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New Value Exception to the Chapter 11 Absolute Priority Rule, The

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The New Value Exception to the Chapter 11 Absolute Priority Rule

Bonner Mall Partnership v. U.S. Bancorp Mortgage Co. (In re Bonner Mall Partnership)[1]

I. INTRODUCTION

The absolute priority rule, as codified in the 1978 Bankruptcy Code, provides that in certain circumstances, junior claimants of a company involved in a Chapter 11 reorganization may not receive or retain any property under the reorganization plan.[2] The new value exception to the Chapter 11 absolute priority rule allows a debtor's owner to retain an interest in a business or property under certain circumstances, even if all senior claimants are not paid in full.[3] The exception, first recognized by the United States Supreme Court in *Case v. Los Angeles Lumber Products Co.*,[4] was originally used to alleviate inflexibility in the application of the absolute priority rule.[5] Today, the exception is important because it allows the management of a business to remain with the original owners, who may be in the best position to reestablish a profitable business.[6] However, there is currently a question as to whether the new value exception survived the enactment of the 1978 Bankruptcy Code.[7] In *Bonner Mall Partnership v. U.S. Bancorp Mortgage*

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1. 2 F.3d 899 (9th Cir. 1993) [hereinafter *Bonner I*], *cert. granted*, 114 S. Ct. 681, *motion to vacate denied*, 115 S. Ct. 386 (1994). The United States Supreme Court granted certiorari to decide "whether appellate courts in the federal system should vacate civil judgments of subordinate courts in cases that are settled after appeal is filed or certiorari sought." *Bonner*, 115 S. Ct. at 388-89.

2. 11 U.S.C. § 1129(b)(2)(B)(ii) (1988). *See infra* notes 42-43 and accompanying text.

3. Linda J. Rusch, *New Value Exception to the Absolute Priority Rule in Chapter 11 Reorganizations, What Should the Rule Be?*, 19 PEPP. L. REV. 1311, 1313 (1992).

4. 308 U.S. 106 (1939).

5. John T. Bailey, *The "New Value Exception" in Single-Asset Reorganizations: Commentary on the Bjolmes Auction Procedure and its Relationship to Chapter 11*, 98 COM. L.J. 50, 50 (1993).

6. *Bonner I*, 2 F.3d at 916. The court points out that several studies demonstrate that past reorganizations have been more successful when former management was allowed to continue running the business. *Id.*

7. Rusch, *supra* note 3, at 1314.

Co. (In re Bonner Mall Partnership),[8] the Ninth Circuit Court of Appeals considered this issue and determined that the exception still survives.[9]

II. FACTS AND HOLDING

Bonner Mall was completed in 1985 and later sold to Bonner Mall Partnership ("Bonner") in October 1986.[10] The mall served as security for a $6.3 million loan which was purchased by U.S. Bancorp Mortgage Co. ("Bancorp").[11] When the cash flow from the mall began to fall short of Bonner's expectations and the real estate tax on the mall went unpaid, Bancorp instituted a nonjudicial foreclosure action.[12] A trustee's sale was set for March 14, 1991, but the sale never occurred because of the automatic stay which took effect when Bonner filed a Chapter 11 bankruptcy petition the day before the sale.[13]

In response to Bonner's bankruptcy petition, Bancorp moved for relief from the automatic stay under 11 U.S.C. § 362(d).[14] The bankruptcy court denied Bancorp's motion and allowed Bonner to propose a reorganization plan.[15] When Bonner proposed its plan to the bankruptcy court, Bancorp renewed its motion for relief from the stay.[16] In support of its motion, Bancorp argued that Bonner's plan was not confirmable as a matter of law

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8. 2 F.3d 899 (9th Cir. 1993), *motion to vacate denied*, 115 S. Ct. 386 (1994).

9. *Id.* at 918.

10. *Id.* at 901.

11. *Id.*

12. *Id.* at 902.

13. *Id.* 11 U.S.C. § 362 provides for an automatic stay of any action against the debtor or its property upon the filing of a Chapter 11 bankruptcy petition. *See* 11 U.S.C. § 362(a) (1988).

14. *Bonner I*, 2 F.3d at 902. A party in interest can request that the bankruptcy court grant relief from the automatic stay. 11 U.S.C. § 362(d) (1988). Section 362(d)(1) provides for relief upon a showing of cause. *Id.* § 362(d)(1). In addition, under § 362(d)(2), the court will grant relief from a stay of an act against property if the debtor has no equity in the property and the property is not necessary to an effective reorganization. *Id.* § 362(d)(2).

15. *Bonner I*, 2 F.3d at 902. The bankruptcy court concluded that Bancorp was not entitled to relief under § 362(d)(2) because the Bonner Mall property was necessary for an effective reorganization. *In re* Bonner Mall Partnership, No. 91-00801-11, 1991 WL 330784, at *1 (Bankr. D. Idaho Dec. 6, 1991) [hereinafter *Bonner II*], *rev'd*, 142 B.R. 911 (D. Idaho 1992), *aff'd*, 2 F.3d 899 (9th Cir. 1993), *motion to vacate denied*, 115 S. Ct. 386 (1994). Although the motion was denied, the court authorized Bancorp "to renew its motions to test the confirmability of the debtor's proposed chapter 11 plan." *Id.*

16. *Bonner I*, 2 F.3d at 902.

because it violated the absolute priority rule[17] by allowing Bonner to retain an interest in the property without requiring payment in full of Bancorp's unsecured claim.[18] Bonner argued that its plan satisfied the absolute priority rule through the new value exception, whereby new capital which is reasonably equivalent to the value of the retained interest is contributed to the plan by the debtor.[19] Bancorp argued that the new value exception did not survive the enactment of the 1978 Bankruptcy Code and was, therefore, not available to Bonner.[20] The bankruptcy court granted Bancorp's motion.[21] The court found that the new value exception did not survive the enactment of the Bankruptcy Code.[22]

Bonner appealed to the United States District Court for Idaho.[23] The sole issue on appeal was "whether the enactment of the 1978 Bankruptcy Code revoked the new value exception to the absolute priority rule recognized under the Bankruptcy Act."[24] The district court held that the new value exception did survive and reversed the bankruptcy court's order.[25] Subsequently, Bancorp appealed the decision to the Ninth Circuit Court of Appeals.[26]

As with the appeal before the district court, the sole issue before the Ninth Circuit was whether the new value exception survived the enactment of the 1978 Bankruptcy Code.[27] The court held that the new value exception survives and may be used by debtors who are able to meet its requirements.[28]

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17. *See infra* notes 43-44 and accompanying text.

