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The New Value Exception to the Absolute Priority Rule Is Alive and Well after 203 North LaSalle

Can the owners of a company retain their equity interests in a Chapter 11 reorganization plan? The answer to this question is often critical in determining whether a Chapter 11 bankruptcy proceeding is a desirable option for the company's owners. If the company is unable to pay its creditors in full, then the absolute priority rule prohibits owners from retaining their interests under a reorganization plan unless the owners contribute new value to the business that is both substantial and essential to the company's reorganization efforts.

Many commentators have questioned the validity of the so called "new value exception" since the Supreme Court's *203 North LaSalle* decision in 1999. This article explores the history of the absolute priority rule and the continued viability of the new value exception after *203 North LaSalle*. [Click here for the full article.](#)

I. The Absolute Priority Rule and New Value in a Nutshell

The absolute priority rule comes into play during the Chapter 11 plan confirmation process. Under Bankruptcy Code § 1129(b)(1), a creditor's plan objection will be upheld if the plan: (1) discriminates unfairly; or (2) is not fair and equitable with respect to each non-accepting class of claims or interests that is impaired under the plan. In this context, "impaired" means that the plan alters the rights of a class of creditors compared to the contractual rights prior to bankruptcy.

For a dissenting class of impaired unsecured creditors, a plan is "fair and equitable" only if the allowed value of the claim is to be paid in full, or if the holder of any claim or interest that is junior to the dissenting creditors will not receive or retain any property under the plan on account of such junior claim or interest. § 1129(b)(2)(B)(ii). This condition is generally referred to as the

absolute priority rule.

Stated plainly, equity interest holders are not permitted to keep their equity under a plan if all senior claims are not paid in full. In many cases, a strict application of this rule would be the death knell for an otherwise-confirmable Chapter 11 plan. This is particularly true in Chapter 11 cases of smaller companies where continued participation by current equity holders may be vital to the reorganization effort.

The new value exception (also called the new value doctrine or the new value corollary) finds its origins in case law rather than the Bankruptcy Code. The new value doctrine opens the door for plan proponents to overcome the absolute priority rule by requiring equity holders to make a *substantial* and *essential* contribution in exchange for their continued ownership of the debtor. To be substantial, most courts require that the contribution (i.e., new value) be: (1) a present contribution; (2) freely tradable in the market; and (3) money or money's worth. To be essential, the case law generally mandates that this new contribution be directly related to the success of the reorganization plan.

II. A Brief History

The absolute priority rule was originally a judicially created concept. It arose from a series of early twentieth-century railroad cases including *Northern Pacific Railway Co. v. Boyd*, 228 U.S. 482 (1913). Under the *Northern Pacific* plan of reorganization, the old equity holders proposed to repurchase the company's stock, but junior creditors' claims were to be wiped out without payment. The Court rejected that proposal and stated that a sale by which stockholders were preferred (by keeping their ownership interest) before junior creditors were paid was not permitted.

The Court created the absolute priority rule to prevent deals between senior creditors and equity holders that would impose unfair terms on unsecured creditors. In *dicta*, the Supreme Court recognized that a new, substantial, and necessary contribution could allow an old equity holder to retain an interest in the reorganized debtor.

The absolute priority rule was further fleshed out by the Supreme Court in *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939). There, the Supreme Court considered an offer by shareholders to continue their participation in the company's business after confirmation of the plan of reorganization. The Supreme Court stated that the shareholders had to do more than just continue to participate in the debtor's business to retain their equity. Instead, they must contribute money or money's worth. In other words, they must contribute new value to the debtor. With this, the new value doctrine was born.

III. The New Value Doctrine under the Bankruptcy Code

The absolute priority rule was codified at § 1129(b)(2)(B)(ii) with the enactment of the Bankruptcy Code in 1978. Interestingly, and despite years of case law by that time, no reference was made to the new value doctrine. In fact, the words "new value" do not appear anywhere in § 1129. This led to a hotly contested debate over whether the new value doctrine was preserved under the Bankruptcy Code.

