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The Challenge of Retaining Interest for Original Equity Owners

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Introduction

Bankruptcy reorganization plans can pose a challenge for old equity shareholders wanting to retain their interests in a reorganized entity, Under the Bankruptcy Code these plans give most creditors a higher priority to receive equity in the reorganized company before shareholders.[1] However, shareholders have different options that can aid them in retaining interests in the company; one such option is the contribution of new value that is subject to market evaluation.

Recently, in *H.G. Roebuck & Son, Inc. v. Alter Communications,* Inc., ("*Roebuck*"),[2] the United States District Court for the District of Maryland reversed the bankruptcy court's decision to grant the debtor the exclusive right to file a reorganization plan. The court held that the plan violated the absolute priority rule by proposing that the debtor retain equity in the reorganized entity by contributing new value that was not sufficiently tested in the market over more senior creditors.[3] Under the plan, most claims were to be paid in full, except for certain general

[1] See 11 U.S.C. 1129(b)(2)(B)(i).
[2] No.: 10-18241, 2011 WL 2261483 (D. Md., June 3, 2011).
[3] *Id*. at * 2.

unsecured claims, including H.G. Roebuck's, which was to be paid something less than 16%.[4] In addition the shareholders were to contribute $34,859 dollars in "new value" to the reorganized company and retain their equity interests.[5] The shareholders argued that injecting this new value satisfied the new value exception and thus allowed for confirmation.[6] The court reasoned that the debtor did not satisfy the "new value" exception because they failed to subject their new value contribution to proper market valuation, to ensure it was a proper exchange, and was therefore only retaining interest "on account of" old equity, a violation under the Bankruptcy Code.[7]

Part I will discuss the relevant statutes and cases regarding the absolute priority doctrine, focusing on the new value exception. Part II will discuss market valuation in detail. Part III will discuss practical implications and advice for shareholders wanting to retain their interests in the reorganized entity. Part IV will conclude and offer an outlook for future cases.

Part I. Background Statutes and Cases

The absolute priority rule mandates that no junior class of creditors shall receive any interest prior to any senior class of creditors and is often invoked when classes of similarly situated creditors disagree about a proposed plan.[8] The courts derive it from the requirement that the proposed plan be "fair and equitable."[9] The debtor has the exclusive right to submit a plan for

[4] *Id*. (Alter published newspapers and other custom publications and its creditor, H.G. Roebuck, was Alter's printer for over fifty years)
[5] *Id*.
[6] *Id*.
[7] *Id*. at *6. *See also* 11 U.S.C. 1129(b)(2)(B)(i).
[8] 11 U.S.C. 1129(b)(2)(B)(i).
[9] 11 U.S.C. 1129(b)(2); *Bank of Am. Natl. Trust & Savings Assoc. v. 203 North LaSalle Street P'ship*, 526 U.S. 434,444 (1999) ("*LaSalle*").

confirmation in the first 120 days after filing for bankruptcy.[10] To confirm a proposed plan, thirteen requirements must be satisfied.[11] Each requirement is mandatory, except for the need of a consensual plan.[12] If the plan is consensual then it is voted on by its creditors and the debtor's ability to retain ownership is determined by the terms of the plan.[13] However, if the plan is not agreed upon then the court will only confirm it when either the dissenting creditors are paid in full,[14] or when no one with a claim junior to the dissenting creditors will retain anything under the plan on account of such junior claim or interest in the property.[15] This confirmation is commonly referred to as a "cramdown."[16] When a cramdown is proposed, the absolute priority rule prevents the retention of any equity interest by shareholders that are junior to any unsecured creditors. This restriction on proposed plans address the inherent danger that a plan proposed by the debtor would "turn out to be too good a deal for the debtor's owners."[17] This requirement ensures that creditors will be paid before any stockholder could retain an equity interest.[18]