18. *Bonner II*, 1991 WL 330784, at *2.

19. *Id.*

20. *Id.*

21. *Bonner I*, 2 F.3d at 902.

22. *Id.*

23. *Id.*

24. Bonner Mall Partnership v. U.S. Bancorp Mortgage Co. (*In re* Bonner Mall Partnership), 142 B.R. 911, 913 (D. Idaho 1992) [hereinafter *Bonner III*], *aff'd*, 2 F.3d 899 (9th Cir. 1993), *motion to vacate denied*, 115 S. Ct. 386 (1994).

25. *Id.* at 917.

26. *Bonner I*, 2 F.3d at 903.

27. *Id.*

28. *Id.* at 918.

III. LEGAL BACKGROUND

A. Significance of the New Value Exception in a Chapter 11 Reorganization Scheme

Chapter 11 allows a business[29] to reorganize in an attempt to provide more value from continued operation of a reorganized entity than would result from liquidation of the business.[30] A major issue to be resolved in a Chapter 11 proceeding is the allocation of this increased value and control of the business among the creditors and equity holders of the business.[31] In many cases, the creditors will approve a reorganization plan which allows the business owners to retain an interest in the business on the theory that the reorganized business has a greater chance of success in the original owners' hands than the creditors'.[32] If the creditor classes approve such a plan, confirmation will be governed by 11 U.S.C. § 1129(a).[33] However, in some

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29. Although Chapter 11 was designed for business reorganizations, Rusch, *supra* note 3, at 1316 n.10, individuals have access to reorganization under Chapter 11. *Id. See also* Toibb v. Radloff, 501 U.S. 157 (1991). Due to the business orientation of the new value exception, issues surrounding the exception will arise only in the business context.

30. Rusch, *supra* note 3, at 1316.

31. Rusch, *supra* note 3, at 1316.

32. Paul S. Aronzon et al., *The New Value Exception: Possibly Alive But Apparently Not Well*, 804 PLI/Corp 395, 399 (1993). *See also Bonner I*, 2 F.3d at 916 (noting that several studies "demonstrate that reorganizations have been more successful when former management was allowed to use its expertise in running the business.").

33. A reorganization plan will be confirmed under § 1129(a) if the 13 requirements of the section are satisfied. 11 U.S.C. § 1129(a)(1-13) (1988). One of the requirements is: "With respect to each class of claims or interests—(A) such class has accepted the plan; or (B) such class is not impaired under the plan." 11 U.S.C. § 1129(a)(8) (1988). Thus, if a class does not approve the plan and is impaired by it, the plan cannot be confirmed under § 1129(a).

Whether a class is impaired under a plan is governed by 11 U.S.C. § 1124. Section 1124 sets forth three circumstances in which a creditor class is *not* impaired.

> First, the plan may propose not to alter the legal, equitable, or contractual rights to which the claim or interest entitled its holder. Second, a claim or interest is unimpaired by curing the effect of a default and reinstating the original terms of an obligation when maturity was brought on or accelerated by the default. . . . Third, a claim or interest is unimpaired if the plan provides for their payment in cash.

S. REP. NO. 989, 95th Cong., 2d Sess. 120 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5906. In many cases, claims are impaired because they are not paid in full. Rusch, *supra* note 3, at 1318-19. For a detailed discussion of impairment, see 5

cases, one or more classes of creditors will object to a plan which allows the business owners to retain an interest without paying the full value of the creditors' claims.[34] When one or more creditor classes object,[35] section 1129(a) does not apply[36] and confirmation of the plan is governed by 11 U.S.C. § 1129(b).

Section 1129(b) sets forth the circumstances in which a reorganization plan may be confirmed over the objection of a creditor class.[37] Among the prerequisites to confirmation contained in section 1129(b) is the requirement that the plan be "fair and equitable."[38] The fair and equitable requirement is applied differently to secured and unsecured classes of creditors.[39] Application of the requirement to unsecured classes of creditors is provided by 11 U.S.C. § 1129(b)(2)(B).[40] As applied to unsecured creditors, "fair and

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LAWRENCE P. KING, COLLIER ON BANKRUPTCY ¶ 1124.03 (15th ed. 1991) and Joseph M. Gaynor, Jr., Comment, *Impairment*, 3 BANKR. DEV. J. 579, 581 (1986).

34. Aronzon et al., *supra* note 32, at 399.

35. *See supra* note 33.

36. However, with the exception of § 1129(a)(8), the requirements of § 1129(a) are incorporated into § 1129(b). 11 U.S.C. § 1129(b)(1) (1988).

37. Confirmation of a reorganization plan in this manner is commonly known as a "cramdown" because "the plan is crammed down the throats of the objecting class(es) of creditors." *Bonner I*, 2 F.3d at 906. For a discussion of cramdowns, see Kenneth N. Klee, *All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code*, 53 AM. BANKR. L.J. 133 (1979).

38. 11 U.S.C. § 1129(b)(1) (1988). The requirements under § 1129(b) are:

> Notwithstanding section 510(a) of this title, if all of the applicable requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of such paragraph if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.

Id. The impairment requirement is the same as in § 1129(a)(8). For a discussion of the impairment requirement, see *supra* note 33.

39. The fair and equitable requirement, as applied to secured creditors, is set forth in § 1129(b)(2)(A). This application of the fair and equitable requirement does not include the absolute priority rule and is therefore irrelevant to a discussion of the new value exception. However, it is important to note that compliance with the fair and equitable requirement as applied to secured creditors, as well as other requirements, is vital to the success of a cramdown confirmation. For a discussion of these other requirements, see Rusch, *supra* note 3, at 1316-20.

