DEWSNUP V. TIMMS[1]: REINFORCEMENT OR VITIATION OF THE "NEW VALUE EXCEPTION" TO CHAPTER 11'S ABSOLUTE PRIORITY RULE?

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I. INTRODUCTION

The viability of the "new value" or "capital infusion" exception[2] to bankruptcy's absolute priority rule[3] has been questioned by courts since the rule's 1978 codification. The new value exception to the absolute priority rule dictates that by infusing a reorganization plan with new capital, a junior creditor can retain an interest in an insolvent company even though a senior creditor has not been paid in full.[4] Within the Chapter 11 reorganization context, the Bankruptcy Reform Act of 1978 partially codifies the absolute priority rule in a cram-down situation[5] but does not specifically address whether that partial codification encompasses the new value exception. Judicial resolution and application of this issue has resulted in conflicting interpretations of the rule. However, in a recent decision, *Dewsnup v. Timms*,[6] the Supreme Court held, in

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1. 112 S. Ct. 773 (1992).

2. The Supreme Court, in Case v. Los Angeles Lumber Products Co., 308 U.S. 106, 121 (1939), described the new value exception as follows:

> It is, of course, clear that there are circumstances under which stockholders may participate in a plan of reorganization of an insolvent debtor .... [There is a] necessity, at times, of seeking new money "essential to the success of the undertaking" from the old stockholders. Where that necessity exists and the old stockholders make a fresh contribution and receive in return a participation reasonably equivalent to their contribution, no objection can be made.

Id. at 121.

3. In essence, the absolute priority rule requires that a dissenting class (a class which does not consent to the Plan) of creditors be provided for fully before any junior class (a class with lesser priority under the Bankruptcy Code) may receive or retain any interest in the reorganized firm. *See* Norwest Bank Worthington v. Ahlers, 485 U.S. 197 (1988).

4. In *Case*, 308 U.S. at 106, the Supreme Court states:

> 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. In such or similar cases the chancellor may exercise an informed discretion concerning the practical adjustments of the several rights.

Id. at 117. "[T]he stockholder's participation must be based on a contribution in money or in money's worth, reasonably equivalent in view of all the circumstances to the participation of the stockholder." *Id.* at 122.

5. *Id.* at 200. 11 U.S.C. § 1129(b)(1) is called the "cram down" provision, in as much as it allows confirmation of a plan to be "crammed down" over the objection of dissenting classes. *See, e.g., In re* Snyder, 967 F.2d 1126, 1128 (7th Cir. 1992).

6. 112 S. Ct. 773 (1992).

a Chapter 7[7] context, that prior judicial interpretation of a bankruptcy principle will not be changed when Congress amends bankruptcy laws unless Congress specifically mandates the change.[8] This decision, coupled with statutory language, legislative history, and the practical realities of Chapter 11 reorganizations, dictates continued recognition of the new value exception to the absolute priority rule.

This Note analyzes the usefulness and viability of the new value exception to the absolute priority rule. The first section details the historical development of the absolute priority rule as well as the origin and purpose of the rule's new value exception.[9] Next, this Note addresses the ambiguity in the Supreme Court's dicta in *Norwest Bank Worthington v. Ahlers*[10] regarding whether the new value exception to the absolute priority rule survived the 1978 Bankruptcy Reform Act and the subsequent failure of some lower courts to recognize the retention of the new value exception.[11] However, in *Dewsnup v. Timms*, the United States Supreme Court propounded language which supports continued viability of the new value exception.[12] This Note concludes that the *Dewsnup* decision, the legislative history of the absolute priority rule, and practical considerations of Chapter 11 reorganizations mandate recognition of the new value exception to the absolute priority rule under the 1978 Code.[13]

II. HISTORICAL DEVELOPMENT OF THE RULE AND ITS NEW VALUE EXCEPTION

The absolute priority rule was developed in several early railroad cases.[14] In *Northern Pacific Railway v. Boyd*,[15] the Supreme Court held that former shareholders could not participate in a reorganized corporation where no provision was made for payment to intermediate creditors.[16] In the lineage of "railroad cases,"[17] this rule of "absolute priority" was developed to protect intermediate creditors from stockholders and bondholders who had united to protect their own interests.[18] Through private agreements, stockholders and bondholders could collaborate in foreclosure and subsequent reorganization, thereby preempting the claims of intermediate creditors.[19] The Court sought to protect the interests of intermediate creditors by disallowing shareholder participation in the reorganized company absent payment on the general[20]

