

**News From OBA
Bankruptcy Section:**

**The Ninth Circuit Recognizes
The New Value Exception To
The Absolute Priority Rule**

By Gary D. Hammond

(Editor's Note: OBA Sections have been invited to submit short notes of Section information for publication in the Bar Journal.)

On August 4, 1993, the Ninth Circuit held in *In re Bonner Mall Partnership*, 2 F.3d 899 (9th Cir. 1993), that the new value exception to the absolute priority rule survived the enactment of the Bankruptcy Code. The new value exception allows old equity owners of a bankrupt corporation to retain an ownership interest in the reorganized company in exchange for new capital contribution, notwithstanding the objection of a class of creditors whose claims are not paid in full.

The *Bonner Mall* decision is important for several reasons. First, *Bonner Mall* represents the first circuit court to squarely address the issue since a 1988 United States Supreme Court case which cast doubt over the new value exception.¹ Second, the opinion is well reasoned and provides other courts with the opportunity to adopt the *Bonner Mall* court's reasoning.

Bonner Mall Partnership ("Bonner") owned a mall in Bonner County, Idaho, subject to a deed of trust held by U.S. Bancorp Mortgage Co. ("Bancorp") to secure a \$6.6 million debt. After Bonner failed to pay its real estate taxes, Bancorp commenced a nonjudicial foreclosure action. On the day before the scheduled sale of the property, Bonner filed a Chapter 11 bankruptcy petition, which automatically stayed the foreclosure sale.² Bancorp moved for relief from the stay under 11 U.S.C. § 362(d)(2) and proved Bonner's lack of equity. The mall was valued at \$3.2 million, indicating that Bancorp had a \$3.2 million secured claim and a \$3.4 million unsecured claim.

As a condition to obtaining relief under 11 U.S.C. § 362(d)(2), Bancorp was required to show that Bonner had no equity in the mall and that Bancorp's claim against Bonner was undersecured. Because Bancorp established these facts, the burden shifted to Bonner to prove that the retention of the mall was necessary to an effective reorganization and there was a reasonable possibility of a successful reorganization

within a reasonable time. The bankruptcy court denied Bancorp's motion and allowed Bonner 30 days to propose a plan.

Bonner filed a reorganization plan, relying on the new value doctrine. Bonner's proposed reorganization plan provided for the transfer of all the debtor's assets to a new corporation. Under the plan, the unsecured claimants, of which Bancorp's was the largest, would receive 300,000 shares of preferred stock in the new corporation. Each share would be valued at \$1.00. The preferred stock would be convertible to a maximum of 300,000 shares of common stock after Bonner had paid off the secured part of Bancorp's claim. The plan required Bonner to pay the secured claim in full in 32 months, with interest payments payable monthly in the interim. Also, under the plan, the equity owners, *i.e.*, the partners, would receive nothing on their claims. However, to raise additional capital for the new corporation, the partners would contribute a total of \$200,000 in cash to the new corporation in exchange for two million authorized shares in the new corporation.³

In response, Bancorp renewed its motion to lift the stay, arguing that the new value exception did not survive the enactment of the Bankruptcy Code and that Bonner's plan was unconfirmable as a matter of law. The bankruptcy court addressed Bancorp's first argument but did not reach the second argument.



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Based on *In re Greystone III Joint Venture*, 995 F.2d 134 (5th Cir. 1991), **petition for rehearing granted in part and opinion withdrawn in part**, 995 F.2d 142 (5th Cir.) (*per curiam*) **cert denied**, 113 S.Ct. 72 (1992), the bankruptcy court noted that there was no longer a

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new value exception. On that basis, the bankruptcy court granted Bancorp's motion for relief from automatic stay. The bankruptcy court stayed its order, however, allowing Bonner the opportunity to appeal to the district court.

On appeal, the district court determined that the only issue before it was whether the Bankruptcy Code had eliminated the new value exception. The district court found that the new value exception survived the enactment of the Bankruptcy Code. Bancorp filed an appeal to the Ninth Circuit. On appeal, the Ninth Circuit noted that the only issue before it was whether the new value exception survived the enactment of the Bankruptcy Code.

The *Bonner Mall* court began its analysis by stating that 11 U.S.C. § 1129(a) establishes 13 requirements for confirmation of a reorganization plan, all of which must generally be satisfied. As the court noted, one of the requirements is set forth under 11 U.S.C. § 1129(a)(8), which requires that "with respect to each class of claims, such class has voted to accept the plan or such class is not impaired under the plan." Under the debtor's plan all classes were impaired and, therefore, all classes must accept the plan for a consensual confirmation.

The Bankruptcy Code provides, however, that where all requirements for confirmation except 11 U.S.C. § 1129(a)(8) are met, the bankruptcy court shall confirm a plan over the objection of an impaired class or classes if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interest that is impaired under, and has not accepted, the plan.⁴ This form of confirmation is commonly known as a "cramdown" because the plan is literally crammed down the throats of the objecting classes of creditors.