Opposing schools of thought emerged. Proponents of the new value doctrine argue, in part, that the absolute priority rule written into the Bankruptcy Code at § 1129(b)(2)(B)(ii) includes a new value component even though the words "new value" do not appear in that section. Specifically, they interpret the phrase "on account of" as permitting recognition of a new value corollary to the rule. If equity holders pay for their equity, the argument goes, then they are not retaining that equity "on account of" their junior interest. Instead, they are paying new value to purchase the ownership anew.

Conversely, opponents argue that the plain language of the Bankruptcy Code must be strictly construed – in essence, if Congress wanted to preserve the new value doctrine, it specifically could have said so. Twenty years later, the Supreme Court considered the issue in *Bank of America National Trust and Savings Assn. v. 203 North LaSalle Street Partnership*, 526 U.S. 434 (1999).

IV. 203 North LaSalle: Putting Value to the Test

When the Supreme Court decided *203 North LaSalle* in 1999, both sides of the new value debate were eager for the Court to settle the score. Unfortunately, no definitive answer was forthcoming.

203 North LaSalle was a single-asset real estate case. During the debtor's exclusive period to propose a plan of reorganization (known as the "exclusivity period"), the debtor sought to confirm a Chapter 11 plan over the objection of dissenting junior creditors. Under that plan, the old equity holders would have retained their interests in the real estate project by contributing \$20 million in tax liabilities that would otherwise have been due if the lender foreclosed. The plan did not provide a mechanism for non-insiders to bid on the equity. Seemingly, this case perfectly framed the issue of whether the new value exception was still valid.

The Supreme Court struck down the plan but declined to rule directly on the validity of the new value corollary. Instead, it held that, on any reading, the proposed plan failed to satisfy the absolute priority rule.

The decision focused on the importance of exposing valuable property to a free market of potential bidders. This is often now referred to as the "market test." The Court determined that the debtor could not and did not meet its burden to prove that the equity holders were paying full value for their interests because the plan did not open the equity to bidders and because it was proposed during the exclusivity period. In essence, the plan proponents failed to prove that retention of their ownership interests was not merely "on account of" or "because of" the interests they already held.

In the end, the debate that *203 North LaSalle* spawned about the continued viability of the new value corollary was somewhat overblown. Although the Court declined to specifically acknowledge the new value doctrine, it did nothing to cast doubt on its existence, and even provided important instruction on the doctrine's application.

V. New Value in the Sixth Circuit after 203 North LaSalle

Since *203 North LaSalle*, the majority of bankruptcy courts in the Sixth Circuit have continued to apply the rationale that old equity holders may retain their interests by contributing new money or money's worth that is substantial and essential to the company's reorganization efforts. The new value doctrine was applied in a recent unpublished decision from the Middle District of Tennessee, *In re: A&F Electric Company, Inc.*, Case No. 07-01377. (Click [here](#) for a copy of the court's memorandum opinion, hereinafter, "*A&F Electric Memorandum*.") The plan in *A&F Electric* proposed a 35% distribution to unsecured creditors and called for the company's sole shareholder to retain his equity interest in exchange for a \$100,000 cash contribution. The plan was proposed during the exclusivity period, but it opened bidding on the equity to any creditor that wished to submit a competing offer.

The court confirmed the plan over a creditor's absolute priority rule objection "based upon the proof at trial that the \$100,000 from [the debtor's shareholder] meets both the substantial and necessary thresholds to qualify under the new value exception to the absolute priority rule." *A&F Electric Memorandum*, at 21.

VI. Conclusion

The new value doctrine is a long-recognized corollary to the absolute priority rule, one that is very much alive after *203 North LaSalle*. The lesson from these cases is that a new value plan cannot be confirmed if the old equity holders are the only ones given an opportunity to bid on the debtor's ownership interests. Subject to that important caveat, it is likely that new value contributions that are substantial and essential to a debtor's reorganization efforts will continue to provide a basis for confirming plans that would otherwise violate the absolute priority rule.

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