CONTRIBUTOR

ARTICLE

United States: Confirmation Denied: Chapter 11 Plan Did Not Satisfy New Value Exception To Absolute Priority Rule Without Market Testing

05 April 2022

by Paul M. Green and Mark Douglas

Jones Day

Your **LinkedIn Connections** with the authors

When existing interest holders attempt to retain ownership of a chapter 11 debtor after confirmation of a nonconsensual plan of reorganization, the Bankruptcy Code's plan confirmation requirements, including well-established rules regarding the classification and treatment of creditor claims and equity interests, can create formidable impediments to their reorganization strategy. In *In re Platinum Corral, LLC*, 2022 WL 127431 (Bankr. E.D.N.C. Jan. 13, 2022), the U.S. Bankruptcy Court for the Eastern District of North Carolina applied the Bankruptcy Code's "cram-down" confirmation requirements in denying confirmation of a chapter 11 plan under which one of the debtor's existing equity holders would receive 100% of the new equity in the reorganized company in exchange for cancellation of a prepetition unsecured "loan" and a $100,000 cash infusion.

According to the court, one of the insiders' loan was properly characterized as a capital infusion and the plan violated the "absolute priority rule" because the old owner, whose claims were subordinate to other unsecured claims, would receive value under the plan without paying the more senior dissenting class of unsecured claims in full. The court also found that the owner's promised $100,000 cash infusion did not satisfy the "new value exception" to the absolute priority rule because the value of the new equity to be distributed to him under the plan had not been market tested.

Classification of Claims and Interests Under a Chapter 11 Plan

Section 1122 of the Bankruptcy Code provides that, except with respect to a class of "administrative convenience" claims (i.e., relatively small unsecured claims, such as trade claims below a certain dollar amount), a plan may place a claim or interest in a particular class "only if such claim or interest is substantially similar to the other claims or interests of such class." The Bankruptcy Code, however, does not define "substantially similar." This task was left to the courts, relying upon past practice under the former Bankruptcy Act and lawmakers' statements in connection with the enactment of the Bankruptcy Code indicating that the term should be construed to mean similar in legal character or effect as a claim against the debtor's assets or as an interest in the debtor. *See generally* Collier on Bankruptcy ("Collier") ¶ 1122.03[1] (16th ed. 2022). Thus, interests, such as stock, may not be classified together with claims, such as trade or bond debt, because the relationship between the debtor and its creditors, who assume credit risk but not enterprise risk, is fundamentally different from the relationship between the debtor and its stockholders, who do shoulder enterprise risk as investors.

In passing on the propriety of a plan's claims-classification scheme, courts generally examine the nature of the claim (e.g., senior or subordinated, secured or unsecured) and the relationship of the claim to the debtor's property. For example, secured claims must be classified separately from unsecured claims, and priority claims should not be placed in the same class as general unsecured claims. *Id.*

Although the Bankruptcy Code provides that only substantially similar claims may be classified together, it does not require that all substantially similar claims be placed into a single class. Instead, substantially similar claims may be divided into separate classes if separate classification is reasonable. *Id.*

A classification scheme designed to fabricate an accepting impaired class under section 1129(a)(10) is sometimes referred to as class "gerrymandering." The practice can involve, among other things: (i) classification of claims whose holders are favorable to a plan in the same class with the claims of creditors who are not, with the expectation that supporting claims will sufficiently outnumber dissenting claims to ensure acceptance of the plan by the class as a whole; or (ii) separately classifying the claims of dissenting creditors from the claims of creditors favorable to the plan to ensure that the dissenting creditors cannot defeat cram-down confirmation

The latter form of gerrymandering has arisen almost exclusively in single-asset real estate cases, where the plan proponent attempts to classify the mortgagee's unsecured deficiency claim separate from the claims of other unsecured creditors. That practice has been invalidated by a majority of the circuit courts of appeals that have faced the issue. *See id.* at ¶ 1122.03[5].

Recharacterization

The power to treat a debt as if it were actually an equity interest is derived from principles of equity. It emanates from the bankruptcy court's power to ignore the form of a transaction and give effect to its substance. *See Pepper v. Litton*, 308 U.S. 295, 305 (1939). However, because the Bankruptcy Code does not expressly empower a bankruptcy court to recharacterize debt as equity, some courts disagree as to whether they have the authority to do so and, if so, the source of such authority.