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7. Chapter 7 of the Bankruptcy Code involves the liquidation of a debtor's non-exempt assets. 11 U.S.C. §§ 701–766 (1988 & Supp. III 1991).
8. 112 S. Ct. at 779.
9. *See infra* text accompanying notes 14–60.
10. 485 U.S. 197 (1985).
11. *See infra* text accompanying notes 61–104.
12. 112 S. Ct. at 779. *See infra* text accompanying notes 105–38.
13. *See infra* text accompanying note 139–41.
14. *See, e.g.*, Northern Pac. Ry. v. Boyd, 228 U.S. 482 (1913).
15. 228 U.S. 482 (1913).
16. *Id.* at 508. The Railroad reorganization was formulated contractually between the insolvent railroad's shareholders and bondholders pursuant to foreclosure proceedings. "Intermediate" creditors were those creditors whose payoff priority fell between the bondholders (with higher priority) and the shareholders (with lower priority).
17. *See, e.g., id.* at 482; Kansas City Ry. v. Central Union Trust Co., 271 U.S. 445 (1926).
18. *Boyd*, 228 U.S. at 504.
19. *Id.*
20. "General" refers to unsecured creditors. *Id.*

creditors' superior claims.[21] In equitable receivership cases such as *Boyd*, the doctrine of "absolute priority" was commonly interpreted within the phrase "fair and equitable" or its equivalent.[22] The Bankruptcy Act of 1898 required reorganization plans to be "fair and equitable" but did not define these terms.[23] Thus, the absolute priority rule developed as a cross between the interests of "fair and equitable" and a rule of contract law.[24] It was interpreted and applied judicially and was not explicitly codified until 1978.[25]

The *Boyd* court did, however, recognize limited but permissible circumstances under which stockholders could participate in an insolvent debtor's plan of reorganization.[26] Such participation could be accomplished by the issuance, on equitable terms, of income bonds or preferred stock.[27]

In *Boyd*, the court recognized the existence of both the absolute priority rule and the rule's new value exception.[28] The Supreme Court elaborated on its *Boyd* dictum in *Kansas City Railway v. Central Union Trust Co.*,[29] noting that, generally, additional funds will be necessary for a successful reorganization, and it may be impossible to obtain them unless stockholders are permitted to contribute the needed capital in exchange for retaining an interest in the debtor which is sufficiently valuable to induce the contribution.[30] Stockholders would thus be allowed to participate in a plan of reorganization under limited circumstances.[31]

In *Kansas City Railway*, unsecured creditors challenged the proposed reorganization, claiming that the plan was unfair and "unduly preferential to stockholders of the insolvent corporation."[32] The reorganization plan provided that unsecured creditors and stockholders were to receive a combination of

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21. The *Boyd* Court professed:

> If the value of the [rail]road justified the issuance of stock in exchange for old shares, the creditors were entitled to the benefit of that value, whether it was present or prospective, for dividends or only for purposes of control. In either event it was a right of property out of which the creditors were entitled to be paid before the stockholders could retain it for any purpose whatever.

Id. at 508.

22. Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106, 115 (1939).

23. Kahm & Nate's Shoes No. 2 v. First Bank, 908 F.2d 1351 (7th Cir. 1990) (even if new value exception still exists, a debtor contribution of $34,800 cash plus a guaranteed $600,000 loan is insufficient).

24. *Id.* at 1360.

25. 11 U.S.C. § 1129(b)(2)(B)(ii).

26. Northern Pac. Ry. v. Boyd, 228 U.S. 482, 508 (1913). "This ... does not ... require the impossible and make it necessary to pay an unsecured creditor in cash as a condition of stockholders retaining an interest in the reorganized company. [The creditor's] interest can be preserved by the issuance, on equitable terms, of income bonds or preferred stock." *Id.*

27. *Id.*

28. The Court concluded that "the creditors were entitled to be paid before the stockholders could retain [the value of the railroad]." *Id.* The court also noted that "this conclusion does not, as claimed, require the impossible and make it necessary to pay an unsecured creditor in cash as a condition of stockholders' retaining interest in the reorganized company. His interest can be preserved by the issuance, on equitable terms, of income bonds or preferred stock." *Id.*

29. 271 U.S. 445 (1926).

30. *Id.* at 455.

31. Stockholder participation may be acceptable when additional funds are essential to the success of the reorganization and when, absent stockholder participation, the funds will be impossible to obtain. *Id.*

32. *Id.* at 450.

bonds, preferred stock, and common stock on account of their claims.[33] The unsecured creditors argued that to be considered fair, a reorganization plan must preserve the priority of creditors' interests over stockholders' interests.[34] Although the *Kansas City Railway* court ultimately held that the absolute priority rule prevailed,[35] the Court again emphasized the necessity of seeking new money in Chapter 11 reorganizations.[36] When additional funds are necessary, the chancellor may exercise his discretion concerning the rights involved and allow a shareholder to retain an interest.[37]

The *Boyd* and *Kansas City Railway* Courts recognized that additional funds are needed for a successful reorganization. Because the risk of business failure lies with the shareholder, it is he who is most likely willing to contribute the necessary additional capital.[38] However, if he is not allowed to have any interest in the reorganized company, he has no incentive to forward additional funds.[39] As a result, the Supreme Court indicated that shareholders would be allowed to retain sufficient interest in a reorganized company to entice them into investing further capital.[40] This rationale for the new value exception in Chapter 11 reorganizations has been recognized by numerous courts.[41]

When the 1934 Bankruptcy Act created statutory authority for corporate reorganizations, courts questioned the continued existence of the absolute priority rule and its new value exception under the statute.[42] Section 77B(f) of the Act[43] utilized the words "fair and equitable" in its specified requirements for a

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33. *Id.* at 451–52. The plan provided that preferred stockholders could receive one share of common stock, $6 in adjustment bonds, and $14 in prior lien bonds upon payment of $20 for each $100 share of previously owned stock. *Id.* at 451. Common stockholders could receive one share of common stock, $7.50 in adjustment bonds, and $17.50 in prior lien bonds upon payment of $25 for each $100 share of previously owned stock. *Id.* Unsecured creditors could receive either one-third of a share of preferred stock and two-thirds of a share of common stock for each $100 of their claims or could receive one share of common stock, $6 in adjustment bonds, and $14 in prior lien bonds upon payment of $18 for each $100 of their claims. *Id.* at 451–52.

