

In re Lett: Preserving APR Plan Confirmation Objections on Appeal

May/June 2011

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Earlier this year, the United States Court of Appeals for the Eleventh Circuit decided in *In re Lett* that objections to a bankruptcy court's approval of a cram-down chapter 11 plan on the basis of noncompliance with the "absolute priority rule" may be raised for the first time on appeal. The Eleventh Circuit ruled that "[a] bankruptcy court has an independent obligation to ensure that a proposed plan complies with [the] absolute priority rule before 'cramming' that plan down upon dissenting creditor classes," whether or not stakeholders "formally" object on that basis.

Lett History

The debtor, an individual, filed for chapter 11 protection in Alabama in 2004, in part to address a judgment lien on all of his property held by the Alabama Department of Economic and Community Affairs ("ADECA"). In total, ADECA claimed the debtor owed approximately \$3 million. The debtor proposed four different chapter 11 plans, each of which proposed to pay ADECA very little. Each plan bifurcated the debt to ADECA into a secured claim and an unsecured claim. As to the secured portion of the claim, the last of the four plans proposed to pay \$235,615 in installments of \$12,616 beginning roughly five years after confirmation. For the unsecured portion of the claim, the plan proposed to pay approximately \$20,000 in two annual installments, after payment of all secured claims. Other unsecured claims were classified separately, and claimants were scheduled to receive a distribution equal to one percent of their claims in a single installment six months after confirmation. Further, the plan proposed that, as of

the plan's effective date, "all property of the Estate shall revert in the Reorganized Debtor, all free and clear of all claims, liens, encumbrances and other interests of creditors."

Although ADECA voted to reject the proposed plan, at least one impaired class of creditors voted to accept it. At the confirmation hearing, the debtor's counsel asserted that the plan complied with the cram-down provisions in the Bankruptcy Code, including the "absolute priority rule" codified in section 1129(b)(2)(B), which dictates that, unless senior class members are paid in full, no holder of any junior claim or interest shall "receive or retain under the plan on account of such junior claim or interest any property." ADECA presented a number of objections—none of which, however, addressed the plan's noncompliance with the absolute priority rule. Ultimately, the bankruptcy court confirmed the plan, ruling, among other things, that the plan "met the absolute priority requirements embodied in § 1129(b)(2)."

ADECA appealed the confirmation order to the district court. There, ADECA argued for the first time that the absolute priority rule was not satisfied because: (i) the plan proposed payments to the class of general unsecured creditors without paying ADECA's senior unsecured claim in full; and (ii) the plan called for the debtor to retain property interests without paying unsecured creditors in full. The debtor countered that the appeal was moot because the plan had been "substantially consummated" and because ADECA did not seek a stay pending appeal.

The district court held that the appeal was not moot under the substantial consummation standard because only secured creditors had received payments under the plan. Even so, the court dismissed the appeal because ADECA failed to object at the confirmation hearing on the basis

that the plan violated the absolute priority rule. The district court ruled that ADECA was foreclosed from raising that issue for the first time on appeal. ADECA appealed to the Eleventh Circuit.

The Eleventh Circuit's Ruling

The Eleventh Circuit vacated the district court's decision and remanded the case below for a hearing on the merits. Among other things, the court held that ADECA's objections regarding noncompliance with the absolute priority rule could be raised for the first time on appeal. In reaching this conclusion, the Eleventh Circuit addressed the "civil plain error rule," under which an appellate court will consider an issue not raised below if it involves a pure question of law and if refusal to consider it would result in a miscarriage of justice. The Eleventh Circuit faulted the district court's determination that the rule precluded appellate review of the bankruptcy court's order on the absolute priority rule because, according to the district court, no miscarriage of justice would result from its declining to hear ADECA's absolute-priority-rule arguments.

The Eleventh Circuit ruled as it did not because of any miscarriage of justice, but because "the application of the absolute priority rule in a Chapter 11 cram down proceeding sufficiently places the matter before the bankruptcy court so as to preserve the issue for appeal." Pointedly, the Eleventh Circuit held that "[a]n impaired creditor in a dissenting class need not formally object on such ground in the bankruptcy court in order to appeal an improperly confirmed cram down plan."

