Senior Class Gifting Is Not the End of the Story: Some Recent Developments Regarding the Absolute Priority Rule and the New Value Exception

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Much attention in the commercial bankruptcy world has been devoted recently to judicial pronouncements concerning whether the practice of senior creditor class "gifting" to junior classes under a chapter 11 plan violates the Bankruptcy Code's "absolute priority rule." Comparatively little scrutiny, by contrast, has been directed toward significant developments in ongoing controversies in the courts regarding the absolute priority rule outside the realm of senior class gifting—namely, in connection with the "new value" exception to the rule and whether the rule was written out of the Bankruptcy Code in individual debtor chapter 11 cases by the addition of section 1115 as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"). This article examines these concepts as well as some recent court rulings addressing them.

Cram-Down and the "Fair and Equitable" Requirement

If a class of creditors or shareholders votes to reject a chapter 11 plan, it can be confirmed only if the plan satisfies the "cram-down" requirements of section 1129(b) of the Bankruptcy Code. Among these requirements is the mandate that a plan be "fair and equitable" with respect to dissenting classes of creditors and shareholders.

Section 1129(b)(2)(B) of the Bankruptcy Code provides that a plan is "fair and equitable" with respect to a dissenting impaired class of unsecured claims if the creditors in the class receive or retain property of a value equal to the allowed amount of their claims or, failing that, in cases not involving an individual debtor, if no creditor of lesser priority, or no equity holder, receives or retains any distribution under the plan "on account of" its junior claim or interest. This requirement is sometimes referred to as the "absolute priority rule."

History of the Absolute Priority Rule

The U.S. Supreme Court first formally articulated the absolute priority rule, originally referred to as the "fixed principle," in *Northern Pacific Railway Co. v. Boyd*, 228 U.S. 482 (1913), which involved an equity receivership of a railroad. In *Boyd*, the old stockholders and bondholders agreed to a plan of reorganization in 1896 pursuant to which the company was to be sold to a new company in which the old stockholders had rights. Boyd asserted an unsecured claim against the predecessor company that resulted in a judgment in 1896 and was revived in 1906. However, because the old railroad's assets had been sold to the new company 10 years earlier, there were no longer any assets on which to levy an execution. Boyd accordingly sued to hold the new company responsible for the old company's debt to him. The Supreme Court ruled that the stockholders' receipt of property was invalid:

> [I]f purposely or unintentionally a single creditor was not paid, or provided for in the reorganization, he could assert his superior rights against the subordinate interests of the old stockholders in the property transferred to the new company. They were in the position of insolvent debtors who could not reserve an interest as against creditors. . . . Any device, whether by private contract or judicial sale under consent decree, whereby stockholders were preferred before the creditor, was invalid.
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> [I]n cases like this, the question must be decided according to a fixed principle, not leaving the rights of the creditors to depend upon the balancing of evidence as to whether, on the day of sale, the property was insufficient to pay prior encumbrances.

Thus was established the "fixed principle"—a concept that later came to be known as the "absolute priority rule." According to this precept, stockholders could not receive any distribution in a reorganization case unless creditor claims were first paid in full. The Supreme Court continued to apply this principle in equity receivership cases throughout the early 1900s, emphasizing that it should be strictly applied.

In 1934, Congress amended the former Bankruptcy Act to introduce the words "fair and equitable" to bankruptcy nomenclature. Section 77B(f) of the Act provided that a plan of reorganization could be confirmed only if the bankruptcy judge was satisfied that the plan was "fair and equitable and does not discriminate unfairly in favor of any class of creditors or stockholders and is feasible." The provenance of this restriction was none other than the "fixed principle." As later expressed by the Supreme Court in *Bank of America Nat. Trust and Sav. Ass'n v. 203 North LaSalle*, 526 U.S. 434 (1999), *reversing Matter of 203 North LaSalle Street Partnership*, 126 F.3d 955 (7th Cir. 1997), "[t]he reason for such a limitation was the danger inherent in any reorganization plan proposed by a debtor, then and now, that the plan will simply turn out to be too good a deal for the debtor's owners." The "fair and equitable" requirement endured as part of chapter X of the former Bankruptcy Act when Congress passed the Chandler Act in 1938. As applied, the absolute priority rule prohibited any distribution to the holders of junior interests if senior creditors were not paid in full. This was so even if senior creditors agreed to the arrangement.