34. *Id.* at 452.

35. *Id.* at 454.

36. *Id.* at 455. The Court noted that

> [g]enerally, 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. In such or similar cases the chancellor may exercise an informed discretion concerning the practical adjustment of the several rights.

Id.

37. *Id.*

38. *Id. See also In re* Snyder, 967 F.2d 1126 (7th Cir. 1992).

39. *Kansas City Ry.*, 271 U.S. at 455.

40. *Id.*

41. *See, e.g., In re* Pullman Constr. Indus., Inc., 107 B.R. 909 (Bankr. N.D. Ill. 1989); *In re* 222 Liberty Assocs., 108 B.R. 971 (Bankr. E.D. Pa. 1990); *In re* Creekside Landing, Ltd., 140 B.R. 713 (Bankr. M.D. Tenn. 1992); *In re* Greystone III Joint Venture, 102 B.R. 560 (Bankr. W.D. Tex. 1989), *aff'd by* 127 B.R. 138 (W.D. Tex. 1990), *overruled*, 948 F.2d 134 (5th Cir. 1991), *opinion withdrawn*, 948 F.2d 134, 142 (5th Cir. 1991); *In re* Barren, 141 B.R. 899 (Bankr. W.D. La. 1992).

42. *See, e.g.*, Case v. Los Angeles Lumber Prods., 100 F.2d 963 (9th Cir. 1938) (court of appeals upheld confirmation of a plan which allowed stockholder participation although bondholders were not paid in full); *In re* Barclay Park Corp., 90 F.2d 595 (2d Cir. 1937).

43. Section 77B(f) was the precursor to 11 U.S.C. § 1129(b) (1978) and provided in part: "[A]fter hearing such objections as may be made to the plan, the judge shall confirm the plan if satisfied that (1) it is fair and equitable and does not discriminate unfairly in favor of any class of creditors or stockholders, and is feasible ...." *Case*, 308 U.S. at 114 n.6.

plan of reorganization.[44] The Supreme Court, in *Case v. Los Angeles Lumber Products Co.*,[45] relied on the legislature's adoption of the language "fair and equitable" in the Act to find that the absolute priority rule was firmly imbedded in § 77B.[46] Referring to the Court's language in *Keck v. United States*,[47] the *Case* Court held that where the words employed in a statute had a well known meaning at the time of the enactment, the words are applied in that sense unless the context requires otherwise.[48]

The stockholders in *Case* attempted to participate in the reorganization even though they made no new value contribution.[49] Although the other creditors consented to the plan, the Court would not allow the plan to be confirmed.[50] Instead, it found as a matter of law that the plan was not fair and equitable.[51] The Court required that the debtor either conform to the absolute priority rule by paying its senior creditors in full, or conform to the exception by contributing substantial and necessary funds to the reorganization through the contribution of money or money's worth.[52]

Case interpreted the 1934 Bankruptcy Act[53] as including both the absolute priority rule and its exception.[54] The Supreme Court held that the use in § 77B of the words "fair and equitable" was a statutory adoption of the absolute priority rule as it had been judicially determined pursuant to those words.[55]

In dictum, the Court noted that the exception to the rule was imbedded in § 77B as well.[56] The exception could be invoked when a stockholder contributed "money or money's worth" to the reorganization.[57] His participation in the reorganized business was then equivalent, in view of all the circumstances, to his contribution.[58] To meet the new value exception outlined in *Case*, the capital infusion must be "substantial" and "necessary."[59] Though stockholders had to meet these requirements to invoke the new value exception based on the Supreme Court's holding and dictum in *Case*, lower courts readily recognized,

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44. *Id.*
45. 308 U.S. 106 (1939).
46. *Id.* at 119. "Hence we conclude, as have other courts, that that doctrine is firmly imbedded in Section 77B." *Id.*
47. 172 U.S. 434, 446 (1899) (defendant's attempt to smuggle diamonds into the United States was not violative of the Tariff Act of 1894).
48. *Case*, 308 U.S. at 115.
49. *Id.* at 112.
50. *Id.* at 114.
51. *Id.*
52. *Id.* at 122.
53. *Id.* at 115. "The words 'fair and equitable' as used in Section 77B, sub. f are words of art which prior to the advent of Section 77B had acquired a fixed meaning through judicial interpretations in the field of equity receivership organization [to employ the absolute priority rule]." *Id.* However, "to accord 'the creditor his full rights of priority against the corporate assets' where the debtor is insolvent, the stockholder's participation must be based on a contribution in money or in money's worth, reasonably equivalent in view of all the circumstances to the participation of the stockholder." *Id.* at 122.
54. *Id.* at 114–21.
55. *Id.* at 118–19.
56. *Id.* at 121.
57. *Id.* at 122.
58. *Id.*
59. *In re* Harman, 141 B.R. 878 (Bankr. E.D. Pa. 1992).

despite these requirements, the exception until the enactment of the 1978 Bankruptcy Code.[60]

III. *AHLERS* DICTA IS AMBIGUOUS AS TO WHETHER THE NEW VALUE EXCEPTION SURVIVED THE 1978 BANKRUPTCY REFORM ACT

Because the 1978 Bankruptcy Reform Act partially codified the absolute priority rule[61] and failed to address its exception, courts have questioned whether the exception is still viable under the 1978 Code.[62] Until recently,[63] the Supreme Court had not provided much guidance to lower courts on this issue.

