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How to Keep Insiders Inside in a Chapter 11 Reorganization

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A client approaches you and asks for assistance in reorganizing its business in a Chapter 11 bankruptcy proceeding. Creditors will not be paid in full; best case scenario is 20 cents on the dollar. But of course, your client wants to retain control of the business and keep its stock. Client knows its creditors will not voluntarily accept the plan, but insists there can be no business without current insiders (read your client). What do you say?

Unfortunately, this familiar set of facts bucks right up against a statutory bankruptcy prohibition known as the “absolute priority rule.” Assuming creditors won't go along, bankruptcy counsel must find a way around it. Enter—**the new value exception to the absolute priority rule**. This article will examine the new value exception (or corollary) to the absolute priority rule: its history, case law before and after the Supreme Court's seminal decision in *North LaSalle*, and plan provisions which have satisfied or should satisfy the exception.

A. The Absolute Priority Rule

A bankruptcy court may confirm a plan of reorganization over the objection of a class of creditors only if “the holder of any claim or interest that is junior to the claims of such [objecting] class will not receive or retain under the plan on account of such junior claim or interest any property.” 11 U.S.C. § 1129(b)(2)(B)(ii). *Unruh v. Rushville State Bank of Rushville, Missouri*, 987 F.2d 1506, 1508 (10th Cir. 1993).

This “is the core of what is known as the 'absolute priority rule.'” *Bank of America National Trust and Savings Association v. 203 North LaSalle Street Partnership*, 526 U.S. 434, 442, 119 S.Ct. 1411, 1416, 143 L.Ed.2d 607 (1999). In its most general sense, “the absolute priority rule 'provides that a dissenting class of unsecured creditors must be provided for in full before any junior class can receive or retain any property [under a reorganization] plan.'” *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 202, 108 S.Ct. 963, 966, 99 L.Ed.2d 169 (1988) (alteration in original).

B. The New Value Corollary

The absolute priority rule began as a common law rule which predated the current Code. Prior to the legislative enactment of Section 1129(b)(2)(B)(ii), the Bankruptcy Act only required that a reorganization plan be fair and equitable. *North LaSalle*, 526 U.S. at 444, 119 S.Ct. at 1417. Courts interpreted this to mean that creditors had to be paid before stockholders could retain equity interests. *Id*.

In *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106, 60 S.Ct. 1, 84 L.Ed. 110 (1939), however, the Court, in *dictum*, opened the door to the possibility that, notwithstanding the common law absolute priority rule, stockholders could

participate in a reorganization plan. Based on *Case*, some courts began holding that equity holders could retain an equity interest in a reorganized entity if they contributed "new value." A contribution sufficient to overcome the absolute priority rule had to be: (1) in the form of money or money's worth; (2) reasonably equivalent to the interest retained or received by the equity holders; and (3) necessary for the debtor's reorganization. *North LaSalle*, 526 U.S. at 442, 119 S.Ct. at 1416. Some courts later added the requirements that the contribution be (4) up front and (5) substantial. *See In re Snyder*, 967 F.2d 1126, 1131 (7th Cir. 1992); *In re Haskell Dawes, Inc.*, 199 B.R. 867, 872 (Bankr. E.D. Pa. 1996).

In *North LaSalle*, the Supreme Court declined to decide whether a new value corollary or exception to the absolute priority rule still existed after the passage of Section 1129(b)(2)(B)(ii). Instead, the Court, limiting its holding to the specific facts, held that the debtor's pre-bankruptcy equity holders could not, over the objection of a senior class of impaired creditors, contribute new capital to receive ownership interests in the new entity, when that opportunity was given exclusively to the old equity holders without consideration of alternatives or market valuation. *Id*. at 437, 119 S.Ct. at 1414. The Court reasoned that the exclusive opportunity to invest in the reorganized entity, and thereby receive equity in it, must be considered property received "on account of" old equity interests in the entity. *Id*. at 456, 119 S.Ct. at 1423.

The Supreme Court also clarified in *North LaSalle* that the "on account of" language in Section 1129(b)(2)(B)(ii) means "because of" and requires only a causal connection between the equity interest and the property to be received or retained. *Id. at* 450-51, 119 S.Ct. at 1420. As proclaimed in its opinion:

> [A] causal relationship between holding the prior claim or interest and receiving or retaining property is what activates the absolute priority rule.

Id. at 451, 119 S.Ct. at 1420.

C. New Value After *North LaSalle*

1. Market test

North LaSalle held that there must be some way to test the value of a proposed contribution. *Id*. at 457-58, 119 S.Ct. at 1423-24. Where the plan grants an exclusive right, "the best way to determine value is exposure to a market." *Id.* at 457, 119 S.Ct. at 1423. The Court, however, refused to decide "[w]hether a market test would require an opportunity to offer competing plans or would be satisfied by a right to bid for the same interest sought by old equity . . . ." *Id.* at 458, 119 S.Ct. at 1424.

Under a plan proposed in *In re Global Ocean Carriers Ltd*., 251 B.R. 31 (Bankr. De. 2000), the debtor's largest shareholder retained the exclusive right to determine who would be debtor's owner, as well as at what price, without the benefit of a public auction or competing plan. *Id.* at 51-52. The court held that this violated the absolute priority rule.