Congress partially codified the absolute priority rule into section 1129(b)(2) of the Bankruptcy Code in 1978. Prior to the enactment of the Bankruptcy Code, the absolute priority rule prevented junior classes from receiving consideration at the expense of a senior creditor even if the majority of senior creditors agreed. Now, the rule applies only if the senior class does not vote to accept the plan. Thus, the rule would be an obstacle to confirmation only if a class of senior creditors is "impaired" by, for example, receiving less than full payment, the senior class votes to reject a chapter 11 plan, and the plan provides for some distribution to junior creditors or interest holders.

The New Value Exception

In 1939, the Supreme Court made explicit the connection between old equity cases and bankruptcy practice by holding in *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106 (1939), that under section 77B(f) of the former Bankruptcy Act, the requirement of a "fair and equitable" plan of reorganization meant application of the absolute priority rule. In *Case*, the debtor's existing shareholders sought to retain an ownership interest in the company, even though senior creditors were not to be paid in full. The shareholders argued that retention of their interests was important to the company's future success, given their familiarity with business operations and the advantages of continuity in management. The Supreme Court ruled that continued shareholder participation in the ownership of an insolvent company may be acceptable under certain circumstances. From this pronouncement evolved the controversial "new value" corollary or exception to the absolute priority rule.

Under the new value exception, a junior stakeholder (*e.g.*, a shareholder) may retain its equity interest under a chapter 11 plan over the objection of a senior impaired creditor class, provided the shareholder contributes new capital to the restructured enterprise. According to some courts, that capital must be new, substantial, necessary for the success of the plan, reasonably equivalent to the value retained, and in the form of money or money's worth.

In *In re Bonner Mall Partnership*, 2 F.3d 899 (9th Cir. 1993), *motion to vacate denied, case dismissed sub nom. U.S. Bancorp Mortg. Co. v. Bonner Mall Partnership*, 513 U.S. 18 (1994), the Ninth Circuit held that "if a proposed plan satisfies all of these [five] requirements, i.e. the new value exception, it will not violate section 1129(b)(2)(B)(ii) of the Code and the absolute priority rule." Such a plan, the court wrote, "will not give old equity property 'on account of' prior interests, but instead will allow the former owners to participate in the reorganized debtor on account of a substantial, necessary, and fair new value contribution." Other courts have concluded that the new value exception did not survive the enactment of the Bankruptcy Code in 1978 because, among other things, the concept is not explicitly referred to in section 1129(b)(2) or elsewhere in the statute.

Since the enactment of the Bankruptcy Code, the U.S. Supreme Court has only obliquely addressed the viability of the new value exception. In its decision in *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988), the court held that, even if the new value exception to the absolute priority rule survived the enactment of the Bankruptcy Code in 1978, new value could not be satisfied by promised contributions of labor. The court was similarly reluctant to tackle the issue head on in the other two cases to date in which it had an opportunity to do so. In 1994, the court declined to vacate the Ninth Circuit's *Bonner Mall* opinion, and in 1999, it similarly declined to overrule the Seventh Circuit's interpretation of the corollary in *Matter of 203 North LaSalle Street Partnership*. Instead, the court held that one or two of the five elements of the new value corollary could not be satisfied when old equity retains the exclusive right to contribute the new value. The court expressly declined to define what "on account of" requires, except to hold that it cannot be satisfied when old equity has the exclusive right to propose a plan.

The Absolute Priority Rule in Individual Chapter 11 Cases

"High-asset" individual debtors, such as business owners or owners of rental property or other significant business and personal assets, whose financial problems are too extensive to qualify for treatment under the wage-earner provisions in chapter 13, commonly seek protection under chapter 11 of the Bankruptcy Code. Such debtors are a prominent feature of commercial insolvency practice in California and certain other western states. Recent statistics indicate that the volume of individual chapter 11 cases has risen significantly since the October 17, 2005, effective date of BAPCPA.

BAPCPA amended section 1129(b)(2)(B)(ii) with respect to individual chapter 11 debtors. It now provides (with added language italicized) as follows:

> (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, *except that in a case in which the debtor is an individual, the debtor may retain property included in the estate under section 1115, subject to the requirements of subsection (a)(14) of this section.*

The added language allows individual chapter 11 debtors to retain "property included in the estate under section 1115," even if a dissenting class of unsecured creditors could otherwise argue that retention of such property violates the absolute priority rule.

