

**UNCHARTERED WATERS:
THE NEW VALUE EXCEPTION TO THE
ABSOLUTE PRIORITY RULE AFTER LASALLE**

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I. The New Value Exception to the Absolute Priority Rule

A. The New Value Exception to the Absolute Priority Rule refers to a device used by plan proponents to obtain confirmation of Chapter 11 plans in many cases. The Absolute Priority Rule refers to Bankruptcy Code §§1129 (b)(2)(B) and (C) (11 U.S.C. §§1129(b)(2)(B) and (C)), which require that senior classes of creditors or equity interest holders be paid in full before any value can be provided to or retained by a junior class. For example, priority unsecured claims must be paid in full before non-priority unsecured claims can receive payment, and non-priority unsecured claims must be paid in full before shareholders can retain value for their shareholder interests in the debtor corporation. These provisions are in the “cram down” provisions of Bankruptcy Code §1129(b); the Absolute Priority Rule is applicable only when one or more senior impaired classes does not accept the plan.

B. The New Value Exception, sometimes referred to as the “New Value doctrine” or the “New Value Corollary”, is a common law exception to the Absolute Priority Rule.¹ In seeking confirmation of a plan by use of the New Value Exception, the plan proponent typically includes a provision in the proposed plan by which the subordinate class - usually equity holders, such as stockholders - pays or transfers to or for the debtor’s estate new value in order to retain that class’ existing interest, or to receive a payment, even though one or more senior classes (typically, the non-

¹The New Value Exception is generally regarded as originating in Case v. Los Angeles Lumber Company, 308 U.S. 106, 60 S.Ct. 1, 84 L.Ed. 110 (1939). See 7 Collier on Bankruptcy

priority unsecured creditors) are not to receive full payment under the plan. The New Value Exception is premised upon the assertion that the junior class (e.g., the class of the stockholders) is not retaining value on account of its existing interests, but is retaining or receiving value (e.g., the ownership of the reorganized debtor, such as in the form of the stock) for the new value contributed by the members of that class. In concept, the provision operates much as if the junior class were purchasing new interests by the new value contributed.

¶ 1129.04[4][c][i][A], at pages 1129-104 through 1129-108 (15th ed.rev. 6/99).

C. The issue has been raised as to whether the New Value Exception to the Absolute Priority Rule exists under the Bankruptcy Code (11 U.S.C. §§101 *et. seq.*). The New Value Exception originated under the Bankruptcy Act of 1898 (as amended); when Congress enacted the Bankruptcy Code in 1978, it did not specifically include the New Value Exception. Over the years since the enactment of the Bankruptcy Code, many Courts have concluded that the New Value Exception exists under the Bankruptcy Code;² however, the issue has not been finally resolved, and the United States Supreme Court has declined to specifically rule on whether or not the New Value Exception exists under the Bankruptcy Code. Cases involving the New Value Exception have been presented to the Supreme Court; in those cases the Supreme Court has ruled upon the matters before it without deciding the continued vitality of the New Value Exception, making findings that state, *inter alia*, “assuming that the New Value Exception exists, it would require” See e.g., Bank of America National Trust and Savings Association v. 203 North LaSalle Street Partnership, 526 U.S. 434, 119 S.Ct. 1411, 143 L.Ed. 2d 607 (1999); and Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 108 S.Ct. 963, 99 L.Ed 2d 169 (1988).

D. Another major issue relating to the New Value Exception is the question of what constitutes sufficient new value. In the Ahlers decision, the Supreme Court found that “sweat equity”, without some other tangible value contributed, is not sufficient to satisfy the New Value Exception. Norwest Bank of Worthington v. Ahlers, 485 U.S. 197, 108 S.Ct. 963, 99 L.Ed. 2d 169 (1988). As addressed hereinbelow, the recent Supreme Court decision, Bank of America National

²See, e.g., In re Bonner Mall Partnership, 2 F.3d 899, 910-916 (9th Cir. 1993). cert. granted, 510 U.S. 1039, 114 S.Ct. 681, 126 L.Ed. 2d 648, vacatur denied and appeal dismissed as moot, 513 U.S. 18, 115 S.Ct. 386, 130 L.Ed.2d 233 (1994).

Trust and Savings Association v. 203 North LaSalle Street Partnership, 526 U.S. 434, 119 S.Ct. 1411, 143 L.Ed 2d 607 (1999), held that value must be reviewed and assessed in the context of market value for the interest retained.

E. The market value assessment which the Supreme Court held is necessary for the New Value Exception presents practical problems. Many interests simply are not readily susceptible of market valuation, at least in the conventional sense. Some interests appear to have no marketable value. Nonetheless, it appears that a plan proponent attempting to utilize the New Value Exception will have to address the market value of the interest of the subordinate class.

2. The Statute

The “Absolute Priority Rule” is stated in 11 U.S.C. §§1129(b)(2)(B) and (C):

(B) With respect to a class of unsecured claims -

(i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or

(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.