The new value exception gives old equity holders an opportunity to purchase shares in the reorganized debtor and retain their interest. Prior to the Bankruptcy Code's enactment in 1978, there was a common law new value exception. However, there is an ongoing debate whether this exception survived the enactment of the Code or was abolished by it. The actual words "new value" do not appear anywhere in section 1129 of the Code, the section on confirmation of a proposed plan. But proponents of the doctrine argue that the phrase "on

[10] 11 U.S.C. 1129.
[11] 11 U.S.C. 1129(a)(1)-(13) (2000).
[12] *Id*.
[13] *Id*.
[14] 11 U.S.C. 1129(b)(2)(B)(i)
[15] *Id*.
[16] 11 U.S.C. 1129(b) (2) (B) (ii).
[17] *LaSalle* at 444.
[18] *LaSalle* at 444.

account of"[19] permits and recognizes the new value exception. If the old equity holders pay and invest *new* value in the reorganized company then they are no longer retaining equity "on account of" of their previous interest, but rather from the new investment. In *Case v. Los Angeles Lumber Products Co,*[20] the Supreme Court formulated how this exception would work.[21] By making fresh contributions to the plan when there is a need for new capital, a stockholder may receive reasonably equivalent value in the reorganized company.[22] Under such circumstances, when the stockholder contributes money, the Court felt that no objections could be made.[23] Opponents of the new value exception argue that the Bankruptcy Code should be strictly construed and the absence of this exception was intentional and deliberate.[24]

A. *203 North LaSalle*

In *Bank of America National Trust & Savings Association v. 203 North LaSalle Street Partnership* ("*LaSalle*"),[25] the Supreme Court explored the contours of the new value exception.[26] During the debtor's exclusive period to propose a reorganization plan, the debtor sought to confirm a Chapter 11 plan over the objection of dissenting junior creditors.[27] Under that plan, the old equity holders would retain their interests by contributing $20 million in tax liabilities that would otherwise have been due if the lender foreclosed.[28] The plan did not provide

[19] 11 U.S.C. 1129(b) (2) (B) (ii).
[20] 308 U.S 106 (1939).
[21] *Id*. at 118
[22] *Id*. at 119.
[23] *Id*. at 118.
[24] *See* Lewis, *203 N. LaSalle Five Years Later: Answers to the Open Questions*, 38 J. MARSHALL L. REV. 61
[25] 526 U.S. 434 (1999)
[26] *Bank of Am. Natl. Trust & Savings Assoc. v. 203 North LaSalle Street P'ship,* 526 U.S. 434 (1999)
[27] *Id*. at 435.
[28] *Id*.

a mechanism for non-insiders to bid on the equity.[29] The Court held that a debtor's pre-bankruptcy equity holders may retain ownership interests by contributing new value over the objections of more senior class of impaired creditors only when there is some form of market valuation or competitive bidding.[30] The Court focused on the need for a market test, a test exposing the new value to a free market valuation and potential bidders, and held that the debtor failed to prove that their new value underwent such a test. The Court reasoned that this valuation is needed to ensure that the former equity holders' proposed contribution is the best obtainable price. [31] While the Court rejected the proposed plan, it refused to rule on the validity of the new value exception, explaining that "we do not decide whether the statute includes a new value corollary or exception" and ultimately rejected the proposed plan for failing to satisfy other requirements.[32]

Following *LaSalle* other courts have emphasized the importance of market valuation with respect to the new value exception. In *In re General Teamsters, Warehousemen and Helpers Union, Local 890,* [33] the United States Court of Appeals for the Ninth Circuit narrowed the new value exception and held that an equity holder may retain its interest only if its contribution ensures successful reorganization.[34] *Roebuck* is a recent case that stresses the limit of the new value exception, the limit which defines market valuation literally and requires actual submission to market competition. There, the district court further restricted the new value exception and held that the debtor must test the new value in actual market valuation or competitive bidding.[35]

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[29] *Id*. at 437.
[30] *Id*. at 457.
[31] *Id*.
[32] *LaSalle* at 443.
[33] 265 F.3d 869
[34] *Id* at 879.
[35] *Roebuck* at 6.

