No. 19-60051

IN THE
# UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

In re: UBALDO JUAREZ,
*Debtor*.

EDGAR TODESCHI and GEORGINA PONCE,
*Appellants*,

– v. –

UBALDO JUAREZ,
*Appellee*.

On Appeal from the United States Bankruptcy Appellate Panel
for the Ninth Circuit No. 19-1028

## BRIEF OF AMICI CURIAE NATIONAL CONSUMER BANKRUPTCY RIGHTS CENTER AND NATIONAL ASSOCIATION OF CONSUMER BANKRUPTCY ATTORNEYS IN SUPPORT OF APPELLEE AND SEEKING AFFIRMANCE OF THE BANKRUPTCY APPELLATE PANEL'S DECISION

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# RULE 26.1 CORPORATE DISCLOSURE STATEMENT

*Todeschi, et al. v. Juarez,* No. 19-60051

Pursuant to Fed. R. App. P. 26.1, Amici Curiae, the National Association of Consumer Bankruptcy Attorneys and the National Consumer Bankruptcy Rights Center, make the following disclosure:

1) Is party/amicus a publicly held corporation or other publicly held entity? **NO**

2) Does party/amicus have any parent corporations? **NO**

3) Is 10% or more of the stock of party/amicus owned by a publicly held corporation or other publicly held entity? **NO**

4) Is there any other publicly held corporation or other publicly held entity that has a direct financial interest in the outcome of the litigation? **NO**

5) Does this case arise out of a bankruptcy proceeding? **YES**. If yes, identify any trustee and the members of any creditors' committee. **Edward K. Bernatavicius, Chapter 11 Trustee**

This 10th day of April, 2020.

*/s/ Tara Twomey*
Tara Twomey
Attorney for Amici Curiae

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## STATEMENT OF INTEREST OF *AMICI CURIAE*

NCBRC is a nonprofit organization dedicated to preserving the bankruptcy rights of consumer debtors and protecting the bankruptcy system's integrity. The Bankruptcy Code grants financially distressed debtors rights that are critical to the bankruptcy system's operation. Yet consumer debtors with limited financial resources and minimal exposure to that system often are ill-equipped to protect their rights in the appellate process. NCBRC files *amicus curiae* briefs in systemically-important cases to ensure courts have a full understanding of applicable bankruptcy law, the case, and its implications for consumer debtors.

NACBA is also a nonprofit organization, with approximately 2,500 consumer bankruptcy attorney members. NACBA advocates on issues that cannot adequately be addressed by individual member attorneys. It is the only national association of attorneys organized to protect the rights of consumer bankruptcy debtors. NACBA files *amicus curiae* briefs in various cases seeking to protect those rights. *See, e.g., Am.'s Servicing Co. v. Schwartz-Tallard*, 803 F.3d 1095 (9th Cir. 2015) (en banc).

NCBRC, NACBA and its membership have a vital interest in the outcome of this case. Exemptions, which permit debtors to retain necessities, including their homestead, are key to implementing one of the primary goals of bankruptcy: providing a fresh start to the honest but unfortunate debtor. For that reason, exempt

assets are not considered property of the estate and are not available for distribution to creditors. The Appellants' assertion that the Absolute Priority Rule in chapter 11 requires a debtor to provide new value for exempt property runs counter to the purpose behind exemptions in bankruptcy, is unsupported by the Bankruptcy Code, and has been rejected by the majority of courts to address the issue. Moreover, the threat of losing the value of their exemptions would cause debtors to opt for chapter 7 liquidation, which, in turn, would likely reduce the amount of recovery unsecured creditors could hope to obtain. For these reasons, amici urge this Court to affirm the decision of the Bankruptcy Appellate Panel.

## AUTHORSHIP AND FUNDING OF AMICI BRIEF

Pursuant to Fed. R. App. P. 29(c)(5), no counsel for a party authored this brief wholly or partially, and no person/entity other than NACBA, its members, NCBRC, and their counsel made any monetary contribution toward the preparation and/or submission of this brief.

