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Counsel's Corner

George W. Kuney*

New Value Questions Remain, Whatever the Decision in *Bonner Mall*

The U.S. Supreme Court has decided that vacatur is not appropriate in the Ninth Circuit case commonly known as *Bonner Mall.*[1] That Ninth Circuit decision validated the existence of the "new value exception" to the absolute priority rule—a crucial issue in work-out negotiations and Chapter 11 reorganizations.[2] The parties' settlement on the merits deprived the bar of a Supreme Court opinion answering, once and for all, whether the "new value" exception exists under the Bankruptcy Code; however, the Court's decision not to vacate the decision below means that the new value exception is alive and well, at least in the Ninth Circuit. Ironically, little may have really changed from pre-*Bonner Mall* days, however. Litigation will now turn away from the exception's existence toward defining its elements and the meaning of "fair and equitable" in a new value context, but the same practical problems will predominate, and the same judicial attitudes toward new value, especially in a single asset real estate case, can be expected to prevail.

A Fundamental Chapter 11 Issue

The new value exception's existence has long been one of Chapter 11's fundamental open issues.[3] The exception enables many debtors to operate within Chapter 11 far longer than would be permitted if no such exception existed, as a creditor could then more easily demonstrate that a reorganization would not be effected within a reasonable time. This affects the potential duration of a Chapter 11 case—a far reaching consideration affecting the

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* Allen, Matkins, Leck, Gamble & Mallory, San Diego, Cal.

[1] U.S. Bancorp Mortgage Co. v. Bonner Mall Partnership, 115 S. Ct. 386 (Nov. 8, 1994).

[2] In re Bonner Mall Partnership, 2 F.3d 899 (9th Cir. 1993).

[3] Although the new value exception was an established part of pre-1978 Bankruptcy Act law, Congress did not make it clear whether the new value exception was retained or superseded when it enacted the Bankruptcy Code. The result of this void has been a patchwork of precedent making reorganization possible in some cases, in certain courts, before certain judges, and not before others. The Ninth Circuit *Bonner Mall* opinion established the existence of the new value exception in the Ninth Circuit.

negotiating leverage of debtors and creditors. Practical matters aside, however, the new value debate is one over a fundamentally philosophical question: whether a lender or trade creditor will be permitted to enforce the spirit behind its contract, pay in full, or lose ownership of nonexempt property.

The new value exception ties into the absolute priority rule. Generally, the absolute priority rule states that unless the senior classes of creditors accept a plan or are paid in full, no junior class (including equity) can receive distributions under a plan of reorganization and the debtor's owners cannot retain ownership.[4] If viable, the new value exception allows a less-than-full-payment plan to be imposed upon creditors if equity makes an appropriate investment. The result can be a pennies-on-the-dollar distribution to unsecured creditors—including the unsecured portion of an under-collateralized loan—while equity retains ownership. Lenders tend to see such Chapter 11 plans as bad faith attempts to strip them of their rights, while equity-holders understand the exception to provide them with a continued stake in exchange for a new investment put at risk. These views have different appeal in a single-asset real estate case as opposed to that of a mid-sized industrial business with numerous employees, but the new value exception issue is not context specific; if it exists, it allows a new value plan in either instance, subject to the other requirements of the Bankruptcy Code.

What Can New Value Accomplish?

Because the Supreme Court did not vacate the *Bonner Mall* opinion below, the Ninth Circuit opinion, although arguably diminished by the notation "*cert. granted, case dismissed as moot,*" establishes the exception on the West Coast. The fight will now shift to the meaning of "new," "substantial," "necessary for a successful reorganization," and "reasonably equivalent to the value or interest received"—elements that define the new value exception—and "fair and equitable"—the overarching cram-down test that controls the exception's application. For example, can a debtor invest $500,000 in a shopping center worth $3,000,000 and thus wipe out unsecured (or undersecured) debt of another $2,000,000?

[4] The absolute priority rule is codified in 11 U.S.C. § 1129(b)'s "fair and equitable" language, as well as the more specific formulations of 11 U.S.C. §§ 1129(b)(2)(A) (secured claims), 1129(b)(2)(B) (unsecured claims), and 1129(b)(2)(C) (equity interests).

What if the enterprise is a machine shop with a substantial payroll? Is "substantiality" judged by the amount or percentage of unsecured debt eliminated? What "necessity" must the new value fill?—creditor payments?—a commercially reasonable loan to value ratio?—an operating reserve?—maintaining jobs? In general, when is it "fair and equitable" to strip down a creditor's lien rather than allowing its exercise of Bankruptcy Code § 363(k)/1111(b) rights (which amount to foreclosure in the single asset real estate case)? The requirements for a confirmable new value plan will not be "black letter law" for some time to come.