40. This section provides:

> (2) For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements:
> (B) With respect to a class of unsecured claims—

equitable" includes[41] the requirement that the plan provides that each claim holder will receive property equal in value to the amount of the claim.[42] If the plan does not provide this, the fair and equitable requirement can only be met if holders of a junior claim or interest will not receive or retain any property under the plan.[43] This rule is commonly known as the absolute priority rule and has been applied in Chapter 11 cases since it was first introduced by the United States Supreme Court in *Louisville Trust Co. v. Louisville, New Albany & Chicago Railway*.[44] Because a plan must be deemed fair and equitable to be confirmed, a plan which does not propose to give full value for unsecured claims must observe, with one possible exception,[45] the absolute priority rule. The existence of this possible exception—the new value exception—is the sole issue in *Bonner I*.[46]

When recognized, the new value exception allows an equity holder to escape the absolute priority rule by allowing receipt or retention of "an interest

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(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.

11 U.S.C. § 1129(b)(2)(B) (1988).

41. Section 1129(b)(2) states that the concept of fair and equitable "*includes* the following requirements . . . ." (emphasis added). This wording suggests that the requirements set forth in the section are not necessarily the only requirements with which a plan must comply to be fair and equitable. *See infra* notes 103-04 and accompanying text.

42. 11 U.S.C. § 1129(b)(2)(B)(i) (1988).

43. *Id.* § 1129(b)(2)(B)(ii).

44. 174 U.S. 674 (1899). The principle of complete subordination of equity holders set forth by the Court is the same as is now codified at 11 U.S.C. § 1129(b)(2)(B)(ii) and referred to as the absolute priority rule. *See* Aronzon et al., *supra* note 32, at 405-07. For discussion of the development of the absolute priority rule, see Edward S. Adams, *Toward a New Conceptualization of the Absolute Priority Rule and its New Value Exception*, 1993 DET. C.L. REV. 1445, 1450-57; David M. Powlen & Arnold H. Wuhrman, *The New Value Exception to the Absolute Priority Rule: Is Ahlers the Beginning of the End?*, 93 COM. L.J. 303, 304-05 (1988); J. Ronald Trost et al., *Survey of the New Value Exception to the Absolute Priority Rule*, C836 A.L.I.-A.B.A. 301, 318 (1993).

45. From its debut in Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106 (1939), to the enactment of the 1978 Bankruptcy Code, recognition of the new value exception was universal. Aronzon et al., *supra* note 32, at 404. Since the new Code was enacted, this is no longer true. For a discussion of the history and development of the exception, see *infra* notes 49-62 and accompanying text.

46. *Bonner I*, 2 F.3d at 903.

in the reorganized debtor in exchange for new capital contributions over the objections of a class of creditors."[47] In order to qualify for the exception, the contribution of new value must meet four general requirements. The new value must be: (1) necessary to the reorganization; (2) fresh; (3) of reasonably equivalent value to the interest received or retained; and (4) of money or money's worth.[48]

B. Development of the New Value Exception

The new value exception was originally formulated to alleviate problems resulting from the strict application of the absolute priority rule.[49] The United States Supreme Court first expressed the concept which is now known as the new value exception in *Kansas City Terminal Railway v. Central Union Trust Co.*[50] The Court stated:

> [T]o the extent of their debts creditors are entitled to priority over stockholders against all the property of an insolvent corporation. But it does not follow that in every reorganization the securities offered to general creditors must be superior in rank or grade to any which stockholders may obtain. It is not impossible to accord to the creditor his superior rights in other ways. Generally, additional funds will be essential to the success of the undertaking, and it may be impossible to obtain them unless stockholders are permitted to contribute and retain an interest sufficiently valuable to move them.[51]

The Supreme Court, when faced with the issue of whether the new value exception had been codified in the former Bankruptcy Act,[52] later officially recognized the exception in *Case v. Los Angeles Lumber Products Co.*[53] In *Los Angeles Lumber Products*, the shareholders of the bankrupt company

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47. *Id.* at 901.

48. Aronzon et al., *supra* note 32, at 400. For a detailed discussion of these requirements, see Adams, *supra* note 44, at 1470-80; Trost et al., *supra* note 44, at 344.

49. Several commentators have cited the rigid application of the absolute priority rule as the motivating force behind the new value exception. *See, e.g.*, Bailey, *supra* note 5, at 50; Trost et al., *supra* note 44, at 319.

50. 271 U.S. 445 (1926). *See* Aronzon et al., *supra* note 32, at 401-02.

51. Aronzon et al., *supra* note 32, at 402 (quoting *Kansas City Terminal Ry.*, 271 U.S. at 455).

52. *Bonner III*, 142 B.R. at 914.

53. 308 U.S. 106 (1939). The fair and equitable requirement (now codified at § 1129(b)) was incorporated, at the time of *Los Angeles Lumber Products*, into the former Bankruptcy Act at § 77(a). *Bonner III*, 142 B.R. at 914.

proposed a plan whereby they would retain an ownership interest and management responsibility in the reorganized business.[54] The plan, however, did not provide for payment of full value of the creditor's claims.[55] In addition, the shareholders did not propose to contribute new money to the business. Instead, they argued that their experience in running the business, the value of continuity of management, and the shareholders' financial standing and community influence should be sufficient to allow retention of ownership and management control.[56]

The Supreme Court rejected the shareholders' argument that experience and continuity of management justify retention of an ownership interest.[57] The Court found that such contributions were too difficult to value and should not be used as an exception to the absolute priority rule.[58] The Court held, however, that an exception should be made for new infusions of money or its equivalent where the infusion is reasonably equivalent to the retained interest and is necessary to the success of the reorganized business.[59] In so holding, the Court set the framework for the new value exception.

The Court's formulation of the new value exception in *Los Angeles Lumber Products* is virtually identical to the exception as it exists today.[60] Numerous decisions prior to the enactment of the 1978 Bankruptcy Code expressed the new value exception and its requirements in substantially the same form as was set forth in *Los Angeles Lumber Products*.[61] Similarly, post-1978 Code cases which have recognized the exception have continued to apply it as originally formulated by the Supreme Court.[62] Although there is

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54. *Los Angeles Lumber Prods. Co.*, 308 U.S. at 111-12.