> To avoid this result the Debtors must subject the "exclusive opportunity" to determine who will own Global Ocean to the market place test.. . . This can be achieved by either terminating exclusivity and allowing others to file a competing plan or allowing others to bid for the equity (or the right to designate who will own the equity) in the

> context of the Debtors' Plan.

Id. at 52. The court also rejected the suggestion that talking to another unrelated party about investing in the reorganized debtor would be sufficient to satisfy the market place test. *Id.* at n. 19.

In *In re Situation Management Systems, Inc.*, 252 B.R. 859 (Bankr. Mass. 2000), the court held that a new value provision in a reorganization plan was grounds for terminating the debtor's exclusive right to file a plan. *Id.* at 865. The court further reasoned that, "where, as here, there is a party interested in acquiring the Debtor, the opportunity to offer a competing plan is a preferable procedural mechanism to auction . . . ." *Id*.

In *In re Davis*, 262 B.R. 791 (Bankr. Az. 2001), the plan provided for a new value alternative permitting individual debtors to contribute certain non-estate funds, but did not permit competing plans or other forms of competition for the new value. *Id.* at 798. The court rejected the plan, reasoning in part that "it fails to use a 'market' or 'non-exclusive' approach to the source of new value." *Id.* at 799. In an attempt to remedy the situation, the court terminated the exclusivity period, allowing competing plans to be filed. *Id*.

It appears then that post-*North LaSalle*, the simplest way to effectuate the retention of equity (or other property—See below at D.3.) is to allow competing plans. Under the post-*North LaSalle* cases described above, courts have terminated exclusivity in an effort to allow "competition" to plans proposed by existing equity owners. The voluntary termination of exclusivity for this purpose, with an opportunity for competing plans, should likewise be sufficient. A second way to provide "competition" would be to open up the opportunity proposed through fair and open auction procedures. By demonstrating that competing bids have been genuinely solicited, the concerns raised by the Supreme Court in *North LaSalle* should be satisfied.

2. Causal relationship

The Court, in deciding *North LaSalle*, did not inquire into any of the common law elements of the new value corollary. Instead, the Court focused on whether a causal relationship existed between the interest retained and the prior interest. *North LaSalle*, 526 U.S. at 456, 119 S.Ct. at 1423.

> [A] causal relationship between holding the prior claim or interest and receiving or retaining property is what activates the absolute priority rule.

Id. at 451, 119 S.Ct. at 1420.

After *North LaSalle*, an argument can be made that the analysis for new value should be limited to whether or not a causal relationship exists. *See, e.g., In re PWS Holding Corp.*, 228 F.3d 224, 238 (3d Cir. 2000) (not addressing common law elements of new value test, instead reasoning that releases were not "made 'on account of' KKR's junior interest as that phrase is construed in *203 North LaSalle*").

D. Common Law New Value Test

In some jurisdictions, such as the Third Circuit, there is a large body of case law fleshing out the elements required for sufficient new value. In these jurisdictions, it is safe to say that the new value exception is alive and well. *See, e.g., In re PWS Holding Corp. Bruno's, Inc*. 228 F3d 224 (3d Cir. 2000). In other jurisdictions, such

as the Tenth Circuit, there is little or no guidance, and it is difficult to know whether a court will even consider a plan incorporating the concept of new value.

In any case, applying well-developed case law should shed light on whether a plan proposing that equity holders retain property should be confirmed. Again, the common law test requires that the new value be (1) in money or money's worth, (2) necessary for the debtor's reorganization, and (3) reasonably equivalent to the interest retained or received by the equity holders. *North LaSalle*, 526 U.S. at 442, 119 S.Ct. at 1416. In addition, some courts have added the requirements that the contribution be (4) up front and (5) substantial. *See In re Snyder*, 967 F.2d 1126, 1131 (7th Cir. 1992). The following discussion offers guidance with respect to each of these elements.

1. Up front and in the form of money or money's worth

"[C]ontributions which satisfy the 'money's worth' requirement 'should be (1) an asset in the accounting sense, (2) tangible, alienable, and enforceable, and (3) a present contribution that can be levied upon at the time of plan approval.'" In re Haskell Dawes, Inc., 199 B.R. 867, 873 (Bankr. E.D. Pa. 1996) (quoting Katherine Kruis, *A Framework for Application of the New Value Exception*, 21 Cal. Bankr. J. 199, 216 (1993)). "Contributions in the form of future payments do not constitute present or 'up front' capital contributions." *Id.; In re Hendrix*, 131 B.R. 751, 753 (Bankr. M.D. Fla. 1991) ("the contribution cannot be a future contribution, it must be present, taking place at or before the effective date of the plan"); *In re Future Energy Corp.*, 83 B.R. 470, 499 (Bankr. S.D. Ohio 1988) ("It is well-established that a new capital investment must be a present contribution, not a contribution promised in the future.")