Section 1115 was also added in 2005 by BAPCPA. It provides in relevant part as follows:

> (a) In a case in which the debtor is an individual, property of the estate includes, in addition to the property specified in section 541—(1) all property of the kind specified in section 541 that the debtor acquires after the commencement of the case . . . ; and (2) earnings from services performed by the debtor after the commencement of the case . . . .

Thus, the bankruptcy estate in an individual chapter 11 case is more expansive than the estate in a case involving a nonindividual debtor because section 1115 specifies that the estate in an individual chapter 11 case "includes" all property covered by section 541 as well as certain property expressly excluded from nonindividual debtor cases under section 541(a)(6)─*i.e.*, an individual debtor's postpetition earnings from services. However, because, among other things, the term "includes" is "not limiting" pursuant to section 102(3) of the Bankruptcy Code, a dispute has arisen as to whether the carve-out added by BAPCPA to section 1129(b)(2)(B)(ii) for property retained by individual debtors might extend to property other than postpetition earnings─in effect, abrogating the absolute priority rule in individual chapter 11 cases.

If "included in the estate under section 1115" in section 1129(b)(2)(B)(ii) means only property that is added by section 1115, it has a very narrow meaning, referring only to postpetition earnings and not to property originally specified in section 541. Conversely, if "included in the estate under section 1115" means that section 1115 entirely supplants section 541, assuming that property of the estate in an individual chapter 11 case is defined only by section 1115, it has a very broad meaning, essentially exempting individuals from the absolute priority rule as to unsecured creditors.

Some courts, representing the minority view as of this writing, have construed section 1115 broadly. These courts interpret the phrase "in addition to the property specified in section 541" to mean that section 1115 absorbs and then supersedes section 541 for individual chapter 11 cases. From this construction is derived the approach that, in individual chapter 11 cases, section 1129(b)(2)(B)(ii)'s exception from the reach of the absolute priority rule extends to all property of the estate, including, for example, prepetition ownership interests in nonexempt property and an individual debtor's ownership interests in a business. According to some courts, this approach comports with the underlying purpose of most of the changes effected by BAPCPA in adapting various provisions of chapter 13─which has no absolute priority rule─to fit in the chapter 11 context.

Other courts, representing a growing majority, subscribe to a narrow construction of section 1115 and confine the exemption from absolute priority to postpetition earnings. At least five bankruptcy courts have taken this position in reported or electronically available opinions thus far in 2011.

Some Recent Cases on Absolute Priority and the New Value Exception

2011 has already seen a wealth of court rulings addressing the new value exception and section 1115. In *In re Red Mountain Machinery Co.*, 2011 WL 1428266 (Bankr. D. Ariz. Apr. 14, 2011), the court confirmed a chapter 11 plan proposing to give equity in the reorganized company to the debtor's principals (and sole shareholders) notwithstanding less than full payment of a lender's unsecured deficiency claim. The court found that new value to be contributed by old equity for new equity interests in the reorganized entity in the amount of up to $1.2 million was "necessary for a successful reorganization" because the Bankruptcy Code unequivocally requires that administrative expenses be paid in full, in cash, on the effective date of the plan, and the debtor's cash position, without such a contribution from old equity, was insufficient to permit such payment. It also concluded that the new value the old equity would contribute under the chapter 11 plan was "reasonably equivalent" to the value of the equity interest they would receive, where exclusivity had expired, such that there was no option value to old equity in having the right to propose a plan, and the amount of the contribution was greatly in excess of the value of the equity interests based on either a pro forma balance sheet of the reorganized debtor or capitalization of the reorganized debtor's projected income.

In *In re Multiut Corp.*, 2011 WL 1486035 (Bankr. N.D. Ill. Apr. 19, 2011), the bankruptcy court denied confirmation of a chapter 11 plan proposing that the debtor's existing shareholder would retain 100 percent of his equity interest in exchange for a cash contribution of $100,000 under the "new value" exception. According to the court, although the money "to be contributed to the Plan is new, necessary for the success of the Plan, and in the form of money or money's worth," and "[w]ithout that contribution, there likely would not be enough funds with which to pay administrative claimants in full on the Effective Date of the Plan," the plan proponent failed to demonstrate that "the $100,000 contribution is reasonably equivalent to [the shareholder's] one hundred percent ownership interest."