In *Norwest Bank Worthington v. Ahlers*,[64] the Chapter 11 debtors, who operated a family farm, attempted to retain an interest in their estate by application of the new value exception to the absolute priority rule.[65] A promise of future labor was the "new value" that the debtors intended to contribute.[66] While the Supreme Court held that the promise of future services does not constitute "money or money's worth" as required by the *Case* exception to the absolute priority rule,[67] the Court expressly declined to rule on the question of whether the exception to the absolute priority rule continues to be viable under the 1978 Code.[68]

Although courts remain divided as to the continued viability of the new value exception, the Supreme Court has not addressed this issue subsequent to the 1978 partial codification of the doctrine. This failure to address the issue has caused confusion among lower courts resulting in inconsistent application of the Bankruptcy Code.[69]

While the majority of courts continue to recognize the exception's existence,[70] recent decisions indicate that the 1978 Code extinguished the new value exception.[71] The only court of appeals to rule on the issue was the Fifth Circuit,

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60. *See, e.g., In re* Four Seasons Nursing Ctrs. of Am., 472 F.2d 747, 750 (10th Cir. 1973).
61. *See supra* note 5.
62. *See, e.g.*, Norwest Bank Worthington v. Ahlers, 485 U.S. 197 (1985).
63. *See* Dewsnup v. Timms, 112 S. Ct. 773 (1992).
64. 485 U.S. 197 (1985).
65. *Id.* at 200.
66. *Id.* at 201.
67. *Id.* at 201–02.
68. *Id.* at 201.
69. *See, e.g., In re* Outlook/Century Ltd., 127 B.R. 650 (Bankr. N.D. Cal., 1991) (no new value exception to the absolute priority rule exists under the 1978 Bankruptcy Code); *In re* Batten, 141 B.R. 899 (Bankr. W.D. La. 1992) (the new value exception to the absolute priority rule is still viable.).
70. *In re* Route 37 Business Park Assocs., 146 B.R. 640, 646 (D.N.J. 1992). "[A] distinct majority of courts faced with the issue have held that the new value exception continues to exist .... [P]rior to the Supreme Court's opinion in *Ahlers*, virtually every court concluded that the new value exception still applies under the 1978 Bankruptcy Code." *Id. See, e.g., Batten*, 141 B.R. at 899; *In re* Creekside Landing, Ltd., 140 B.R. 713 (Bankr. M.D. Tenn. 1992); *In re* Harman, 141 B.R. 878 (Bankr. E.D. Pa. 1992); *In re* E.I. Parks No. 1 Ltd. Partnership, 122 B.R. 549 (Bankr. W.D. Ark. 1990).
71. *See, e.g., Outlook/Century Ltd.*, 127 B.R. at 658; *In re* Embassy Enters., 125 B.R. 552, 554 (Bankr. D. Minn. 1990); *In re* Drimmel, 108 B.R. 284, 288 (Bankr. D. Kan. 1989); *In re* Winters, 99 B.R. 658, 663 (Bankr. W.D. Pa. 1989); *In re* A.V.B.I., Inc., 143 B.R. 738 (Bankr. C.D. Cal. 1992).

in *In re Greystone III Joint Venture.*[72] Initially holding that the new value exception did not survive the 1978 absolute priority rule codification, the court withdrew its holding within four months of its original decision.[73] Two other courts of appeals[74] have had the issue before them but have declined to rule.[75] Similarly, the lower courts which have addressed the viability of the exception have reached inconsistent results.

In *In re Outlook/Century Ltd.*,[76] Outlook/Century Ltd., a single asset debtor, intended to propose a plan under which the debtor would retain the property without paying unsecured creditors in full, arguing that because the limited partnership intended to make substantial contributions of new cash,[77] the plan was confirmable under the new value exception to the absolute priority rule.[78] Dismissing the case, the court focused on the language of § 1129(b)(2)(B)(ii)[79] of the Bankruptcy Code to undermine the proposition that any interest obtained by a junior creditor, such as an equity holder, pursuant to a Chapter 11 reorganization, is independent of its prior interest.[80] Such an interest *must* be conceived as a retention of that equity holder's junior claim.[81] The court reasoned that the proposed contribution of capital could not be considered a "purchase" in which the partners would receive equity in the debtor wholly independent of their existing partnership interests because it was not an open market transaction.[82] Other potential investors were not permitted to participate, and, therefore, the exclusive right of the debtor's existing part-

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72. 948 F.2d 134 (5th Cir. 1991).