## SUMMARY OF ARGUMENT

Exemptions in bankruptcy are intended to make it possible for honest but unfortunate debtors to obtain a fresh start, free of crippling financial worries, while retaining the basic necessities of life. For that reason, property that is exempt is not part of the property of the bankruptcy estate and is not required to be liquidated for distribution to creditors. As individual debtors have increasingly turned to chapter 11 to reorganize, courts have generally found that the Absolute Priority Rule (APR), which sorts creditors into a repayment hierarchy of "junior" and "senior" classes, applies in individual chapter 11 cases just as it has historically applied in commercial cases. In this case, the Appellants rely on the APR for their contention that the Debtor's right to retain exempt property is junior to the rights of unsecure creditors and, therefore, the Debtor must replace exempt property with value.

While no circuit court has yet addressed this issue, the majority of lower courts have found that because exempt property is not part of the bankruptcy estate, it is not subject to the APR and need not be replaced with equivalent value. This view finds support in the statutory construct and distributional scheme.

A decision in the Appellants' favor would certainly cause individual debtors whose debts are too large to qualify for chapter 13 bankruptcy, to elect to liquidate under chapter 7 rather than pay the price of retaining exempt assets, such as their residence, in chapter 11. Where unsecured creditors are likely to receive less in

chapter 7 than in chapter 11, such a result would be detrimental to both debtors and creditors.

## ARGUMENT

### I. EXEMPT PROPERTY SHOULD NOT BE INCLUDED WITHIN THE PHRASE "ANY PROPERTY" UNDER THE ABSOLUTE PRIORITY RULE[1]

Almost twenty years ago a respected bankruptcy newsletter reacted to one of the two cases relied upon by Appellants[2] for the proposition that the Debtor must include his exempt property in the new value he would offer to satisfy the Absolute Priority Rule (APR) with a ringing statement: "To apply the absolute priority rule to an individual debtor's wholly exempt property stands the absolute priority rule on its head - affording to unsecured creditors an artificial 'priority' in exempt property that unsecured creditors simply do not possess." Bankruptcy Law Letter, October 2002, "Absolute Priority and An Individual Chapter 11 Debtor's Exempt Property: Who is Junior to Whom?" 2002 WL 31202841.

Since that time, the applicability of the APR to individual chapter 11's has been much litigated, stemming from the amendments to the Bankruptcy Code made under BAPCPA, with the majority of circuits, including this one,[3] concluding

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[1] Although Amici supports the Appellee debtor with regard to all the issues addressed in this appeal, it writes separately as only on Issue 4 which addresses the applicability of the Absolute Priority Rule to exempt property.

[2] *In re Gaston*, 282 B.R. 45 (Bankr. S.D. Fla. 2002).

[3] *Zachary v. Cal. Bank & Trust (In re Zachary),* 811 F. 3d 1191, 1193 (9th Cir. 2016).

that it remains applicable. However, over the same twenty years no appellate court until now has ruled on whether the APR applies to property exempted by a debtor. In the case now before this court, the Bankruptcy Appellate Panel for the Ninth Circuit (BAP) made the long-awaited ruling, holding that exempt property was not included within the phrase "any property" as that term is used in section 1129(b)(2)(B)(ii).[4] This court may now settle this issue for good in this circuit by affirming the BAP's ruling, a decision which would encourage individual debtors to reorganize their debt in chapter 11's rather than liquidate their estate in a chapter 7 case based on their concern about losing the value of their exemptions in the restructuring effort.