55. *Id.* at 109.

56. *Id.* at 112-13.

57. *Id.* at 122.

58. *Id.*

59. *Id.* at 121-22.

60. Aronzon et al., *supra* note 32, at 402. *But see id.* at 434 n.1 (noting that "[s]ome courts add a 'substantiality' requirement, but this seems to essentially be encompassed in the 'necessity' requirement."); Trost et al., *supra* note 44, at 344 ("A significant number of courts have also incorporated an additional threshold requirement that the new value contribution must be substantial in comparison to the debtor's prepetition claims.").

61. *See, e.g.*, Marine Harbor Properties Inc. v. Manufacturer's Trust Co., 317 U.S. 78, 85-86 (1942); Freeman v. Mulcahy, 250 F.2d 463, 475 (1st Cir. 1957); *In re* Securities & Exch. Comm'n, 142 F.2d 411, 414 (3d Cir. 1944), *cert. granted*, Otis & Co. v. Securities & Exch. Comm'n, 323 U.S. 624 (1945); Highland Towers Co. v. Bondholders' Protective Comm., 115 F.2d 58, 60 (6th Cir. 1940); *In re* Alabama, Tennessee & Northern R.R., 47 F. Supp. 694, 697 (S.D. Ala. 1942); Chase Nat'l Bank v. Wabash Ry., 40 F. Supp. 859, 865 (E.D. Mo. 1941).

62. *See, e.g., In re* Tucson Self-Storage, Inc., 166 B.R. 892, 899 (Bankr. 9th Cir.

little question as to the form and requirements of the new value exception, as discussed below, its very existence is substantially more questionable.

C. *Survival of the New Value Exception Past Enactment of the 1978 Bankruptcy Code: A Lingering Question*

Courts throughout the nation are divided over the issue of whether the new value exception survived enactment of the 1978 Bankruptcy Code.[63] Although a majority of courts have held that the exception remains valid, some commentators have suggested that courts may be moving away from recognition of the exception.[64]

The Supreme Court recently was faced with the new value issue in *Norwest Bank Worthington v. Ahlers*.[65] In its opinion, the Court questioned the continuing viability of the exception, but flatly refused to decide the issue.[66] The Court avoided the issue by assuming the continued existence of

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1994); *In re* Snyder, 967 F.2d 1126, 1128-29 (7th Cir. 1992); Kham & Nate's Shoes No. 2, Inc. v. First Bank, 908 F.2d 1351, 1362 (7th Cir. 1990); *In re* U.S. Truck Co., 800 F.2d 581, 588 (6th Cir. 1986); *In re* King Resources Co., 651 F.2d 1326, 1339 (10th Cir. 1980); *In re* One Times Square Assocs. Ltd. Partnership, 159 B.R. 695, 707 (Bankr. S.D.N.Y. 1993); *In re* Montgomery Court Apartments of Ingham County, Ltd., 141 B.R. 324, 343 (Bankr. S.D. Ohio 1992); *In re* Sovereign Group 1985-27, Ltd., 142 B.R. 702, 706 (E.D. Pa. 1992); *In re* Capital Ctr. Equities, 144 B.R. 262, 267-68 (Bankr. E.D. Pa. 1992); *In re* Batten, 141 B.R. 899, 907 (Bankr. W.D. La. 1992); *In re* Michelson, 141 B.R. 715, 720 (Bankr. E.D. Cal. 1992); *In re* F.A.B. Indus., 147 B.R. 763, 765 (C.D. Cal. 1992); *In re* SLC Ltd. V, 137 B.R. 847, 851 (Bankr. D. Utah 1992); *In re* Tallahassee Assocs., L.P., 132 B.R. 712, 716 (Bankr. W.D.Pa. 1991); *In re* 222 Liberty Assocs., 108 B.R. 971, 983 (Bankr. E.D.Pa. 1990); *In re* Mortgage Inv. Co., 111 B.R. 604, 618 (Bankr. W.D. Tex. 1990); *In re* Pullman Constr. Indus. Inc., 107 B.R. 909, 947 (Bankr. N.D. Ill. 1989); *In re* Yasparro, 100 B.R. 91, 96 (Bankr. M.D. Fla. 1989); *In re* V. Savino Oil & Heating Co., 99 B.R. 518, 526 (Bankr. E.D.N.Y. 1989); *In re* Future Energy Corp., 83 B.R. 470, 497 (Bankr. S.D. Ohio 1988); *In re* 47th and Belleview Partners, 95 B.R. 117. 119 (Bankr. W.D. Mo. 1988); *In re* Henke, 90 B.R. 451, 456 (Bankr. D. Mont. 1988); *In re* Jartran, Inc., 44 B.R. 331, 366 (Bankr. N.D. Ill. 1984); *In re* The Duplan Corp., 9 B.R. 921, 925 (S.D.N.Y. 1980).

63. *Bonner I*, 2 F.3d at 907.

64. *See, e.g.*, Aronzon et al., *supra* note 32, at 409, 411 (noting that a majority of courts recognize the exception, but a strong dissent seems to be emerging); *But see* Adams, *supra* note 44, at 1466 ("The current view by most courts and many commentators seems to be that the judicial rule will survive until Congress explicitly terminates it.").

65. 485 U.S. 197 (1988).

66. *Id.* at 203 n.3.

the exception, but finding that its requirements were not satisfied under the facts of the case.[67]

Since the Supreme Court's refusal to rule on the question of the new value exception's continuing validity in *Ahlers*, every court of appeals decision[68] until *Bonner I* has similarly declined to answer the question.[69] During the same time frame, a majority of district courts and bankruptcy courts have held that the exception survived enactment of the Code.[70]

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67. *Bonner I*, 2 F.3d at 907.