73. Originally decided Nov. 19, 1991, the court's opinion was amended on February 27, 1992. Withdrawing the portion of its opinion regarding the continued viability of the new value exception to the absolute priority rule, the court stated, "[i]n withdrawing this portion of the panel opinion we emphasize that the bankruptcy court's opinion on the 'new value exception' to the absolute priority rule has been vacated and we express no view whatever on that part of the bankruptcy court's decision." *Id.* at 142. The bankruptcy court held that the exception was still viable. *In re* Greystone III Joint Venture, 102 B.R. 560 (Bankr. W.D. Tex. 1989).

At least one court has opined that the Fifth Circuit's withdrawal was influenced by *Dewsnup*:

> Although the Fifth Circuit's decision to withdraw the earlier portion [of its decision] does not state whether it was influenced by the Supreme Court's decision in *Dewsnup*, the dissenting judge on rehearing seemed to imply that it did. "How one should approach issues of a statutory construction arising from the Bankruptcy Code has been clouded, in my view, by *Dewsnup v. Timm.*"

In re Bonner Mall Partnership, 142 B.R. 911, 917 (Bankr. D. Idaho, 1992) (quoting *Greystone III Joint Venture*, 948 F.2d at 142 (Jones, J., dissenting)).

74. *In re* Bryson Properties, XVIII, 961 F.2d 496 (4th Cir. 1992); *In re* Snyder, 967 F.2d 1126 (7th Cir. 1992).

75. *Bryson*, 961 F.2d at 505 ("[E]ven if some limited new capital exception were viable under the Bankruptcy Code, it would not be so expansive as to apply under the facts of this case."); *Snyder*, 967 F.2d at 1131 ("We therefore again reserve the issue of the new value exception's continued viability for another day.").

76. 127 B.R. 650 (Bankr. N.D. Cal. 1991).

77. *Id.* at 652.

78. *Id.*

79. 11 U.S.C. § 1129(b)(2)(B)(ii) specifies that with respect to a class of unsecured claims: "[T]he 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." *Id.*

80. *Outlook/Century Ltd.*, 127 B.R. at 656.

81. *Id.* at 654.

82. *Id.* at 653–54.

ners to obtain equity interests in the debtor itself constitutes property that the partners retain "on account of" their existing interests.[83]

The plain language of the Code, however, supports the proposition that the terms "on account of" such junior claim or interest encompasses the new value exception to the absolute priority rule.[84] Once such a junior claim is extinguished in a reorganization proceeding, any interest granted to the equity holder in the reorganized company should be construed as a new interest, purchased with the infused capital. This construction conforms with the traditional application of the doctrine.[85]

Additionally, the *Outlook* court, without authority, determined that the right of the debtor's existing partners to obtain equity interests in the debtor itself constitutes property that the partners retain "on account of" their existing interests.[86] Historically, however, the Supreme Court relied on the terms "property" and "interest," the same terms used in the 1978 Code, when it adopted the absolute priority rule and the new value exception pursuant to the common law and the 1934 Act.[87] Such language cannot now be interpreted to encompass a codification of the rule, yet to exclude recognition of the rule's historical exception.

Furthermore, legislative history indicates that § 1129(b)(2)(B)(ii) of the Bankruptcy Reform Act of 1978[88] is a specific codification of the absolute pri-

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83. *Id.* at 653.

84. Marston Enters., Inc./Spring Run Apartments, 13 B.R. 514 (Bankr. E.D.N.Y. 1981); *In re* Landau Boat Co., 13 B.R. 788 (W.D. Mo. 1981).

85. At least one court has reasoned that the "new value exception" is not an exception at all, but rather an "independent act which is not per se a violation of the absolute priority rule." *In re* Woodscape Ltd. Partnership, 134 B.R. 165, 173 (D. Md. 1991). The court explained that

> an infusion of new value does not constitute a distribution of property values of the estate to unsecured creditors before equity interest holders. A new contribution must be independently justified as adequate, and there is thus no need for an exception to the absolute priority rule. There is only a need, particularly where the contribution is from holders of equity interests in an insolvent entity that would otherwise be extinguished, to be assured that the new value is real, i.e. "a contribution in money or in money's worth, reasonably equivalent in view of all the circumstances to the participation of the stockholder."

Id. at 173–74 (quoting Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106, 122 (1939)). *See also In re* Snyder, 967 F.2d 1126, 1130 (7th Cir. 1992) (Seventh Circuit declined to rule whether or not the new value exception to the absolute priority rule survived its 1978 partial codification).

86. *Outlook/Century Ltd.*, 127 B.R. at 654.

87. The *Boyd* Court stated that any value in the railroad was "a right of property out of which the creditors were entitled to be paid before the stockholders." Northern Pac. Ry. v. Boyd, 228 U.S. 482, 508 (1913).

The *Kansas City Railway* Court noted that "no such proceedings can be rightfully carried to consummation which recognize and preserve any interest in the stockholders without also recognizing and preserving the interests ... of every creditor of the corporation." Kansas City Ry. v. Central Union Trust Co., 271 U.S. 455, 454 (1926).

