptcy by making bankruptcy for such individuals harder — but not impossible.[7] BAPCPA, as applied to date, has changed the three chapters to provide no effective bankruptcy relief for many middle-class consumers — none whatsoever.

Chapter 7 under BAPCPA is no longer available to middle-class consumers; all are conclusively presumed to be abusing the bankruptcy system by filing for chapter 7.[8] Section 707(b)(1) states that the remedy for such filings is to either dismiss the bankruptcy or "convert such a case to a case under chapter 11 or 13." In other words, BAPCPA took chapter 7 away from middle-class consumers and shoved them into chapters 11 and 13 instead.

Chapter 13 plans under BAPCPA must last an entire five years, discharge can occur only after all plan payments are made, a "super discharge" no longer exists, and debt limits for eligibility have been raised (today: $526,700 in unsecured debts and $1,580,125 in secured debts).

Under BAPCPA, chapter 11 plan requirements for individual debtors are synced with chapter 13: It must last an entire five years, and discharge occurs only after all five years of plan payments are made. However, the absolute-priority rule still applies to individual debtors, as previously noted, with individuals keeping only exempt assets because of the not-abrogated absolute-priority rule. So what about the new value corollary?

Congressional Intent: Similarity with Chapter 13

Since BAPCPA, chapter 13 has become the only viable bankruptcy option for middle-class consumers — but pity the poor debtor who cannot qualify for chapter 13. This is not what Congress intended in BAPCPA.

Rather, Congress intended to make rules similar for individuals in chapters 11 and 13. For example, after BAPCPA, (1) both chapters 11 and 13 require a five-year plan and payment of all of the debtor's projected disposable income; (2) the debtor is ineligible for a discharge under either chapter 11 or 13 until all plan payments have been made; (3) the definition of "projected disposable income" in chapter 13 is incorporated by reference into chapter 11 (*see* § 1129(b)(15)(B)); and (4) the disposable-income requirements in both §§ 1325(b)(1) and 1129(a)(15) arise only when someone objects to the plan.

Supreme Court Cases

The Supreme Court has opined on the possibility of a "new value corollary" twice: in *203 North LaSalle* and in *Ahlers*.

Bank of America v. 203 North LaSalle

In *Bank of America v. 203 North LaSalle Street Partnership*,[9] the Supreme Court stated that the phrase "on account of such junior claim or interest" in § 1129(b)(2)(B)(ii) raises the possibility of a new value corollary ("Congress does not intend *sub silentio* to enact statutory language that it has earlier discarded," but "the phrase 'on account of' is not *silentium*"). However, the Court then punted ("We do not decide whether the statute includes a new value corollary or exception"[10]) and instead decided that the new value corollary is unsatisfied because the debtor determines the contribution amount, not the market.[11]

Bank of America had a $93 million claim secured by a first mortgage on the debtor's office building valued at $54.5 million. The debtor defaulted, and Bank of America began foreclosure. The debtor filed for chapter 11, with a plan that classified three claims: (1) Bank of America's $54.5 million secured claim; (2) Bank of America's $38.5 million unsecured deficiency claim; and (3) the unsecured trade claims.

The debtor's plan paid Bank of America's allowed secured claim in full, paid a 16 percent dividend on Bank of America's unsecured deficiency claim, and paid trade claims in full, and the debtor's owners retained 100 percent ownership of the reorganized debtor for a new value of $6.1 million cash. Bank of America objected, asserting the absolute-priority rule. The bankruptcy court confirmed the debtor's plan, and the Seventh Circuit Court of Appeals affirmed. The Seventh Circuit's opinion focused on the statutory phrase, "on account of" in § 1129(b)(2)(B)(ii) as permitting a new value corollary, which allowed old equity to retain ownership for new money reasonably equivalent to the value of the property being retained. As previously noted, the Supreme Court reversed for lack of exposure to the market.

6 *See, e.g.*, 8 *Collier on Bankruptcy*, Chapters 1325 & 1328 (15th ed. 1998).
7 BAPCPA's purpose has been described as (1) "to deter people from pursuing bankruptcy by making filing for it more difficult and expensive, as well as less financially advantageous," and (2) "to make filing for bankruptcy more difficult, more expensive and less financially advantageous for households." Matthew Notowidigdo, "Assessing the Bankruptcy Law of 2005," Inst. for Policy Research, Northwestern Univ. (Dec. 16, 2019). *See also* Steve Maas, "Bankruptcy Reform of 2005 Sharply Reduced Filings," *The Digest*, Nat'l Bureau of Econ. Research (Dec. 1, 2019).
8 *See* 11 U.S.C. § 707(b).
9 526 U.S. 434, 448 (1999).
10 *Id.* at 443.
11 *See id.* at 457.
12 485 U.S. 197 (1988).

Norwest Bank Worthington v. Ahlers

In *Norwest Bank Worthington v. Ahlers*,[12] the debtor farmed as a sole proprietorship, with loans from Norwest Bank secured by farmland. The debtor defaulted, and Norwest Bank began foreclosure proceedings. The debtor filed a chapter 11 petition and plan, and Norwest Bank responded with a motion for relief from the automatic stay. The bankruptcy court granted the requested relief because the debtor's plan was "utterly infeasible." On appeal, the Eighth Circuit reversed, finding that a feasible plan is possible because of the new value corollary. The Supreme Court reversed, concluding that the new value corollary does not apply because Congress had already created new-value relief for farmers in chapter 12.

BAPCPA Changes Based on *203 North LaSalle* and *Ahlers*

In enacting BAPCPA, Congress created a chapter 11 safety valve for middle-class consumers (*i.e.*, the new value corollary) while simultaneously excluding them from chapter 7. BAPCPA applied *203 North LaSalle* by quantifying the amount of cash needed for an individual debtor to satisfy the new value corollary (*i.e.*, five years of projected disposable income (§ 1129(a)(15)).

BAPCPA also applied *Ahlers* in creating a chapter 12-like new value corollary for individuals in chapter 11:[13] It amended the absolute-priority rule (§ 1129(b)(2)(B)(ii)) to identify an individual debtor's post-petition earnings as a source of new value and to allow individual debtors to "retain" their post-petition earnings — an explicit authorization to use such earnings as new value. In BAPCPA, Congress intended to make bankruptcy relief more difficult — but not impossible — for middle-class consumers. Without a new value corollary, chapter 11 for such individuals is virtually impossible.

Conclusion

Existing case law declares that the absolute-priority rule still applies to individual debtors in chapter 11, which means that chapter 11 continues to be ineffective for them. But while BAPCPA codified a new value corollary to make chapter 11 effective for middle-class consumers, bankruptcy courts have not even considered this possibility, thereby solidifying chapter 11's ineffectiveness for those debtors. The necessary next step is for bankruptcy courts to consider BAPCPA's codification of the new value corollary — to confirm Congress's intent to provide effective chapter 11 relief for middle-class consumers. abi

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13 Without the new value corollary, individuals in chapter 11 are worse-off than before BAPCPA (*i.e.*, unable to keep any nonexempt property *and also* subject to both a five-year disposable-income requirement and a deferral of discharge until completion of payments).