68. The question was addressed in the Fifth Circuit decision in Phoenix Mutual Life Ins. Co. v. Greystone III Joint Venture (*In re* Greystone III Joint Venture), 948 F.2d 134 (5th Cir. 1991), *modified*, 995 F.2d 1274 (5th Cir.), *cert. denied*, 113 S. Ct. 72 (1992). However, the decision was modified to leave the new value exception question open by removing the portion of the decision which held that the exception had not survived enactment of the 1978 Bankruptcy Code. *Id.*

69. Trost et al., *supra* note 44, at 336 & n.93 (citing Unruh v. Rushville State Bank, 987 F.2d 1506, 1510 (10th Cir. 1993); John Hancock Mut. Life Ins. Co. v. Route 37 Business Park Assocs., 987 F.2d 154, 162 n.12 (3d Cir. 1993); *In re* Lumber Exch. Bldg. Ltd. Partnership, 968 F.2d 647, 650 (8th Cir. 1992); *In re* Snyder, 967 F.2d 1126, 1131 (7th Cir. 1992); *In re* Bryson, 961 F.2d 496, 504-05 (4th Cir. 1992); *In re* Greystone, 948 F.2d 134, 142 (5th Cir. 1992); Kham & Nate's Shoes v. First Bank, 908 F.2d 1351, 1362 (7th Cir. 1990); *In re* Stegall, 865 F.2d 140, 142 (7th Cir. 1989)).

70. Trost et al., *supra* note 44, at 342 & n.107 (citing *In re* Green, 98 B.R. 981 (Bankr. 9th Cir. 1989); *In re* S.A.B.T.C. Townhouse Ass'n, Inc., 152 B.R. 1005 (Bankr. M.D. Fla. 1993); *In re* Albrechts Ohio Inns, Inc., 152 B.R. 496 (Bankr. S.D. Ohio 1993); *In re* ROPT Ltd. Partnership, 152 B.R. 406 (Bankr. D. Mass. 1993); *In re* Waldengreen Assocs., 150 B.R. 468 (Bankr. M.D. Fla. 1993); *In re* Eitemiller, 149 B.R. 626 (Bankr. D. Idaho 1993); *In re* F.A.B. Industries, 147 B.R. 763 (C.D. Cal. 1992)); *In re* Route 37 Business Park Assocs., 146 B.R. 640 (D.N.J. 1992), *aff'd*, 987 F.2d 154 (3d Cir. 1993); *In re* Shepcaro, 144 B.R. 3 (Bankr. D. Mass. 1992); *In re* Sovereign Group, 142 B.R. 702 (E.D. Pa. 1992); *In re* Capital Ctr. Equities, 144 B.R. 262 (Bankr. E.D. Pa. 1992); *In re* Harman, 141 B.R. 878 (Bankr. E.D. Pa. 1992); *In re* Batten, 141 B.R. 899 (Bankr. W.D. La. 1992); *In re* Montgomery Court Apartments of Ingham County, Inc., 141 B.R. 324 (Bankr. S.D. Ohio 1992); *In re* Creekside Landing, Ltd., 140 B.R. 713 (Bankr. M.D. Tenn. 1992); *In re* SLC Ltd. V, 137 B.R. 847 (Bankr. D. Utah 1992); *In re* Bjolmes Realty Trust, 134 B.R. 1000 (Bankr. D. Mass. 1991); *In re* Woodscape, 134 B.R. 165 (Bankr. D. Md. 1991); *In re* Professional Dev. Corp., 133 B.R. 425 (Bankr. W.D. Tenn. 1991); *In re* VIP Motor Lodge, Inc., 133 B.R. 41 (Bankr. D. Del. 1991); *In re* Tallahassee Assocs. L.P., 132 B.R. 712 (Bankr. W.D. Pa. 1991); *In re* Hendrix, 131 B.R. 751 (Bankr. M.D. Fla. 1991); *In re* C.P.M. Constr., 124 B.R. 335 (Bankr. D.N.M. 1991); *In re* E.I. Parks No. 1 Ltd. Partnership, 122 B.R. 549 (Bankr. W.D. Ark. 1990); *In re* Mortgage Inv. Co., 111 B.R. 604 (Bankr. W.D. Tex. 1990); *In re* 222 Liberty Assocs., 108 B.R. 971 (Bankr. E.D. Pa. 1990); *In re* Dowden, 143 B.R. 388 (Bankr. W.D. La. 1989); *In re* Sherwood Square Assocs., 107 B.R. 872 (Bankr. D. Md. 1989); *In re* Ashton, 107 B.R. 670

However, only one reported lower court decision since *Ahlers* has confirmed a plan relying on the new value exception without being overturned or vacated.[71]

IV. INSTANT DECISION

The Ninth Circuit, in *Bonner I*, approached the analysis of the new value question in four different ways. First, the court considered whether the Code provision that codified the absolute priority rule eliminated the new value exception by not expressly stating it in the provision.[72] Second, the court examined whether Congress' failure to include the new value doctrine as part of the fair and equitable requirement demonstrated an intent to eliminate the exception.[73] Third, the court considered whether Congress' overhaul of the reorganization process justifies the conclusion that the new value exception no longer exists.[74] Finally, the court analyzed the structure and underlying policies of Chapter 11 to determine whether they are consistent with the new value exception.[75] Under each line of analysis the result was the same: the new value exception survives.[76]

A. Codification of the Absolute Priority Rule Does Not Eliminate the New Value Exception

The first issue which the court addressed is whether the codification of the absolute priority rule at 11 U.S.C. § 1129(b)(2)(B)(ii) is consistent with

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(Bankr. D.N.D. 1989); *In re* Pullman Constr. Indus., Inc., 107 B.R. 909 (Bankr. N.D. Ill. 1989); *In re* Aztec Co., 107 B.R. 585 (Bankr. M.D. Tenn. 1989); *In re* Snyder, 105 B.R. 898 (Bankr. C.D. Ill. 1989), *aff'd*, 967 F.2d 1126 (7th Cir. 1992); *In re* Lettick Typografic, Inc., 103 B.R. 32 (Bankr. D. Conn. 1989); *In re* Johnson, 101 B.R. 307 (Bankr. M.D. Fla. 1989); *In re* Yasparro, 100 B.R. 91 (Bankr. M.D. Fla. 1989); *In re* Snyder, 99 B.R. 885 (Bankr. C.D. Ill. 1989); *In re* Kramer, 96 B.R. 972 (Bankr. D. Neb. 1989); *In re* 47th and Belleview Partners, 95 B.R. 117 (Bankr. W.D. Mo. 1988); *In re* Kendavis Indus. Int'l., Inc., 91 B.R. 742 (Bankr. N.D. Tex. 1988); *In re* Henke, 90 B.R. 451 (Bankr. D. Mont. 1988); *In re* 8th Street Village Ltd. Partnership, 88 B.R. 853 (Bankr. N.D. Ill.), *aff'd*, 94 B.R. 993 (N.D. Ill. 1988); *In re* Future Energy Corp., 83 B.R. 470 (Bankr. S.D. Ohio 1988).