Focus on Fair and Equitable

The *In re Dollar Associates*[5] case explores some of these issues.[6] In that case, the debtor was a limited partnership owning an office building. Although the building was presently worth a mere $8 million, it secured a nonrecourse promissory note to "Bank"[7] with an outstanding balance of approximately $18.5 million. The Debtor also owed approximately $200,000 to other, unsecured trade creditors and had three smaller secured creditors from whom it had purchased an automobile, photocopier and facsimile machine shortly before filing its bankruptcy petition. The Debtor proposed a plan providing that:

1. the Bank would receive (a) an $8.0 million 10-year interest-bearing note, (b) an interest-free note for approximately $4 million representing the net operating income used for seismic retrofitting, (c) a 10-year, interest-bearing note in the amount of 15 percent of its estimated $6.5 million

[5] 172 B.R. 945 (N.D. Cal. 1994).

[6] An excellent and readable overview of the absolute priority rule, the new value exception, and their application in single asset real estate cases prior to *Dollar Associates* is found in Charles R. Sterbach, "Absolute Priority and the New Value Exception: A Practitioner's Primer," 99 Commercial L.J. 176 (Summer 1994).

[7] The "Bank" in this case was actually Gold Coast Asset Acquisition, L.P., a limited partnership that purchased the note and deed of trust at issue from California Federal Savings for $10.7 million. Addressing the impact of this acquisition at a discount, the Court rejected any implication that a claim purchased for less than face value is subject to decreased distributional rights. Rather, "[t]he purchaser of a claim is entitled to enforce all rights under the claim, irrespective of the price paid for the claim." Dollar Associates, 172 B.R. at 968-969.

unsecured deficiency claim, and (d) a share in the building's future appreciation, if any;
2. unsecured trade creditors, termed "necessary service providers," were to receive an 85 percent distribution on their claims;
3. the purchase money secured creditors would be paid in full; and
4. the partners would contribute $1 million and receive a 100 percent equity stake in the reorganized debtor.

In other words, the Debtor's partners would invest $1 million and wipe out $5,525,000 of Bank's unsecured deficiency, as well as 30,000 of the other unsecured creditor claims.

The *Dollar Associates*' court found that applying the new value exception to confirm the plan was not "fair and equitable" after presenting a six-part analysis.

- ☐ The plan could not foster the Chapter 11 goal of preserving equity because the debtor's argument for "strip-down" was based upon a lack of equity.
- ☐ The building had little economic significance beyond its equity and net operating income. Unlike a manufacturing or industrial enterprise, it did not possess a going concern value or supply jobs to the community beyond those which would be provided by any owner/operator.
- ☐ The plan's provisions calling for a significant or full repayment of all non-Bank creditors (who had recourse against the general partner) and a minimal repayment on the Bank's (nonrecourse) deficiency claim did not serve the Chapter 11 goal of maximizing distribution to creditors, insofar as almost the same result would be obtained outside of Chapter 11.
- ☐ The plan did not further the Chapter 11 goal of discharging claims. If the Bank were to foreclose, it would not have a recourse claim against the estate or its principals, and the Debtor's other creditors would retain their recourse claims against the general partner.
- ☐ Ninety-seven-point-five percent of all unsecured claims

(including Bank's) voted to reject the Plan, which, therefore, lacked overwhelming support from creditors.

- Finally, and perhaps most significantly, the Court presented a detailed analysis demonstrating that the Bankruptcy Code was not intended to permit a cram-down plan that stripped a claim secured by real property down to a court determined value.

The *Dollar Associates* court concluded that allowing the debtor to use the new value exception to retain ownership in such a situation would subvert the purpose of Chapter 11:

> Since the issue relates so often to the single asset real estate case, it is useful to recall exactly what Congress enacted in that particular regard. Through [Bankruptcy Code] sections 1111(b), 1124, and 1129(b)(2)(A), Congress specifically legislated to prevent the result that occurred under former Chapter XII and the Pine Gate line of cases. It did not want the debtor to be able to retain the property subject to the mortgage by paying an appraised value that was considered to be the secured portion of it, over the objection of the secured creditor. If the so-called new value exception is applied, in effect, the debtor can accomplish the same result by ignoring the unsecured deficiency which the mortgagee has a right to under section 1111(b) that makes all loans recourse loans.

Thus, while acknowledging the new value exception's existence, the court prevented its application by finding that the particular plan at issue failed the "fair and equitable" test.

Conclusion

The Supreme Court's decision not to vacate *Bonner Mall* effectively establishes the new value exception in the Ninth Circuit, and may cause other circuits to follow that decision. This being the case, issues about the permissible use of new value, not simply its existence, can be expected to take center stage, as they did in *Dollar Associates*. Rather than being eliminated, the controversies that fueled the *Bonner Mall* appeal have changed form and multiplied.