The court held that an expert's valuation of the company together with eight advertisements placed in local newspapers were not evidence that the market had been tested "in any meaningful way."[36] The court reasoned that an expert's opinion regarding the value of the reorganized entity cannot "substitute for true exposure to the market."[37]

B. *Policy Reasons for New Value Exception*

There are three policy reasons behind the new value exception. First, the more people that participate in an auction, the better the result, which ultimately benefits the creditors. Regardless of whom the bidders are, increased competition should drive up the value of the entity and the available funds for the creditors. Second, equity holders may bid higher than a third party creditor or buyer because they are already familiar with the business, have personal income opportunities, such as employment compensation, linked to the business and are less likely to reduce their bids for unknown risks.[38] Last, and perhaps the strongest policy reason for the new value exception, is to increase the likelihood that the business will successfully reorganize, a policy that is akin to one of the overarching goals of Chapter 11, to encourage reorganization and limit liquidation.[39] The ability of shareholders to remain in control and fix the business encourages such reorganization.[40]

[36] *Id.* at 5–6.
[37] *Id*.
[38] *Id*.
[39] *Id*.
[40] *Id*. at 76.

Part II. Market Evaluation

To ensure fairness any new value added must undergo valid market evaluation.[41] *Roebuck* contends that the Supreme Court in *LaSalle* "gave two discrete options… - either allow for competing reorganization plans, or allow for competitive bidding for the same equity interests being retained by the old equity holders."[42] The Court explained that this evaluation ensures that old equity holders would not retain property interest without paying its full value, something impossible to demonstrate if they retain the property under an exclusive plan without any competition. The Court questions why the opportunity to buy new value is exclusive for old equity holders.[43] If the new value contributed is the best obtainable price, then the old equity holders should not need the protection of exclusivity.[44] But if it is not the best obtainable price then there is no good reason for the exclusivity, absent a favor to old equity holders.[45] The Court concludes "that [it is] the exclusiveness of the opportunity, with its protection against the market's scrutiny of the purchase price" that renders old equity holder's interest "on account of" their old equity position and therefore subject to objection.[46]

Although market valuation is critical to the new value exception and the absolute priority rule, the courts have not defined it concretely. *LaSalle* poses the question as "whether 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," but leaves it unanswered.[47] Regardless of the answer, the question is predicated on allowing others the opportunity to bid, which, post exclusivity

[41] *LaSalle* at 457; *Roebuck* at 5-6.
[42] *Roebuck* at 5-6.
[43] *LaSalle* at 456.
[44] *Id*.
[45] *Id*. at 456
[46] *Id*.
[47] *Id*. at 457.

period, should suffice as market valuation.[48] No one would fault old equity holders for the lack of competition by dissenting creditors failing to bid.[49] Once the exclusive period is terminated and all competing plans are permitted, any failure to submit one would, per force, ratify and accept the old equity holders' interest as fair and at the best obtainable price.[50] Other courts have ruled that merely terminating exclusivity is not sufficient since it may not create an adequate market to properly evaluate the new value contribution in small or even medium size Chapter 11 cases.[51]

Part III. Practical Implications for Shareholders

Shareholders often want to participate and retain equity interest in the reorganized company, which requires them to successfully contribute new value that underwent market valuation. Generally any type of monetary investment is considered adding new value, provided that it is necessary for the reorganization.[52] There are two components that a shareholder must satisfy. First, the contribution must be "necessary" for the reorganized entity, necessary to repair and remedy the bankrupt company, and not merely to circumvent the absolute priority rule.[53] Second, the debtor must have no alternative source of capital other than the new contributions by