71. Trost et al., *supra* note 44, at 343-44.
72. *Bonner I*, 2 F.3d at 907.
73. *Id.* at 907-908.
74. *Id.* at 913-14.
75. *Id.* at 908.
76. *Id.* at 907.

the new value exception.[77] Bancorp argued that Bonner's reorganization plan violated the provision because it allowed an old equity owner to retain an ownership interest without providing for full payment of Bancorp's unsecured claim.[78] Bonner argued that a new contribution of capital from a source outside the bankruptcy estate is an independent act which does not violate the absolute priority rule.[79] The parties also took opposite sides on the issue of whether the plain meaning of the statute allows confirmation of a plan which is based on the new value exception.[80]

The court began its analysis by looking to the plain meaning of the statutory language.[81] When reduced to plain English, section 1129(b)(2)(B)(ii) bars "old equity from receiving any property via a reorganization plan 'on account of' its prior ownership interest."[82] The court found that the phrase "on account of" was of vital importance to the interpretation of this statute in the new value context.[83] The court reasoned that a plan which meets the requirements[84] of the new value exception does not allow old equity to receive property *on account of* the prior ownership interest because the capital contribution is new and is unrelated to the prior ownership of the business.[85] Instead, the old equity receives property on account of the *new* capital contribution in that situation.

The court reasoned further that if Congress had intended to prevent old equity from *ever* receiving property when a senior claim is not to be paid in full, it could have simply omitted the "on account of" language from the code.[86] However, Congress did not omit the language and therefore must have contemplated situations in which old equity would receive property in a manner other than "on account of" its prior ownership.[87]

Finally, the court extended this reasoning to situations in which the prior equity holders receive an exclusive right to obtain an ownership interest in

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77. *Id.* at 908.

78. *Id.*

79. *Id.*

80. *Id.*

81. *Id.* (quoting Pennsylvania Pub. Welfare Dept. v. Davenport, 495 U.S. 552, 577-58 (1990) ("The interpretation of a statutory provision must begin with the plain meaning of its language.")).

82. *Bonner I*, 2 F.3d at 908.

83. *Id.* at 909.

84. *See supra* note 48 and accompanying text for discussion of the requirements which must be satisfied in order to qualify for the new value exception.

85. *Bonner I*, 2 F.3d at 909-10.

86. *Id.* at 910.

87. *Id.*

exchange for an infusion of new capital.[88] So long as the requirements of the new value exception are met, the court concluded, this situation would be no different from receipt of an actual ownership interest and would be allowed under the new Bankruptcy Code.[89] The court noted that the requirement that the proposed transaction be "necessary to the success of the reorganization" would likely be pivotal in an exclusive option situation.[90]

B. Congress' Failure to List the New Value Exception Under the Fair and Equitable Doctrine Does Not Express an Intent to Eliminate the Exception

The second issue which the Ninth Circuit addressed in *Bonner I* is whether Congress' failure to specifically provide for the new value exception in the provision containing the fair and equitable requirement demonstrates an intent to eliminate the exception.[91] The court concluded that it does not.[92]

In reaching its conclusion, the court first looked to several cases which stand for the proposition that if Congress intends for legislation to overrule a judicially created concept, it will make its intent clear.[93] Bancorp argued that this rule only applies when there is a conflict between bankruptcy and non-bankruptcy law.[94] The Ninth Circuit rejected this argument, pointing out that while one Supreme Court case applied a similarly narrow interpretation, several later cases rejected the narrow view and applied this rule to situations where there was no conflict with non-bankruptcy law.[95]

Having accepted this proposition, the court then analyzed and rejected two more of Bancorp's arguments. First, Bancorp argued that the new value exception was set forth in dicta only once by the Supreme Court in *Los Angeles Lumber Products* and never mentioned again.[96] As a result, Congress would not have known of the new value exception when it enacted

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88. *Id.* at 910-11.
89. *Id.* at 911.
90. *Id.*
91. *Id.*
92. *Id.* at 913.
93. *Id.* at 912. *See* Dewsnup v. Timm, 502 U.S. 410, 419 (1992) (when Congress amends the bankruptcy laws, it does not start from scratch); *Pennsylvania Pub. Welfare Dept.*, 495 U.S. at 562 (the Bankruptcy Code should not be read to abandon past bankruptcy practice absent a clear indication that Congress intended to do so); Kelly v. Robinson, 479 U.S. 36, 47 (1988); Midlantic Nat'l. Bank v. New Jersey Dept. of Envtl. Protection, 474 U.S. 494, 501 (1986).
94. *Bonner I*, 2 F.3d at 912 n.31.
95. *Id.*
96. *Id.* at 912.

the 1978 Bankruptcy Code.[97] The court rejected this argument, saying that the new value exception was a very widely established pre-Code practice.[98] In addition, while drafting the Code, Congress considered a proposal to broaden the new value exception.[99] Consequently, the court concluded that Congress knew of the new value exception when it enacted the Code.[100]