The *Case* Court, in recognizing the absolute priority rule pursuant to the Act, adopted the language of *Kansas City Railway*, 308 U.S. at 120.

88. 11 U.S.C. §1129 (1978) defines "fair and equitable" to include the following requirements:

> (B) With respect to a class of unsecured claims—
> (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

ority rule.[89] Section 1129 requires that a plan of reorganization be "fair and equitable" and then prescribes the terms of the absolute priority rule for determining whether or not the requirement has been met.[90] The 1978 Code codifies the absolute priority rule from the dissenting class on down.[91] Congress did not directly address the issue of the new value exception's continued viability pursuant to the new statute; however, the legislative history provides further insight.[92]

If the debtor cannot obtain the consent of all classes of creditors and stockholders, the court may confirm the plan anyway at the request of the plan's proponent.[93] The bill defines "fairly" in terms of the relative rights among the classes.[94] Simply put, the bill requires that the plan pay any dissenting class in full before any class junior to the dissenter may be paid at all.[95] The rule is a partial application of the absolute priority rule which was applied under Chapter X and requires a full valuation of the debtor as the absolute priority rule did under previous law.[96] The important difference is that the bill permits senior classes to take less than full payment in order to expedite or insure the success of the reorganization.[97]

The important distinction between the absolute priority rule as it is currently partially codified and the absolute priority rule as it was applied under Chapter X is that the rule now has no effect on senior non-dissenting and/or unimpaired classes.[98] Furthermore, since the legislative commentary does not explicitly eliminate the "new value" exception, it may be inferred that the exception continues to be viable.

In *In re Pullman Construction Industries, Inc.*,[99] the Bankruptcy Court for the Northern District of Illinois applied the language of the Supreme Court

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(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.

Id. §1129(b)(2)(B)(ii).

89. Specifically, the 1978 Code provides that:

> [I]f the class is impaired, then they must be paid in full or, if paid less than in full, then no class junior may receive anything under the plan. *This codifies the absolute priority rule from the dissenting class on down.* With respect to classes of equity, the court may confirm over a dissent if the members of the class are unimpaired, if they receive their liquidation preference or redemption rights, if any, or if no class junior shares under the plan. *This, too, is a codification of the absolute priority rule with respect to equity.*

H.R. Rep. No. 598, 95th Cong., 2d Sess. 224 (1978), *reprinted in* 1978 U.S.C.C.A.N. 6184 (emphasis added).

90. *Id.*

91. H.R. Rep. No. 598, 95th Cong., 2d Sess. 413 (1978), *reprinted in* 1978 U.S.C.C.A.N. 6369.

92. *Id.*

93. *Id.*

94. *Id.*

95. *Id.*

96. *Id.*

97. *Id.* at 6184.

98. At common law, and pursuant to Chapter X's § 77B, under the absolute priority rule, a junior creditor could not retain any interest in a reorganized company *even if the senior creditors agreed to the retention of that interest.* Section 1129(b) is a *partial* codification of the rule in that if senior classes agree, or if senior classes are paid their claims in full, a junior creditor may retain its interest.

99. 107 B.R. 909 (Bankr. N.D. Ill. 1989).

in *Midatlantic National Bank v. New Jersey Department of Environmental Protection*[100] in its analysis of the exception's continued viability.[101] The *Pullman* Court noted that nothing in § 1129(b)(2)(B)(ii) or its legislative history suggests that Congress intended to modify past judicial interpretation of the absolute priority doctrine or its new capital exception.[102] Relying on *Midatlantic*, the court reasoned that when Congress codifies a judicially developed concept, it is presumed, absent an express statement to the contrary, that Congress intended to adopt the interpretation placed on that concept by the courts.[103] The *Pullman* Court thus concluded that the new value exception to the absolute priority rule still exists under the Bankruptcy Reform Act of 1978.[104]

While the Supreme Court failed in *Ahlers* to commit to the exception's continued existence, both statutory language and the legislative history support continued recognition of the new value exception to the absolute priority rule.

IV. *DEWSNUP V. TIMMS* SUPPORTS THE CONTINUED VIABILITY OF THE NEW VALUE EXCEPTION TO THE ABSOLUTE PRIORITY RULE

In addition to statutory language and legislative history, the Supreme Court's recent ruling in *Dewsnup v. Timms*[105] provides further support for continued recognition of the new value exception. In fact, several bankruptcy courts have relied on the Supreme Court's language in *Dewsnup* to assess whether the new value exception to the absolute priority rule is still viable.[106] Although similar Supreme Court language has previously been cited in support of the exception's viability,[107] *Dewsnup*, a bankruptcy case, provides a basis for renewed support.