[48] *See* Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 STAN. L. REV. 69 (1991).
[49] *See* In re Union Fin. Servs. Group, Inc., 303 B.R. 390,424
[50] Bruce A. Markell, *LaSalle and the Little Guy: Some Initial Musings on the Ultimate Impact of Bank of America, Nt & Sa v. 203 North LaSalle Street Partnership*, 16 Bankr. Dev. J. 345, 353-54 (2000)
[51] *See* Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 STAN. L. REV. 69 (1991).
[52] *Case* at 121.
[53] *See Case* at 126; *See also* Lewis, *203 N. LaSalle Five Years Later: Answers to the Open Questions*, 38 J. MARSHALL L. REV. 61

old equity.[54] This is to ensure that the former equity holders do not obtain their new interests "on account of" their old equity.[55]

The 'tricky' part of successfully contributing new value is determining what a valid market valuation is. There are two approved options, albeit one superior to the other. The superior option is to conduct an auction, subject the shares to actual market testing, determine the most accurate and reasonable value, and apply that result to the old equity owner's new value.[56] Exposure to a competitive bidding environment ensures that the creditors receive the greatest amount of possible value and that the debtor is not using bankruptcy as a bargain.[57] The second, more debatable option is to merely allow for other plans to be filed, regardless of whether they do or do not require an auction.[58]

Some courts have definitively held what is unacceptable and not considered a valid market test. In *LaSalle*, the Court held that the proposed plan was unconfirmable because "its provision for vesting equity in the reorganized business . . . [did not extend] an opportunity to anyone else either to compete for that equity or to propose a competing reorganization plan."[59] In *Roebuck* the court held that an expert's valuation of the company, along with "cryptic advertisements" were also insufficient.[60] In *Coltex*, the appellate court held that without marketing the property in question to third parties, it was insufficient to only allow old partners

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[54] *See* Official Creditors' Comm. V. Potter Material Serv., Inc. 781. F.2d 99, 101 (7th Cir. 1986)
[55] *See* In Re Coltex, 138 F. 3d 39, 42; See Generally Lewis, supra note 52.
[56] *See* Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127 (1986).
[57] *See* Strub, *Competition, Bargaining, and Exclusivity under the New Value Rule: Applying the Single Asset Paradigm of Bonner Mall,* 111 BANKR. L.J. 228, 240 (1994).
[58] *See* Lewis, *203 N. LaSalle Five Years Later: Answers to the Open Questions*, 38 J. MARSHALL L. REV. 61, 87; Warren, *A Theory of Absolute Priority*, 1991 ANN. SURVERY AM. L. 35.
[59] *LaSalle* at 454.
[60] *Roebuck* at 7.

to contribute new value, and prohibit other parties.[61] Lastly, some courts have held that credit bidding would not be permitted in a new value contribution, because the creditor's collateral is not being auctioned.[62]

Consequently, once a debtor decides to use a cramdown approach and proposes to invest new value into the company, his exclusive right to propose a plan is terminated and others are permitted to propose differing plans.[63] Now that the debtor attempts to receive interest in the reorganized company ahead of other creditors, albeit by injecting new value, the courts have terminated the exclusive right to propose a plan, and allow all other creditor to enter a plan for consideration.[64]

IV. Conclusion

When *LaSalle* reached the Supreme Court, bankruptcy experts and attorneys hoped that their dilemma and uncertainties about the new value exception would finally be resolved.[65] However, the Court deflected the chance to finally settle the issue and based their decision on other issues in the proposed plan. Slowly, the lower courts are offering their opinions on how old equity holders can retain their equity interests. While many options have resulted in adverse decision for old equity holders, it is clear that subjecting new value to the market and engaging in an auction to fairly evaluate the contribution will allow old equity holders to retain their interest in the reorganized company regardless of objections from dissenting creditors.

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[61] *Coltex* at 44-45.
[62] *See* Beal Bank, S.S.B. v. Waters Edge L.P., 248 B.R. 668, 679-680 (D. Mass 2000).
[63] *Roebuck* at 8.
[64] *Id*.; *See also* Lewis, *203 N. LaSalle Five Years Later: Answers to the Open Questions*, 38 J. MARSHALL L. REV. 61, 65.