The second argument which the court considered is that Congress expressed a clear intent to change the judicially established pre-Code practice.[101] Bancorp argued that by not codifying the new value exception, Congress expressed the requisite intent necessary to change pre-Code practice.[102] The court did not find this argument persuasive. In reaching its conclusion, the court looked to the language in section 1129(b)(2) which states: "fair and equitable . . . *includes* the following requirements . . . ."[103] The court reasoned that Congress, by using the word "includes," meant to set forth the basic requirements for the fair and equitable test while allowing for possible additional requirements.[104] Thus, "[t]here is nothing in the language of the Code that suggests that courts cannot continue to apply the requirements of the new value exception in determining whether a plan that affords old equity a property interest in exchange for a capital contribution is 'fair and equitable'."[105]

The Ninth Circuit went on to discuss the significance of the legislative history. It pointed out that "[w]here the text of the Code does not unambiguously abrogate pre-Code practice, courts should presume that Congress intended it to continue unless the legislative history dictates a contrary result."[106] In this case, the legislative history did not dictate a contrary result.[107] In fact, the court suggested that the Code's legislative history actually supports the continued existence of the new value exception.[108]

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97. *Id.*
98. *Id.*
99. *Id.*
100. *Id.*
101. *Id.*
102. *Id.*
103. 11 U.S.C. § 1129(b)(2) (1988) (emphasis added).
104. *Bonner I*, 2 F.3d at 912.
105. *Id.*
106. *Id.* at 913 (citing *Dewsnup*, 502 U.S. at 419).
107. *Bonner I*, 2 F.3d at 913.
108. *Id.* "[The legislative history] contains statements by sponsors of the Code that although section 1129(b)(2) lists several specific factors interpreting 'fair and equitable,' others were omitted to avoid statutory complexity and because courts would independently find that they were fundamental to 'fair and equitable treatment.'" *Id.*

C. Congress' Overhaul of the Reorganization Process does not Justify the Conclusion that the New Value Exception was Abolished

Bancorp's third major argument was that the fact Congress overhauled the reorganization process should necessarily lead to a conclusion that the new value exception was abolished.[109] Bancorp first cited *Union Bank v. Wolas*[110] in support of its argument.[111] In *Wolas*, the Supreme Court held that the pre-Code practice at issue[112] was eliminated by enactment of the Code.[113] The Court relied in part on "the major changes made to the statutory framework by the enactment of the Code . . . ."[114] However, the Court's decision was also based largely on the fact that the plain text of the Code eliminated the pre-Code practice.[115] As a result, the decision cannot be read to eliminate pre-Code practice based solely on the fact that Congress had made major changes to the statutory framework. Based on this reasoning, the court in *Bonner I* found that absent plain language in the Code, major changes in the statutory framework alone are not sufficient to eliminate pre-Code practice.[116]

Bancorp also argued that because the changes to the reorganization process in *Bonner I* were more significant than those at issue in *Wolas*, the changes should justify elimination of the new value exception.[117] In rejecting this argument, the court pointed out that although the changes may be significant, they are "in harmony with the pro-confirmation principle underlying the new value exception.[118]

(citing 124 CONG. REC. 32,407 (1978) (statement of Rep. Don Edwards); 124 CONG. REC. 34,006 (1978) (statement of Sen. Dennis DeConcini)).

109. *Bonner I*, 2 F.3d at 913.

110. 502 U.S. 151 (1992).

111. *Bonner I*, 2 F.3d at 913.

112. The pre-Code practice at issue in that case was the "current expense" rule—a judicially created exception to the general rule that a bankruptcy trustee may avoid certain property transfers made by a debtor within 90 days before bankruptcy. *Wolas*, 502 U.S. at 158.

113. *Bonner I*, 2 F.3d at 914.

114. *Id.*

115. *Id.*

116. *Id.*

117. *Id.*

118. *Id.*

D. New Value Exception is Consistent with Underlying Policies of Chapter 11

Finally, the court in *Bonner I* evaluated how well the new value exception fits in with the policies underlying Chapter 11.[119] In doing so, the court identified two major policies underlying Chapter 11: (1) to permit successful rehabilitation of debtors; and (2) to maximize the value of the estate.[120] The court found that both policies are supported by the new value exception.[121]

The Ninth Circuit found that the new value exception supports the successful rehabilitation of debtors by providing the debtor with an additional source of capital.[122] This capital is important to the debtor because it can be used by the estate in the reorganization, as well as funding the plan and paying creditors.[123] The exception also supports the goal of maximization of the estate. Former owners may be in the best position to turn a failing business around. The court in *Bonner I* pointed out that "in many situations the new value exception allows control and management of the company to remain with the original owners, who arguably can best reestablish a profitable business. Old owners may have valuable expertise and experience that outside investors lack."[124]

E. Ninth Circuit Conclusion

The Ninth Circuit Court of Appeals concluded that there was nothing in the new Bankruptcy Code, Congress' intent in adopting the Code, nor any policy underlying Chapter 11 which would suggest that the new value exception did not survive enactment of the Code.[125] Based on these conclusions, the court held that the new value exception is still a viable doctrine in the Ninth Circuit and may be used to meet the fair and equitable requirement set forth in section 1129(b)(1).[126]

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119. *Id.* at 915-17.

120. *Id.* at 915.

121. *Id.*

122. *Id.*

123. *Id.*

124. *Id.* at 916 (citing Snyder v. Farm Credit Bank (*In re* Snyder), 967 F.2d 1126, 1130 (7th Cir. 1992)). *See supra* note 30 for a discussion of studies which indicate that reorganizations may be more successful when former owners participate in management of the reorganized business.

125. *Bonner I*, 2 F.3d at 917-18.