### A. Section 1129(b)(2)(B)(ii) Does Not Require Debtors to Offer New Value for Exempt Property

Appellants rely on two nonprecedential, out of circuit cases for their assertion that the Debtor must provide new value for both nonexempt and exempt property, *In re Ashton*, 107 B.R. 670 (Bankr. D.N.D. 1989), and *In re Gaston*, 282 B.R. 45 (Bankr. S.D. Fla. 2002). Both cases rely on an inappropriately narrow reading of the words of the statute, focusing only on the words "any property" and concluding that term must include exempt property. However, other words in the

[4] Unless specified otherwise, all chapter and section references are to the Bankruptcy Code, 11 U.S.C. §§ 101-1532, and all "Rule" references are to the Federal Rules of Bankruptcy Procedure.

statute show that taking the words out of context gives them false meaning. The statute with explains whether a plan is fair and equitable reads:

> (ii) 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, …. (emphasis added).

The Supreme Court almost thirty years ago explicitly ruled that exempt property is not property of the estate. *Taylor v. Freeland & Kronz*, 503 U.S. 638, 112 S. Ct. 1644, 118 L. Ed 2d 280 (1992) (unless a party objects, the property claimed exempt is exempt from the estate). *See also In re Henderson*, 321 B.R. 550 (Bankr. M.D. Fla. 2005), *aff'd sub nom. Van Buren Indus. Investors v Henderson (In re Henderson),* 341 B.R. 783 (M.D. Fla. 2006). It follows that section 1129(b)(2)(B)(ii) does not address exempt property at all.

As the BAP aptly concluded, the APR only comes into play if the Debtor retains "any property" "under the plan on account of [the Debtor's interest]" in that property. The Debtor does not retain exempt property either under the plan or on account of its junior interest; it retains exempt property due to its right to exempt it under section 522. Moreover, sections 522(c) and (k) provide that exempt property is not liable for the payment of prepetition claims or administrative expenses. Appellants' simplistic, out of context reading of the words "any property" such that the Debtor must pay the value of exempt assets by way of a new value contribution

is inconsistent with the protection of exempt property set forth in those subsections.

The words of the statute do not compel the Debtor to provide new value in order to retain his exempt assets.

**B. Debtor's Interest in Exempt Property is not Junior to Unsecured Debt**

The priorities which must be recognized to make the APR a meaningful term in a chapter 11 are not found in that chapter of the statute at all. The use of the term "junior" in section 1129(b)(2)(B)(ii) compels, of course, a consideration of a ranking of claims, with those holding greater rights considered "senior' to the lower rights of the junior creditors. This ranking of claims has its origin in section 726(a), the order of distribution for property of the estate found in Subchapter II of Chapter 7 – Liquidation. There is no parallel distribution scheme in chapter 11. Chapter 11 practice has adopted, *de* facto, this distribution scheme from chapter 7 without either statutory or Rule authority compelling that outcome. However, since section 1129(b)(2)(B)(ii) would be meaningless without some hierarchy that makes a claim "senior" or "junior", this universal practice makes sense. But how can chapter 11 borrow the order of distribution from chapter 7 without following it in like manner? Under the chapter 7 distribution order, a debtor's exempt property is not distributed at all, because the exemption removes that property from the estate, in effect making the exempt interest "senior" to all others, even administrative

priority or other priority claims. The Debtor's interest in exempt property is most certainly not junior to the unsecured creditors' claims in a chapter 7 and cannot be so in a chapter 11 either.

We submit that recognizing that the origin of the priority scheme is in chapter 7 distribution rights compels the conclusion that section 1129(b)(2)(B)(ii) does not divest a chapter 11 debtor of the protection for property provided by exemptions. This subsection of the Code was never intended by the drafters to apply to exempt property or a distinct distribution scheme to claims in a chapter 11 would have been enacted.