Importantly, the contribution of labor, experience, and expertise by an equity holder is NOT in "money's worth" and therefore not sufficient for new value purposes. *North LaSalle*, 526 U.S. at 445, 199 S.Ct. at 1417-18.

2. Necessary to the reorganization

The requirement that the contribution be necessary to the reorganization is met if:

> (i) the contribution will be used to fund repairs or improvements to the debtor's property that are necessary to its reorganization; or (ii) the contribution is needed to enable the debtor to make payments due under the plan of reorganization and continue operating.

In re Haskell Dawes, Inc., 199 B.R. at 873.

Courts have held that contributions of new value are only "necessary" if they are to be used for the continued operations of the debtor, such as where capital is necessary to repair or alter property owned by a debtor. Where, however, there has been no specific need for capital other than to overcome the absolute priority rule, contributions of capital have failed to satisfy the "necessity" prong of the new value exception. *See In re Sovereign Group, supra*, 142 B.R. at 70 and cases cited therein.

Moreover, if the new value is being contributed only for the purpose of funding nominal payments to unsecured creditors, "necessity" is not shown. *In re Sovereign Group*, 142 B.R. at 708 (the partial payment of a pre-existing debt to an objecting creditor, particularly in such an insignificant amount, will not facilitate reorganization); *In re Mortgage Invest. Co. of El Paso, Texas*, 111 B.R. 604, 619 (Bankr. W.D. Tex. 1990) (where infusion of capital was to be used for payment of

a class of creditors, infusion not necessary to continued operations of debtor.).

3. Reasonably equivalent to the interest being retained
"The reasonable equivalence requirement ensures that equity holders will not get around the absolute priority rule by offering token cash contributions." *In re Graphic Communications, Inc.*, 200 B.R. 143, 150 (Bankr. E.D. Mich. 1996). If the value of the interest being retained were more than the value of the contribution, the old equity holder would be receiving something "on account of" his or her junior claim. *In re Haskell Dawes, Inc.*, 199 B.R. at 877.

In analyzing whether the property to be contributed is reasonably equivalent to the property to be retained, a court should consider not only the equity interests proposed to be retained, but also other "benefits" proposed to be retained. These might include salaries, health benefits, releases of personal debts and potential liabilities, tax benefits, and other company perks, such as a company car. *See Haskell Dawes*, 199 B.R. at 879-80; *In re Beaver Office Products, Inc.*, 185 B.R. 537, 544-545 (Bankr. N.D. Ohio 1995); *In re Creekside Landing, Ltd.*, 140 B.R. 713, 718 (Bankr. M.D. Tenn. 1992); *In re Pullman Construction*, 107 B.R. 909, 949 (Bankr. N.D. Ill. 1989).

A court must then measure the value to be received or retained against the proposed new value contribution. Often, this will require an evaluation of the value of the reorganized debtor. *In re Graphic Communications, Inc.*, 200 B.R. at 150 (holding that failure to present evidence regarding the value of the reorganized debtor was fatal to plan).

4. Substantial
In determining whether a proposed contribution is substantial, courts generally consider a combination of two or more of the following factors:

[T]he size of the contribution; its relation to the amount of unsecured claims against the estate; its relation to the plan's distribution to unsecured creditors; its relation to the amount of pre-petition claims; its relation to a normal market contribution; and the amount of debt to be discharged.

Haskell Dawes, 199 B.R. at 875. In the context of a close corporation, because "normal market contributions" do not exist, courts have generally considered only the following two factors in determining whether a proposed contribution is substantial: (1) the percentage of return on creditors' claims relative to the contribution; and (2) whether the proposed payment represents the equity holder's best efforts. *Applied Safety, supra*, 200 B.R. at 590; *Haskell Dawes*, 199 B.R. at 875-876.

Courts have held that contribution-to-unpaid debt ratios within certain ranges are not substantial. *Haskell Dawes*, 199 B.R. at 876 (contribution of 5.1% of unsecured debt not substantial); *In re Woodbrook Associates*, 19 B.R. at 876 (new value of 3.8% not substantial); *In re Sovereign Group*, 142 B.R. at 710 (new value contribution of $135,000 which represented only 3.6% of unsecured debt not substantial). The contribution percentage should be considered both in light of total unsecured claims and the plan's proposed distribution to unsecured creditors. *See Haskell Dawes*, 199 B.R. at 876. However, the determination of whether a contribution is "substantial" cannot rest on a mathematical formula alone. *Id*.

In addressing whether the contribution constitutes the "best efforts" of the inside equity holders, it is appropriate to inquire into a contributor's financial condition. *See Id.* at 877. Thus, inquiries into the insider's personal assets, revenue streams

and liquidity are all relevant to plan confirmation.

CONCLUSION

As a result of the market test requirement in *North LaSalle*, any plan that would provide for continuing ownership in a reorganized debtor over the objection of a class of creditors without the benefit of competing plans or an "auction" should fail. In addition, in many jurisdictions, well-developed case law on what is or is not sufficient for purposes of the new value exception offers helpful guidance on what may pass muster. The new value exception is apparently here to stay, and this article should help those of us who are hired to keep the insiders inside in a Chapter 11 context.