126. *Id.* at 918. The court in *Bonner I* did not rule on whether Bonner's plan could meet the requirements of the exception and thereby gain confirmation. It did,

V. COMMENT

The opinion in *Bonner I* raises and answers many of the issues which come up in the context of the new value exception's continuing validity. Of particular importance are the issues relating to congressional intent and policies underlying Chapter 11. Arguments on both sides of these issues undoubtedly will be raised in any case concerning the exception. Because the opinion rejected many of the arguments against the continuing validity of the exception, advocates and litigants on both sides of the new value debate will need to adjust their strategies. Those favoring continuing viability now have one decision with persuasive authority—with the possibility of more to come. Those opposed now have seen how a court might respond to some of the major arguments against continuing validity of the exception. They will now need to adjust these arguments to overcome the potential responses, if possible, or develop new theories as to why the new value exception should not survive.[127]

In addition to its impact on possible future decisions, *Bonner I* may also have a significant impact on parties to reorganizations in the Ninth Circuit. One effect will likely be seen in the negotiation process which takes place before any of the creditor classes object to the plan. Due to this decision, creditors will be aware that debtors in the Ninth Circuit may be able to obtain plan confirmation over their objections even if their claims are not paid in full. This certainty may mark a shift in bargaining power from creditors to debtors. However, it is unlikely that any major shift will take place, given the stringent nature of the requirements for access to the new value exception.[128]

Another noteworthy aspect of the decision is its emphasis on the stringent requirements of the new value exception. This makes sense in that the court

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however, express doubts as to whether confirmation would occur. Eventually, the court concluded that the bankruptcy court initially must make the determination of the possible confirmability of Bonner's plan. *Id.*

127. For instance, one commentator has asserted that the reasoning in *Bonner I* is flawed when applied to single asset reorganizations. Michael H. Strub, Jr., *New Value Rule: Applying the Single-Asset Paradigm: Competition, Bargaining, and Exclusivity Under the New Value Rule: Applying the Single-Asset Paradigm of Bonner Mall*, 111 BANKING L.J. 228 (1994). Although *Bonner I* is a case involving a single asset, the court did not have occasion to apply its reasoning to the facts of the case. The commentator suggests that had the court done so, it would have realized that its reasoning is unworkable in such situations because the new value exception imposes requirements which are inconsistent with the objectives of a single-asset reorganization. *Id.* It may be possible to use such an argument in future cases where a single asset is involved.

128. As noted above, few plans based on the new value exception are successfully confirmed. *See supra* text accompanying note 71.

seemed to view the high standards as a precautionary measure against abuse of the exception. The court seemed to recognize the potential for debtors to use the exception in an inappropriate manner. It responded to this by suggesting in dicta that the already strict requirements remain so, if not tighten up a bit.[129]

This potential tightening of the initial requirements for availability of the new value exception to a debtor may have several effects. First, if courts do indeed apply an even higher standard, hopefully the intended effect of less abuse of the exception will result. In theory, by increasing the threshold standards, more debtors with potential to abuse the process will be denied a new value exception induced confirmation. Of course, this is exactly what the court in *Bonner I* is trying to accomplish.[130]

Second, if a higher standard is applied and results in a more efficient and abuse-free reorganization process, other courts may begin to take notice. This could influence courts which were once reluctant to recognize the exception's viability to reconsider the value of the exception. If, by allowing the exception in a narrower form, reorganizations become more likely to succeed and enjoy increased estate values, the policy arguments presented in *Bonner I* will only become stronger. Consequently, recognition of the exception may become much more attractive to many courts.

However, stricter application of the requirements of the new value exception may have potentially negative effects. Where recognized, the new value exception is already difficult to take advantage of due to its tough prerequisites. If courts begin to further restrict access to the exception by tightening its requirements and go too far, the exception may become functionally useless. If it becomes too difficult to meet the requirements of the exception, there may be little difference between a jurisdiction which recognizes the exception and one which does not. As a result, any potential benefits which may be gained from the exception would be lost.

Whatever its future impact on the reorganization process in the Ninth Circuit, *Bonner I* is an important case because it is the first case in some time to address and answer the issue of the new value exception's continuing viability. Those with an interest in the issue now have some idea of how courts may treat the new value question. Further, the decision represents the highest court opinion directly answering the question since the Bankruptcy

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129. *Bonner I*, 2 F.3d at 918 ("[W]e conclude that the new value 'exception,' with its stringent requirements, survives. We recognize that, if applied carelessly, the doctrine has the potential to subvert the interests of creditors and allow debtors and old equity to abuse the reorganization process. The proper answer to these concerns is vigilance on the part of bankruptcy courts in ensuring that all of the requirements of the new value exception are met in every case.").

130. *Id.*

Code's enactment in 1978.[131] Because of its potential to swing the pendulum in other jurisdictions, some of the possible effects discussed above also may begin to occur in circuits other than the ninth.

Prior to the *Bonner I* decision, there was a major split in the Ninth Circuit over the new value exception issue.[132] Obviously, *Bonner I* will serve to quiet this debate and unify the circuit. However, one major question remains: what effect will *Bonner I* have on the other circuits?

The answer to this question is unclear at this point in time. As discussed previously, the courts of appeals in the other circuits have remained largely silent on this issue.[133] Although *Bonner I* is a thorough and well-reasoned decision, other courts may continue to follow the Supreme Court's lead in avoiding the issue by deciding cases on other grounds.[134] As previously noted, the exception's requirements are difficult to meet, so in many cases it is easier for a court to simply assume the continued existence of the exception and find that its requirements are not met, rather than decide the difficult issue of whether the exception survives. Several commentators have speculated that this issue will most likely remain unresolved until Congress directly addresses it.[135] However, even if this speculation proves true, *Bonner I* is still important because it identifies the issues of the debate and sets forth numerous policy justifications for keeping the new value exception.

VI. CONCLUSION

Although the Ninth Circuit is unified with respect to the new value exception, the debate still continues in courts throughout the rest of the country. Only time will tell whether *Bonner I* will push these courts towards a resolution of the issue. Perhaps Congress will eventually be called on to resolve the issue through the legislative process. But for now, *Bonner I* should prove to be an important decision which has the possibility of shaping the new value debate and providing insight into the issues surrounding the question of the continuing viability of the new value exception.

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131. J. Ronald Trost et al., *Supplement to Survey of the New Value Exception to the Absolute Priority Rule*, C836 A.L.I.-A.B.A. 273, 280 (1993).

132. Aronzon et al., *supra* note 32, at 417.

133. *See supra* notes 68-69 and accompanying text.

134. *See supra* notes 65-67 and accompanying text.

135. *See, e.g.*, Rusch, *supra* note 3 at 1314-15; Aronzon et al. *supra* note 32 at 433.