Every circuit court of appeals that has considered the issue has upheld the power of a bankruptcy court to recharacterize a claim as equity, notwithstanding the parties' characterization of a prepetition advance as a "debt." *See generally* Collier at ¶ 510.02 (citing cases). Some circuits have held that a bankruptcy court's power to recharacterize derives from the broad equitable powers set forth in section 105(a) of the Bankruptcy Code, which provides that "[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code]." *See In re Dornier Aviation (N. Am.), Inc.*, 453 F.3d 225 (4th Cir. 2006); *In re SubMicron Sys. Corp.*, 432 F.3d 448 (3d Cir. 2006); *In re Hedged-Invs. Assocs., Inc.*, 380 F.3d 1292 (10th Cir. 2004); *In re AutoStyle Plastics, Inc.*, 269 F.3d 726 (6th Cir. 2001). In *Hedged Investments*, the Tenth Circuit explained that, if courts were bound by the parties' own characterization of a transaction, "controlling equity owners of a troubled corporation could jump the line of the bankruptcy process and thwart the company's outside creditors' and investors' priority rights." *Hedged Investments*, 380 F.3d at 1298.

The Fifth and Ninth Circuits have taken a different approach, holding instead that section 502(b)(1) of the Bankruptcy Code, which provides in relevant part that "the court ... shall allow [a] claim ... except to the extent that ... such claim is unenforceable against the debtor and property of the debtor, under any agreement or applicable law," is the proper statutory authority for recharacterization. *See In re Lothian Oil Inc.*, 650 F.3d 539 (5th Cir. 2011); *In re Fitness Holdings Int'l, Inc.*, 714 F.3d 1141 (9th Cir. 2013).

The Eleventh Circuit has also recognized the legitimacy of the remedy, but without specifying the source of the court's power to exercise it. *See In re N & D Props., Inc.*, 799 F.2d 726, 733 (11th Cir. 1986) (noting that shareholder loans may be deemed capital contributions "where the trustee proves initial under-capitalization or where the trustee proves that the loans were made when no other disinterested lender would have extended credit"). In *In re Airadigm Communs.*, Inc., 616 F.3d 642, 653 (7th Cir. 2010), the Seventh Circuit declined to decide whether recharacterization of a debt was appropriate (although the bankruptcy court concluded below that it did not have the power to do so), but noted that the "overwhelming weight of authority" supports the authority of bankruptcy courts to recharacterize loans as equity.

In *AutoStyle*, the Sixth Circuit applied an 11-factor test derived from federal tax law. Among the enumerated factors are the labels given to the alleged debt; the presence or absence of a fixed maturity date, interest rate, and schedule of payments; whether the borrower is adequately capitalized; any identity of interest between the creditor and the stockholder; whether the loan is secured; and the corporation's ability to obtain financing from outside lending institutions. This and similar tests have been adopted by many other courts. *See, e.g., Dornier Aviation*, 453 F.3d at 233 (applying *AutoStyle* factors); *SubMicron Sys. Corp.*, 432 F.3d 448 (seven-factor test); *Hedged Investments*, 380 F.3d at 1298 (13-factor test); *N & D Props*, 799 F.2d at 733 (two-factor test); *In re Transcare Corp.*, 2020 WL 8021060, *37 (Bankr. S.D.N.Y. July 6, 2020) (noting that "[c]ourts in this District have adopted the eleven-factor analysis set forth in *AutoStyle*"). Under the *AutoStyle* test, no single factor is controlling. Instead, each factor is to be considered in light of the particular circumstances of the case.

In *Lothian Oil* and *Fitness Holdings*, the Fifth and Ninth Circuits respectively ruled that state law should determine whether a debt should be recharacterized as equity. *Lothian Oil*, 650 F.3d at 543-44; *Fitness Holdings*, 714 F.3d at 1148.

Cram-Down Chapter 11 Plans

If a class of creditors or shareholders votes to reject a chapter 11 plan, it can be confirmed only if the plan satisfies the "cram-down" requirements of section 1129(b) of the Bankruptcy Code. Among those requirements are the mandates that, with respect to dissenting classes of creditors and shareholders: (i) the plan must be "fair and equitable"; and (ii) the plan must not "discriminate unfairly." 11 U.S.C. § 1129(b)(1).

Fair and Equitable. Section 1129(b)(2)(B) of the Bankruptcy Code provides that a plan is "fair and equitable" with respect to a dissenting impaired class of unsecured claims if the creditors in the class receive or retain property of a value equal to the allowed amount of their claims or, failing that, in cases not involving an individual debtor, if no creditor or equity holder of lesser priority receives or retains any distribution under the plan "on account of" its junior claim or interest. This requirement is sometimes referred to as the "absolute priority rule."