### C. The Majority of Bankruptcy Courts Agree that the Statute Does Not Compel New Value for Exempt Property

Although a few cases have followed the out-of-context reading of "any property" by *Gosman* and *Ashton*, many more have reasoned that because exempt property is not property of the estate, a debtor need not account for it in a new value calculation. Before the enactment of BAPCPA, which diverted the discussion of exempt property while cases sorted out whether the APR still applied at all to individual chapter 11's, a different Florida bankruptcy court disagreed with the conclusions of the *Gosman* court, *In re Henderson*, 321 B.R. 550 (Bankr. M.D. Fla. 2005), *aff'd sub nom. Van Buren Indus. Investors v. Henderson (In re Henderson),* 341 B.R. 783 (M.D. Fla. 2006). The *Henderson* court stated there were three components of the APR: (1) identification of the junior claims or

interests; (2) identification of the property retained by the holders of such claims or interests; and (3) a determination whether the property is retained "on account of" the junior claim or interest. *Id.* at 59. It reasoned that since exempt property is no longer property of the estate, such property retained by a debtor did not fit within the third component, so the APR was not implicated.

Applying similar reasoning, bankruptcy courts in Wisconsin, Connecticut, Pennsylvania, Georgia and Virginia all have concluded that a debtor's retention of exempt property does not offend section 1129(b)(2)(B)(ii) because such retention is not "on account of the debtor's junior interest" in the property. *In re Gerard*, 495 B.R. 850 (Bankr. E.D. Wis. 2013); *In re Bullard*, 358 B.R. 541, 544 (Bankr. D. Conn. 2007); *In re Brown*, 498 B.R. 486 (Bankr. E.D. Pa. 2013); *In re Steedley*, 2010 WL 3528599, at *3 (Bankr. S.D. Ga. 2010); and *In re Maharaj*, 449 B.R. 484, 493 n.4 (Bankr. E.D. Va. 2011), *aff'd on other grounds* 681 F. 3d 558 (4th Cir. 2012).

None of these cases has found its way to a circuit court, leaving the question open not only in the Ninth Circuit, but all over the country. This court's decision can fill that void.

### D. Allowing Chapter 11 Debtors to Retain Exempt Property Without Providing New Value Will Encourage Reorganization Over Liquidation

As discussed above, section 522, applicable to all chapters, allows an individual debtor to exempt from property of the estate certain properties, as

defined by either federal or state law.[5] As stated by the Supreme Court in *United States v. Indus. Bank*, 459 U.S. 70, 72 n.1 (1952) "[t]he exemptions were designed to permit individual debtors to retain exempt property so that they will be able to enjoy a 'fresh start' after bankruptcy."

In a chapter 7 proceeding, the trustee is not entitled to turnover and liquidation of exempt property, allowing debtors to retain such property to assure the necessities of life on their road to economic recovery. When a chapter 13 debtor must meet the liquidation test established by section 1325(a)(4), only the value of nonexempt property of the estate is included in the calculation of the amount which must be distributed under the plan to unsecured creditors. Although it is not unusual for a chapter 13 debtor to use exempt property in order to make a proposed plan feasible for confirmation, such acts are voluntary, not compelled by the statute. Both chapters recognize that exempt property is not property of the estate, protected by the mandate of section 522(b)(1).

Notwithstanding the operation of the other chapters, Appellant argues that an individual chapter 11 debtor must provide new value in exchange for retaining exempt assets in order for a plan to be confirmed. Amici assert that this unjust result is contrary to the policy behind the fresh start assured to the honest but

[5] Section 522(b)(2) allows a state to opt out of the federal exemptions and to require a debtor to select state law exemptions. In the case at bar, Arizona has opted out.

unfortunate debtor. Moreover, the threat of losing the right to protect essential property with exemptions would operate to discourage debtors from attempting to reorganize their debt, which in most instances will mean that creditors, particularly unsecured creditors, will receive less.

BAPCPA substantially broadened the assets in an individual's chapter 11 estate by enacting section 1115, which provides that property of the estate, in addition to property specified in section 541, includes property that the debtor acquires post petition and before the case is closed, dismissed or converted to another chapter and also earnings from services performed by the debtor after commencement of the case and before the case is similarly concluded. This new section provides a substantial benefit to unsecured creditors because it most likely will increase the dividend paid on unsecured prepetition debt, particularly in the instance where the debtor is a professional or other high earning individual because the creditors will have a say in how that postpetition income is spent. The quid pro quo for the individual debtor is the opportunity to save non-exempt property, that otherwise would be lost in a chapter 7 liquidation, by using such post petition earnings to pay back all or a substantial portion of the debt over the life of the plan.