The court recognized the inherent protections built into the Bankruptcy Code's cram-down requirements, which serve to protect dissenting impaired creditors. These protections, the court

reasoned, prevent a debtor from isolating claims for unfair treatment or from putting the interests of equity holders ahead of the interests of creditors. The Eleventh Circuit further observed that “[i]mportantly, the Bankruptcy Code envisions a bankruptcy court exercising an independent duty to ensure that the strictures of § 1129(b) are met with regard to dissenting classes of creditors in a Chapter 11 cram down.” This duty exists, the court emphasized, even in the absence of objections regarding compliance with the cram-down requirements.

According to the Eleventh Circuit, the record plainly showed that the bankruptcy court “fully understood this independent obligation” and addressed the absolute priority rule in confirming the plan despite ADECA’s failure to object by specifically requiring the debtor to proffer evidence that the plan conformed to the absolute priority rule. Even if the court ultimately erred as a matter of law on the merits, the Eleventh Circuit wrote, “it cannot be said that it did not *reach* the merits or that the court did not contemplate its duties under § 1129(b).”

Recognizing the potentially expansive reading of its analysis in other situations, the Eleventh Circuit limited its holding, observing that “the requirements of § 1129(b) in a cram down proceeding sufficiently present the absolute priority rule in the bankruptcy court as to preserve the issue for review and obviate the civil plain error rule in this narrow context.” Although a creditor who fails to object at a confirmation hearing “may waive many arguments,” the court wrote, “such a creditor should presume that the bankruptcy court will complete its statutorily mandated duties—and, relatedly, for the appellate courts to hear challenges when the court errs as a matter of law concerning the absolute priority rule.”

In a concurring opinion, one judge specifically stated that he joined with his colleagues

only because [the] decision to dispense with the contemporaneous objection rule in appeals from bankruptcy court . . . is strictly limited by the unique nature of the bankruptcy court's duty to inquire into and review the cram down provisions of a Chapter 11 plan for purposes of enforcing the absolute priority rule.

Looking Forward

Under *Lett* and a 1994 Ninth Circuit case, *In re Perez*, in which the court reached the same conclusion, a party in interest's failure to raise a specific objection based upon noncompliance with the absolute priority rule in connection with confirmation of a cram-down chapter 11 plan does not preclude appellate review of the confirmation order on that basis. Even so, stakeholders in other circuits would be well advised not to rely on *Lett* and *Perez* as a safety net—other appellate courts faced with a party's failure to interpose such an objection may not be so generous.

The Eleventh Circuit's conclusion that cram-down chapter 11 plan objections based upon the absolute priority rule should be singled out for special treatment is somewhat difficult to explain. Other confirmation requirements in section 1129, such as the proscription of "unfair discrimination" in section 1129(b)(1), the requirement in section 1129(a)(3) that the plan be "proposed in good faith and not by any means forbidden by law," and the "best interests of creditors" test set forth in section 1129(a)(7), are arguably as fundamentally important as the absolute priority rule. Moreover, the bankruptcy court also has a duty to determine that any cram-down chapter 11 plan complies with those requirements.

Finally, from a strategic perspective, it is significant that *Lett* identifies substantial consummation as a barrier to raising an objection on appeal. For this reason, plan proponents intent upon minimizing the possibility of a successful challenge to a confirmation order should consider structuring the plan so that substantial consummation occurs as soon as possible after entry of the confirmation order. This can be done by structuring the plan transactions such that many of them are completed on or shortly after the plan effective date and, in addition, by seeking a waiver (or at least a reduction) of the automatic 14-day stay imposed under Rule 3020(e) of the Federal Rules of Bankruptcy Procedure.

Alabama Dept. of Econ. & Comm. Affairs v. Lett (In re Lett), 632 F.3d 1216 (11th Cir. 2011).

Everett v. Perez (In re Perez), 30 F.3d 1209 (9th Cir. 1994).