(C) With respect to a class of interests -

(i) the plan provides that each holder of an interest of such class receive or retain on account of such interest property of a value, as of the effective date of the plan, equal to the greatest of the allowed amount of any fixed liquidation preference to which such holder is entitled, any fixed redemption price to which such holder is entitled, or the value of such interest; or

(ii) the holder of any interest that is junior to the interests of such class will not receive or retain under the plan on account of such junior interest any property.

3. *The LaSalle Decision*

The Supreme Court decided LaSalle in May, 1999. In LaSalle, the Court held that a plan granting the existing shareholders the exclusive right in a reorganization plan to pay a certain value to retain an interest in the debtor corporation, and which plan did not fully pay creditors, was not confirmable where the impaired creditors did not consent to such provisions. The debtor's shareholders may purchase an interest in the reorganized corporation, but others must have an opportunity to bid on the new equity interest of the reorganized debtor. If shareholders intend to retain or purchase stock in the debtor corporation, the value of that interest must be determined by market forces, such as by a competing plan or a bid procedure on the debtor's interests. The Court did not indicate a method for determining market value. Bank of America National Trust and Savings Association v. 203 North LaSalle Street Partnership, 526 U.S. 434, 119 S.Ct. 1411, 143 L.Ed.2d 607 (1999).

4. Unanswered Questions and Some Pre-*LaSalle* Guidance

The American Bankruptcy Institute Journal has identified five areas which the Supreme Court left unaddressed in its LaSalle opinion. First, would an offer to bid as opposed to an actual auction suffice the open market requirement? Second, may third parties bid, or only existing creditors? Third, must an auction occur if the equity involved is publicly traded? Fourth, must an auction occur if the debtor proposes its plan after exclusivity terminates? Fifth, does exclusivity terminate if no creditor files a competing plan? 18-OCT Am.Bankr.Inst.J. 20.

1. The Bjolmes Two-Step Approach

The Bankruptcy Court for the District of Massachusetts decided Bjolmes in 1991. The court in Bjolmes stated that when a creditor opposes a plan of reorganization, that creditor is a potential buyer of the equity interests in the debtor. An auction should be held among the debtor's shareholders and any creditors interested in purchasing the equity interest. If the creditors were not interested in bidding or lacked funds to bid, equity interests "must presumably be placed on the market in order to encourage third-party buyers." This two-step approach is to offer the equity interest in the debtor first to the creditors, and then to third parties. In each case, the existing equity interest holders may bid on the new interest created under the plan. In re Bjolmes Reality Trust, 134 B.R. 1000 (Bankr. D. Mass. 1991).

B. Auction After Objection

As noted in the ABI Journal, other pre-LaSalle courts only required an auction of the equity interest after one of the creditors objected to the reorganization plan's proposal for a new value contribution. In re Ropt Ltd. Partnership, 152 B.R. 406 (Bankr. D. Mass. 1993).

V. Post-*LaSalle* Speculation Several courts and treatises have addressed satisfying the open market requirement of *LaSalle* and when LaSalle applies.

A. Bid Procedure

LaSalle calls for an open market auction of the debtor's equity, but gives no procedural or substantive guidelines on how the auction should be conducted. 7 Am.Bankr.Inst.L.Rev. 389 (1999). In Minkoff, the Bankruptcy Court for the District of Kansas would not approve of a debtor's reorganization plan because the plan allowed a junior interest to retain some assets and stock of the debtor corporation, without full payment of senior classes. The court allowed the debtor to amend the plan and provide for a bid procedure. The court did not outline the requirements of the bid procedure but seemed to allow the debtor leeway to devise a plan by which others could bid on the equity interest. In re Minkoff, 1999 WL 1424987 (Bankr.D.Kan. 1999).

B. Competing Plans

The open market requirement also may be satisfied by a competing plan. In this scenario, the debtor-in-possession proposes a plan and each creditor may propose its own plan, or in groups or collectively the creditors may propose a competing plan(s). The market value is determined by the court when it decides which plan to accept. 104 Com.L.J. 147 (Summer 1999). This approach is, in some respects, an extension of Bjolmes where creditors have the first opportunity to bid against the existing equity interest holders for the debtor's assets. However, if no competing plan is proposed, would Ropt apply? If Ropt applies, then the creditor's failure to propose a plan may be seen as a waiver and as consent to the debtor's estimated value of the interests. The non-objection is a waiver of the creditor's prerogative to propose a higher sum for the equity interest. The equity interest is not then offered to third parties. This procedure does not appear to satisfy the open market requirements of LaSalle. It appears that the second step of Bjolmes may be appropriate to satisfy the open market requirement of LaSalle; otherwise the equity interest is not exposed to market forces. Under Bjolmes, the interest is offered to third parties if the creditors do not bid on it.