In holding that a Chapter 7 debtor[108] could not redeem real property by paying secured creditors the fair market value of the property, the Supreme Court in *Dewsnup* stated that the Court would not interpret the Bankruptcy Code to effect a major change in pre-Code practice where legislative history

100. 474 U.S. 494 (1986).
101. *Pullman*, 107 B.R. at 946.
102. *Id.* (citing *Midatlantic Nat'l Bank*, 474 U.S. at 501).
103. *Pullman*, 107 B.R. at 946.
104. *Id.*
105. 112 S. Ct. 773 (1992).
106. *See, e.g., In re* Snyder, 967 F.2d 1126 (7th Cir. 1992) (in light of *Dewsnup*, court declined to rule on whether the new value exception to the absolute priority rule still exists; even if the exception is still viable, debtor's proposed release of a lien on farm machinery plus a cash payment amounting to only 2.7% of the sum due unsecured creditors is insufficient to qualify for the exception); *In re* Bonner Mall Partnership, 142 B.R. 911 (Bankr. D. Idaho 1992). Relying on the Supreme Court's language in *Dewsnup*, the Idaho District Court held that the new value exception to the absolute rule survived the enactment of the 1978 Bankruptcy Code. "The *Dewsnup* opinion gives courts new guidelines when attempting to interpret the language of the Bankruptcy Code." *Id.* at 916.
107. *See In re* Route 37 Business Park Assocs., 146 B.R. 640, 647 (D.N.J. 1992) ("[I]f Congress intends for legislation to change the interpretation of a judicially created concept, it makes that intent specific." (quoting Midlantic Nat'l Bank v. New Jersey Dep't of Envtl. Protection, 474 U.S. 494, 501 (1986))).
108. Under the 1978 Code, a Chapter 7 debtor is one who liquidates his estate. 11 U.S.C. §§ 101(12) and 701 (1988).

does not specifically indicate that Congress intended to make a change.[109] Because the new value exception is a judicially created exception to the absolute priority rule which was in full force prior to the enactment of the 1978 Bankruptcy Code, and since the Code does not specifically address the exception, several courts have relied on the *Dewsnup* language in holding that the new value exception still exists.[110]

For example, in *In re Bonner Mall Partnership*,[111] the district court noted that the *Dewsnup* opinion gives courts new guidelines when attempting to interpret the language of the Bankruptcy Code.[112] Pursuant to these guidelines, courts should construe the language of the 1978 Code consistently with pre-Code practices.[113]

The district court further stated that the language of 11 U.S.C. § 1129(b) is ambiguous and that no mention is made in the language or the legislative history of the new value exception.[114] Relying on *Dewsnup*, the Court was hesitant to read the Code in contravention of pre-Code practice and would not hold that the new value exception has been extinguished.[115]

Similarly, in *In re SLC Limited V*, the Bankruptcy Court held that the new value exception survived the enactment of the 1978 Bankruptcy Code.[116] The court reiterated the *Dewsnup* analysis, stating that congressional silence regarding codification of the new value exception cannot be interpreted as eliminating a substantial, judicially created exception to the absolute priority rule, especially when § 1129(b)(2) is not ambiguous on its face.[117] Absent a showing of specific intent to change the judicially created new value exception, particularly considering the plain language of the statute, the court would not look into legislative history to determine the scope of § 1129(b)(2).[118]

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109. The Court stated:

> When Congress amends the bankruptcy laws, it does not write on a clean slate. Furthermore, this Court has been reluctant to accept arguments that would interpret the Code, however vague the particular language under consideration might be, to effect a major change in pre-Code practice that is not the subject of at least some discussion in the legislative history.

112 S. Ct. at 779.

110. *See, e.g.*, *In re* Bonner Mall Partnership, 142 B.R. 911 (Bankr. D. Idaho 1992); *In re* SLC Ltd. V, 137 B.R. 847, 850 (Bankr. D. Utah 1992).

111. 142 B.R. 911 (Bankr. D. Idaho 1992).

112. "The Supreme Court makes it clear that when the language of the Code is somewhat ambiguous, courts should try to construe the language as consistent with pre-Code practices, unless some contrary intent is shown in the legislative history." *Id.* at 916.

113. *Id.*

114. *Id.* at 916.

115. *Id.* at 917.

116. 137 B.R. 847 (Bankr. D. Utah 1992).

117. *Id.* at 853–54.

118. *Id.*

V. PRACTICALITY SUPPORTS THE CONTINUED EXISTENCE OF THE EXCEPTION

The statutory language of the Code[119] and its legislative history[120] support the proposition that the new value exception to the absolute priority rule remains viable. *Dewsnup*, although not a definitive ruling in the issue, provides guidance regarding the Supreme Court's interpretation of the 1978 Bankruptcy Code.[121] The practical realities of bankruptcy reorganization provide additional reinforcement for the proposition that the new value exception to the absolute priority rule should continue to be recognized under the 1978 Bankruptcy Code.

The policy of Chapter 11 reorganizations is to permit the successful rehabilitation of debtors.[122] To accomplish the "fresh start" goal, courts must recognize the practical realities of obtaining a confirmable bankruptcy plan. The original *Greystone* decision,[123] while vacated by the Fifth Circuit, was expressly adopted by several bankruptcy courts.[124] Noting the realities of Chapter 11 reorganizations, the court argued that if the new value exception were deemed eliminated, a perfectly sensible reorganization would fail for lack of capital.[125] Equity holders can hardly be expected to pump capital into a venture if they cannot in the process maintain an interest in the business.[126]