Many factors go into the decision whether to file a chapter 7 or 11 when an individual debtor is ineligible for chapter 13 relief.[6] Potential debtors and their counsel must weigh the compelled contribution of post-petition assets and earnings to a chapter 11 plan against the loss of control of non-exempt property to a trustee if a chapter 7 liquidation is the alternative. Where debtors see a possible reorganization of their business or holdings, keeping that possibility alive can be in the best interest of not only debtors but also unsecured creditors. Even where the balance of debt and assets makes an ultimate liquidation appear to be the final solution, an individual's ability to control the sale of estate assets to maximize value compared to the fire sale or auction techniques of a trustee can make the choice of filing a chapter 11 more attractive than just turning over control to the trustee in a chapter 7. However, if the interpretation of the role of exemptions in a chapter 11 is different than the role of such exemptions in a chapter 7, such that they would be recognized as protecting certain assets for a debtor's benefit in the chapter 7 but providing no such protection in a chapter 11, that difference can have a profound effect on a debtor's choice.

For example, if a debtor is in a state with a liberal homestead exemption which would allow him to remain living in a house with several hundred thousand

[6] Section 109(e) limits the use of Chapter 13 to debtors with no more than $1,254,850 in secured debt and $419,275 in unsecured debt.

dollars' worth of equity and no risk of losing it in a chapter 7, substantial off-setting benefits would have to derive from a chapter 11 for him to choose that chapter if he would be compelled to pay those hundreds of thousands of dollars into the estate as new value because his exemption rights are not recognized in a chapter 11. The likelihood of choosing a chapter 11 would be greatly diminished by such operation of law. And that diminished likelihood, on balance, will result in a worse outcome for the class of unsecured creditors. Consistency in application of the Bankruptcy Code dictates an interpretation of the statute that would treat the exemptions the same, whichever chapter is picked by debtors.

## CONCLUSION

Appellants' assertion that the Debtor must provide new value for the exempt property which he would retain under his proposed plan has no basis in the words of the statute and no well-reasoned support from more than thirty years of bankruptcy court case law. Such view is contrary to the policy behind the allowance of exemptions to assist the honest but unfortunate debtor with a fresh start. Moreover, the concept of priorities in bankruptcy distribution compels the conclusion that a debtor's interest in exempt property is not junior to that of the class of unsecured creditors, making § 1129(b)(2)(B)(ii) entirely inapplicable to this proceeding. And, finally, the likely result of the implementation of Appellants'

assertion would be fewer debtors filing chapter 11's, a result which will pay the unsecured creditors on balance less than they would receive under a chapter 11 plan. The Debtor need not provide new value to retain his exempt assets.

For these reasons, this Court should affirm the decision of the Bankruptcy Appellate Panel below.

Respectfully submitted,

*/s/ Tara Twomey*
Tara Twomey
Attorney for Amici Curiae

## STATEMENT OF RELATED CASES

Pursuant to Ninth Circuit Local Rule 28-2.6, Amici hereby states that there are no related cases in this Court.

*/s/ Tara Twomey*
Tara Twomey
Attorney for Amici Curiae

## CERTIFICATE OF COMPLIANCE

1. This brief complies with the type-volume limitation of Fed. R. App. P. 29(a)(5) because this brief contains 3,168 words, excluding parts exempted by Fed. R. App. P. 32(a)(7)(B)(iii).

2. This filing complies with Fed. R. App. P. 32(a)(5) and the type style requirements of Fed. R. App. P. 32(a)(6) because this brief has been prepared in a proportionally spaced typeface using Microsoft Word in Times New Roman 14-point type.

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