As the *Bonner Mall* court recognized, the issue before the bankruptcy court in deciding whether to grant Bancorp's motion for relief from stay was whether the plan had a reasonable possibility of confirmation. In other words, whether the standards set forth in 11 U.S.C. § 1129(b)(1) could be feasibly satisfied. The *Bonner Mall* court determined that the resolution of this question turns on whether there is a reasonable possibility that a bankruptcy judge could find the debtor's plan "fair and equitable." 11 U.S.C. § 1129(b)(2) defines "fair and equitable" as including several enumerated requirements. Under this section, a plan will be considered "fair and equitable" only if, with respect to a class of unsecured claims, the plan provides that each holder of a claim of such class

receives on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of the claim, or the holder of any junior claim will not retain under the plan any property on account of such junior claim.⁵ Section 1129(b)(2)(B) is a two-part codification of the judge-made absolute priority rule, compliance with which is a prerequisite to any determination that a plan is fair and equitable.

In *Bonner Mall*, each of the unsecured claims would not be paid in full on the effective date of the plan. As a result, the first part of 11 U.S.C. § 1129(b)(2)(B) could not be satisfied. Accordingly, the debtor's plan could not be "fair and equitable" unless it complied with the last part of 11 U.S.C. § 1129(b)(2)(B) — that no junior claim receive any property on account of such junior claim. Therefore, resolution of the case turned on whether the equity holders were retaining any interest in the reorganized debtor on account of their claim.

The *Bonner Mall* court reasoned that the new value exception survived the enactment of the Bankruptcy Code for three reasons. First, the Bankruptcy Code revisions codifying the absolute priority rule do not prohibit confirmation of the new value plan. Second, Congress' failure expressly to include the new value plan as a standard to be considered in applying the "fair and equitable" principle does not reflect an attempt to eliminate the exception. Finally, the new value exception is fully consistent with the structure and underlying policies of Chapter 11.

The *Bonner Mall* court reasoned that the critical issue under 11 U.S.C. § 1129(b)(2)(B) is whether the old equity partners are to receive their stock interest in the new corporation "on account of" their old equity interest. Using a plain meaning approach, the Ninth Circuit held for the debtor. The *Bonner Mall* court rejected Bancorp's argument that the disputed language established a protracted causality standard that prevented old equity from receiving property under a cramdown reorganization plan. Instead, the court reasoned that Congress intended a direct causality standard. The court reasoned that this gave meaning to the "on account of" language, which the *Bonner Mall* court believed would otherwise be superfluous.

The *Bonner Mall* court also determined that the new value exception serves as a corollary to and complements the absolute priority rule. The court approved the five-part test announced in *Case v. Los Angeles Lumber*, 308 U.S. 106 (1939), that old equity

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must offer value that is: 1) new, 2) substantial, 3) money or money's worth, 4) necessary for successful reorganization, and 5) reasonably equivalent to the value of the interest received.

The *Bonner Mall* court also decided that Congress' failure to specifically include the new value exception as part of the 11 U.S.C. § 1129(b) "fair and equitable" doctrine did not indicate an intent to abolish the exception. The court used the rule of construction that Congress had not clearly shown an intent to eliminate the judicial doctrine which it was aware of when enacting the Bankruptcy Code. The *Bonner Mall* court determined that silence was not enough.

Finally, the *Bonner Mall* court decided that the new value exception was consistent with the underlying policies in Chapter 11. The two primary objectives of Chapter 11 are to permit debtors to rehabilitate and to maximize the value of the estate. According to the *Bonner Mall* court, the new value exception promotes both of these goals by encouraging an investment in the new debtor and facilitating valuable participation by old equity.

The Ninth Circuit's decision in *In re Bonner Mall* is the highest decision to squarely address the new value exception to the absolute priority rule. Prior to the Supreme Court's decision in *Norwest Bank Worthington v. Ahlers*, several courts had addressed the new value exception.⁶ Since *Ahlers*, several Courts of Appeals have danced around the issue of the new value exception.⁷ With the well-reasoned opinion of *In re Bonner Mall*, other courts will be able to grasp the court's holding in helping to decide any arguments raised concerning the new value exception. Ulti-

mately, it is expected that the Supreme Court will need to resolve the question.⁸ Until then, *In re Bonner Mall* should provide some guidance that the new value exception to the absolute priority rule continues to remain viable even after the enactment of the Bankruptcy Code.

1. *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988).

2. 11 U.S.C. § 362(a).

3. The plan also provided that the partners would subsidize any short fall working capital during the first 32 months after confirmation of the plan. In addition, some of the former equity owners would contribute a collateral trust mortgage on a 4,500 acre property as a guarantee of payment of the debts assumed by the new corporation.

4. 11 U.S.C. § 1129(b)(1).

5. 11 U.S.C. § 1129(b)(2)(B).

6. See, *Teamsters Nat. Freight Indus. Negotiating Comm. v. U.S. Truck Co.*, 800 F.2d 581 (6th Cir. 1986); *Official Creditors Comm. ex rel. Class 8 Unsecured Creditors v. Potter Material Serv., Inc.*, 781 F.2d 99, (7th Cir. 1986).

7. See, *Unruh v. Rushville State Bank of Rushville, MO.*, 987 F.2d 1506 (10th Cir. 1993); *In re Bryson Properties, Inc.*, XVIII, 961 F.2d 496 (4th Cir.), cert. denied, 113 S. Ct. 191(1992); *Anderson v. Farm Credit Bank of St. Paul*, 913 F.2d 530 (8th Cir. 1990); *In re Green*, 98 B.R. 981 (9th Cir. 1989).

8. On November 2, 1993, a Petition for Certiorari was filed in *In re Bonner Mall*. Whether the United States Supreme Court will accept Certiorari remains to be seen.