In *In re Greenwood Point, LP*, 445 B.R. 885 (Bankr. S.D. Ind. 2011), the court held that a chapter 11 plan proposing to distribute new equity to the wife of the debtor's principal, rather than the principal himself, in exchange for a $100,000 contribution, did not violate the absolute priority rule. Furthermore, the court held, even assuming that the absolute priority rule was implicated by equity provisions in the plan, the $100,000 contribution, when no lender was willing to provide such financing upon comparable terms, was sufficient to permit confirmation of the plan, despite nonpayment in full of senior creditor claims, under the new value exception.

The bankruptcy court adopted the narrow view of the impact of section 1115 in *In re Draiman*, 2011 WL 1486128 (Bankr. N.D. Ill. Apr. 19, 2011). In that case, an individual debtor's chapter 11 plan provided for less than full payment of senior creditor claims but proposed that the debtor would retain certain nonexempt assets, including office equipment, furnishings, supplies, and certain management agreements of his management and consulting firm as well as personal household items and an automobile. The court ruled that, although the debtor was entitled to postpetition income from the management company under section 1115, his attempt to keep nonexempt assets of the bankruptcy estate that are not specifically addressed by section 1115 violated the absolute priority rule. However, the debtor also argued that his contribution of $100,000 for the retained assets was sufficient for the new value exception to apply. The court agreed, concluding that the contribution, which was to be made by a business associate, was "new"; "necessary" to the plan because it would serve as the initial funding for a liquidation and litigation trust to be created by the plan; "reasonably equivalent to the value" of the retained assets (which were valued at no more than $30,000); and, being in cash, in "money or money's worth."

In *In re Kamell*, 2011 WL 1760282 (Bankr. C.D. Cal. May 4, 2011), the court similarly adopted the narrow view of BAPCPA and section 1115's impact on the absolute priority rule in individual chapter 11 cases. According to the court, "there is no good reason to conclude that Congress intended to abrogate this long-standing and important centerpiece of Chapter 11 jurisprudence based on the ambiguous language of the BAPCPA amendments.” The court found the narrow view more persuasive than the “broad view,” which reads into the language of sections 1129(b)(2)(B)(ii) and 1115 an intent to abrogate the absolute priority rule entirely, as in chapter 13. The court accordingly ruled that the debtor’s plan could not be confirmed because it proposed to allow the debtor to retain substantial prepetition property without paying dissenting unsecured creditors in full. Other decisions thus far in 2011 adopting the narrow view have included *In re Maharaj*, 2011 WL 1753795 (Bankr. E.D. Va. May 9, 2011); *In re Walsh*, 447 B.R. 445 (Bankr. D. Mass. 2011); and *In re Stephens*, 445 B.R. 816 (Bankr. S.D. Tex. 2011).

Outlook

The appellate courts have yet to address the impact of section 1115 on the absolute priority rule, and only a handful of courts (and none at the circuit level or above) have examined the new value exception in any published opinion in five years or more. That may soon change, especially with respect to section 1115. The number of individual chapter 11 filings has risen considerably in the last two years, and the continued existence (or not) of the absolute priority rule will determine whether plans are confirmable in many of those cases. The issue is an important one that needs resolution in many individual chapter 11 cases. Disputes regarding these issues are likely to percolate upward through the appellate processes in the not too distant future. Perhaps the circuit courts of appeal and even the U.S. Supreme Court will soon have an opportunity to rule on both the impact of section 1115 and the viability of the new value exception.

Interestingly, in *Ala. Dep’t of Econ. & Comm. Affairs v. Ball Healthcare-Dallas, LLC (In re Lett)*, 632 F.3d 1216 (5th Cir. 2011), the Fifth Circuit Court of Appeals was presented with an opportunity earlier this year to weigh in on the absolute priority rule in individual debtor chapter 11 cases as well as the new value exception. However, section 1115 did not apply in that case because the chapter 11 filing preceded the October 17, 2005, effective date of the provision, and the court expressly declined "further discussion of this exception to the absolute priority rule, as it is not at issue in this case." On remand, however, the district court ruled in *In re Lett*, 2011 WL 2413484 (S.D. Ala. June 13, 2011), that the debtor's plan violated the absolute priority rule because certain property would revest in the debtor upon confirmation without paying senior creditor classes in full and that the plan failed to satisfy the new value exception because the debtor contributed no new value to the estate.