

What Is the Absolute Priority Rule and How Does It Affect Payment on My Claim In Chapter 11 Bankruptcy?

Creditor's Rights Toolkit

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This article discusses the key issues of the Absolute Priority Rule in a Chapter 11 bankruptcy.

Under the Absolute Priority Rule, for a Chapter 11 plan to be confirmable, claims of a higher priority must be paid in full in order for lower priority claims to receive any recovery, and all creditors must be paid in full in order for equity interest holders to retain any interest in the debtor, or receive any distribution under the plan. The Absolute Priority Rule is embodied in Section 1129(b)(2) of the Bankruptcy Code.

Generally speaking, the priority of a creditor's claim determines whether, and the extent to which, that creditor can expect to be paid under a confirmed Chapter 11 plan. While secured creditors can typically expect payment in full, general unsecured creditors may receive little to no distributions, depending on the amount of higher priority claims that must be paid in full before such unsecured claims can even be partially paid.

KEY ISSUES

TYPES OF CLAIMS

Under the Bankruptcy Code, there are four types of claims: secured claims, administrative expense claims, priority claims, and general unsecured claims. Secured claims are those supported by a creditor's security interest collateral. Administrative expense claims are claims associated with the ongoing operation of the debtor or the bankruptcy case following the filing of the bankruptcy petition — common examples include amounts owed by the debtor to creditors for their post-petition performance under contracts with the debtor, or amounts owed to a creditor for goods delivered after the filing of the bankruptcy. Priority claims are unsecured claims that the Bankruptcy Code elevates over general unsecured claims, such as certain claims of governmental units for taxes or fees, employee wages (up to a statutory cap), or certain deposits with the debtor (up to a statutory cap). General unsecured claims are claims against the debtor that are not secured by collateral (and are not administrative expense claims or priority claims). General unsecured claims make up the vast majority of claims in most bankruptcy cases.

PRIORITY OF CLAIMS

Section 507 of the Bankruptcy Code outlines the priority scheme for claims in bankruptcy. As a general rule,

unless creditors agree to different treatment, secured claims are of higher priority than unsecured claims. Administrative expense claims and priority unsecured claims rank above general unsecured claims and both types of claims must be paid in full for a plan to be confirmed. General unsecured claims are last in line and only rank above classes of equity interest in the debtor.

THE VOTING EXCEPTION

A Chapter 11 plan can violate the Absolute Priority Rule by providing some recovery to a lower class of claim without paying a higher-ranking claim if the class of higher priority claims votes to accept the plan and consents to such treatment. This exception provides flexibility for the debtor and its creditors to negotiate the terms of a plan of reorganization so that all classes of creditors receive some recovery. For example, creditors' committees often negotiate with a debtor's secured creditors to secure some recovery for unsecured claims, even if the secured creditors are not receiving a 100% distribution.

THE NEW VALUE DOCTRINE

As an exception to the Absolute Priority Rule, a debtor's equity holders may retain some ownership in the debtor following a reorganization if they contribute "new value" (often capital used for the reorganization). However, such value must be substantial, necessary, and reasonably equivalent to the value of the interest the equity holders receive through the plan.

TAKEAWAY

Understanding the Absolute Priority Rule and its exceptions can help a creditor manage expectations for recovery in a Chapter 11 reorganization. It is important to have experienced bankruptcy counsel, who can ensure that a claim is asserted at the highest priority possible, to achieve the best possible recovery.

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