In re Pullman Construction Industries, Inc.[127] further elaborates this practical approach to the problem. The Court noted that if the only option available for business owners is to pay dissenting unsecured creditors in full under § 1129(b)(2)(B)(ii), then as a practical matter there would be little incentive in most cases for the owners of such business to undergo the cost and effort of reorganization instead of liquidating and starting over.[128] Finding the continued existence of the capital infusion exception, the court urged that any other approach would not best advance the legislative purpose of Chapter 11.[129] The continued viability of the new value exception to the absolute priority rule is necessary to achieve successful cram-down reorganizations. To confirm a plan of reorganization, a failing business, among other requisites, must provide a feasible plan. Capital infusion into a failing business is needed to ensure that the plan of reorganization is feasible. As noted in *Pullman*,[130] such an exception is necessary to carry out the legislative purpose of § 1129(b)(2)(B). When new

119. The Code provides that "[t]he 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)(ii) (1988) (emphasis added).

120. H.R. Rep. No. 598. 95th Cong., 2d Sess. 412 (1978), *reprinted in* 1978 U.S.C.C.A.N. 6368–74. *See supra* text accompanying notes 88–98.

121. *See supra* text accompanying notes 105–18.

122. NLRB v. Bildisco, 465 U.S. 513 (1984).

123. *In re* Greystone III Joint Venture, 102 B.R. 560 (Bankr. W.D. Tex. 1989). *See supra* note 73.

124. *E.g.*, *In re* Mortgage Inv. Co., 111 B.R. 604 (Bankr. W.D. Tex. 1990); *In re* Batten, 141 B.R. 899 (Bankr. W.D. La. 1992).

125. *Greystone III Joint Venture*, 102 B.R. at 573.

126. *Id.*

127. 107 B.R. 909 (Bankr. N.D. Ill. 1989).

128. *Id.* at 947.

129. The purpose of Chapter 11 Reorganizations is to allow the debtor a fresh start and to enable him to continue in business. *Id.*

130. "[T]here would be little incentive in most cases for the owners of such businesses to undergo the cost and effort of reorganization instead of liquidating and starting over." *Id.*

capital is exchanged for an interest in the reorganized debtor, the reasons for the application of the absolute priority rule are no longer present.[131]

Continued recognition of the capital infusion exception to the absolute priority rule is necessary to fulfill legislative intent for the successful implementation of Chapter 11 reorganizations.[132] Absent the exception, equity holders have no reason to invest money into otherwise perfectly viable plans of reorganization.[133] It makes no practical sense to expect a businessperson to pour money into an organization in which he cannot maintain any interest.[134] Absent the infusion of new capital, failing businesses will have no means by which to provide a feasible plan.[135]

Additionally, failure to recognize the continued application of the exception precludes utilization of the § 1129(b)(2) cram-down provision. Through § 1129(b)(2), Congress provided a means by which failing businesses can successfully reorganize even in the event that not all the creditors consent to the plan.[136] As a practical reality, where creditors are paid in full,[137] consent will prevail. Again, as a practical matter, absent the infusion of substantial new capital, debtors will be unable to fulfill the § 1129 provisions.[138] Therefore, the new value exception to the absolute priority rule must continue to be recognized to fulfill the legislative purpose advocating successful Chapter 11 reorganizations.

VII. CONCLUSION

Adopted through case law, the absolute priority rule and its new value exception were applied to business reorganizations without question until the 1978 partial codification of the rule. Subsequent to *Ahlers*,[139] lower courts have been divided as to the continued viability of the exception. Although some courts have held that the exception was extinguished in 1978, the majority of courts find that the exception still exists. The 1978 Bankruptcy Code's legislative history and its statutory language also provide support for the exception's viability.

The Supreme Court, while not explicitly addressing the issue, propounded language in *Dewsnup v. Timms* which supports the continued viability

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131. *Id.* at 944. The *Pullman* Court elaborates as follows:

> The infusion of new funds: (i) diminishes the likelihood that worthless securities will be issued, (ii) helps to insure plan feasibility, and (iii) creates an objective negotiating framework when cash is the subject of negotiations among parties to a reorganization proceeding. Holders of junior claims and interests can no longer use the threat of litigation to acquire an interest in the reorganized debtor, but instead, must exchange "money or money's worth" for that interest.

Id. at 944–45.

132. *Id.* at 947.

133. *Id.*

134. *Id.*

135. *Id.*; Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106, 117 (1939).

136. H.R. 598, 95th Cong., 2d Sess. 412 (1978), *reprinted in* 1978 U.S.C.C.A.N. 6368.

137. Pursuant to § 1129, if a creditor is paid in full, the absolute priority rule is inapplicable.

138. The cram-down provision is only applicable where there is a non-consenting impaired class. Where all classes must be paid in full, *a fortiori*, no impaired class will exist, and the cram-down provision will be rendered ineffectual.

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

of the exception.[140] Several lower courts have grasped that language to find that the 1978 Bankruptcy Code adopted the exception as well as the rule.[141]

As a practical reality, the new value exception is necessary to ensure the continued feasibility of Chapter 11 reorganizations. By allowing debtors to maintain an interest in a bankruptcy estate by infusing new capital, the Bankruptcy Courts provide the necessary incentive for debtor participation in the Bankruptcy Code.

140. *See supra* text accompanying notes 105–110.
141. *See supra* text accompanying notes 110–118.