C. Payment in Full Approach

As noted at the outset, the Absolute Priority Rule provisions are part of the cram-down provisions of Bankruptcy Code §1129(b), and the Absolute Priority Rule applies only if a senior impaired class does not accept the plan, and the impairment of that class(es) is not in compliance with §§1129(b)(2)(B) or (C). The Absolute Priority Rule would not be violated if the plan provides for full repayment to creditors, and LaSalle would not apply.

D. LaSalle Limited to Violations of the Absolute Priority Rule

The United States Bankruptcy Court for the District of Delaware discussed and distinguished LaSalle in In re Zenith Electronics Corp., 241 B.R. 92 (Bankr. D.Del. 1999). The court found that LaSalle did not apply to a debtor's plan for reorganization because the plan submitted by the debtor, was approved by all creditors classes. The largest shareholder and creditor of the debtor corporation was LG Electronics ("LGE"), which the plan allowed to purchase all of the stock of the reorganized debtor corporation.

In Zenith Electronics, a group of minority shareholders contended that the plan violated LaSalle because it allowed LGE to purchase the entire stock of the corporation without testing the price in the open market. The court found that the Absolute Priority Rule was not applicable because the plan was approved by all creditors classes, §1129(b)(2)(B) not applicable; as to §1129(b)(2)(C), the court found that LGE was not being allowed to purchase the stock in the reorganized debtor on account of its existing stock, but, instead, "in its capacity as a substantial secured and unsecured creditor who is being given the right." LGE was to forgive \$200 million of debt and provide new funding of \$60 million. The court stated, "The restriction on the debtor's right to propose a plan contained in the 203 North LaSalle case should be limited to the facts of

that case – where the absolute priority rule encompassed in section 1129(b)(2)(B) is violated.” Zenith Electronics, 241 B.R. at 106, 107 (“The instant Plan does not violate the absolute priority rule articulated in section 1129 (b)(2)(B) or (C) because all creditors classes have accepted the Plan and LGE is not retaining any interest because of its shareholder status. LGE is obtaining the equity in Zenith because of its status as a creditor, senior in right to the minority shareholders.”).

LaSalle barred shareholders from having the exclusive right to purchase the debtor corporation without first extending an “opportunity to anyone else to compete for that equity.” LaSalle, 119 S.Ct. at 1422. The Zenith Electronics court would not extend LaSalle beyond its limitation on shareholders to creditors.

A comparable analysis was applied by the United States Bankruptcy Court in the Southern District of Florida. In In re New Midlands Plaza Associates, the Florida court also would not extend LaSalle to a similar situation where all creditor classes with standing to assert the Absolute Priority Rule accepted the plan for reorganization. The court found that since LaSalle dealt with a violation of the Absolute Priority Rule, it cannot apply to a case where the rule does not apply and is not violated. In re New Midlands Plaza Associates, 247 B.R. 877 (Bankr.S.D. Fla 2000).

LaSalle also did not apply to an approved reorganization plan that called for the sale of the debtor’s assets to a third party. Beal Bank, S.S.B. v. Waters Edge Ltd. Partnership, 2000 WL 595247 (D.Mass.). The debtor submitted the reorganization plan. The plan was approved despite the rejection of two dissenting creditors. Among other things, the dissenters contended that the plan violated the Absolute Priority Rule because outside parties did not have an opportunity to bid on the debtor’s assets. The court found that the Rule was not violated because the plan called for the debtor’s assets to be sold to a third party, and not to the existing equity interest holders; LaSalle was not violated because a third party was purchasing the assets.

6. Closing Observations

A. The approaches taken by the courts in In re Bjolmes Realty Trust, 134 B.R. 1000 (Bankr. D. Mass. 1991), In re Ropt Ltd. Partnership, 152 B.R. 406 (Bankr. D. Mass. 1993), and In re Minkoff, 1999 WL 1424987 (Bankr. D.Kan. 1999), may offer some guidance to other courts, but they are not binding on other courts.

B. It is almost a certainty that courts will have to review New Value plans with a degree of flexibility, based upon the particulars of the case before the court. Some equity interests require special considerations in the offering to other potential buyers.

C. In the case of a small, closely held corporation, or the case of an individual, where management is not distinct from ownership, the offering of the equity interest to the “market” may implicate other confirmation issues:

1. How does one comply with the requirements of 11 U.S.C. §1129(a)(5), concerning disclosure of the persons who will be officers and directors of the debtor after plan confirmation, if the ownership of the equity interest may be sold to a third party after confirmation of the plan, pursuant to bidding procedures?

2. Does the possible change in ownership, and thus management, affect the feasibility of the plan?

3. Will the lenders providing financing to the debtor be willing to continue providing financing to the successful bidder?

D. At least in theory, a prospective buyer would take into account the feasibility and the willingness of lenders to continue providing credit in making a bid to purchase the equity interest. However, situations may arise in which the prospective bidder is motivated by other interests - perhaps to eliminate a competitor, or to compel a payment not otherwise allowable.