The New Value Exception to the Absolute Priority Rule. A "new value exception" to the "fair and equitable" requirement set forth in section 1129(b)(2)(B) was developed under pre-Bankruptcy Code law. *See Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106 (1939). Under this new value exception to the absolute priority rule, a junior stakeholder (e.g., a shareholder or subordinated creditor) could retain an equity interest under a chapter 11 plan over the objection of a senior impaired-creditor class, provided that the junior stakeholder contributed new capital to the restructured enterprise. According to some courts, that contributed capital must be: (i) new; (ii) substantial; (iii) necessary for the success of the plan; (iv) reasonably equivalent to the value retained; and (v) in the form of money or money's worth. *See, e.g., In re Crowe*, 2021 WL 2212005 (Bankr. D. Ariz. June 1, 2021).

In *In re Bonner Mall Partnership*, 2 F.3d 899 (9th Cir. 1993), *motion to vacate denied, case dismissed sub nom. U.S. Bancorp Mortg. Co. v. Bonner Mall Partnership*, 513 U.S. 18 (1994), the Ninth Circuit held that "if a proposed plan satisfies all of these [five] requirements, i.e., the new value exception, it will not violate section 1129(b)(2)(B)(ii) of the Code and the absolute priority rule." Such a plan, the court wrote, "will not give old equity property 'on account of' prior interests, but instead will allow the former owners to participate in the reorganized debtor on account of a substantial, necessary, and fair new value contribution."

Courts disagree as to whether the new value exception survived the enactment of the Bankruptcy Code in 1978, principally because the concept is not explicitly referred to in section 1129(b)(2) or elsewhere in the statute. *See generally* Collier at ¶ 1129.03[4](c) ("One of the more hotly contested issues after adoption of the Code has been whether the so-called "new value" cases continued to have validity. The Supreme Court has three times declined to rule on the matter, and the circuit courts are currently in disarray. Other appellate courts tend to favor the doctrine's existence, but some are unsure. Each side has arguments to make.") (footnotes omitted).

Since the enactment of the Bankruptcy Code, the U.S. Supreme Court has only obliquely addressed the legitimacy of the new value exception. In *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988), the court held that, even if the new value exception survived the enactment of the Bankruptcy Code, the new value requirement could not be satisfied by promised future contributions of labor. The Court was similarly reluctant to tackle the issue head-on in the other two cases to date in which it had an opportunity to do so. In 1994, the Court declined to vacate on appeal the Ninth Circuit's *Bonner Mall* opinion, and in 1999, it similarly declined to overrule the Seventh Circuit's interpretation of the corollary in *Bank of Am. Nat. Tr. & Sav. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434 (1999). Instead, in *LaSalle*, the Court held that one or two of the five elements of the new value corollary could not be satisfied when old equity retains the exclusive right to contribute the

new value—i.e., without a market test of the new value.

"It is enough to say, assuming a new value corollary," the Court wrote in *LaSalle*, "that plans providing junior interest holders with exclusive opportunities free from competition and without benefit of market valuation fall within the prohibition of § 1129(b)(2)(B)(ii)." According to the Court, the absolute priority rule is violated if a plan provides for "vesting equity in the reorganized business in the Debtor's partners without extending an opportunity to anyone else either to compete for that equity or to propose a competing reorganization plan."

No Unfair Discrimination. The Bankruptcy Code does not define "unfair discrimination," and "[c]ourts have struggled to give the unfair discrimination test an objective standard." Collier at ¶ 1129.03[a]. Nevertheless, most courts agree that the purpose underlying the requirement is "to ensure that a dissenting class will receive relative value equal to the value given to all other similarly situated classes." *In re LightSquared Inc.*, 513 B.R. 56, 99 (Bankr. S.D.N.Y. 2014); *accord In re SunEdison, Inc.*, 575 B.R. 220 (Bankr. S.D.N.Y. 2017); *In re 20 Bayard Views, LLC*, 445 B.R. 83 (Bankr. E.D.N.Y. 2011); *In re Johns-Manville Corp.*, 68 B.R. 618, 636 (Bankr. S.D.N.Y. 1986), *aff'd*, 78 B.R. 407 (S.D.N.Y. 1987), *aff'd*, 843 F.2d 636 (2d Cir. 1988).

Courts have historically relied on a number of tests to determine whether a plan discriminates unfairly. These include: (i) the "mechanical" test, which prohibits all discrimination and requires that the recoveries of similarly situated creditors be identical; (ii) the "restrictive" approach, which narrowly defines unfair discrimination to mean that, absent subordination, disparate treatment of similarly situated creditors is not permitted; and (iii) the "broad" approach, which considers whether (a) a reasonable basis for discrimination exists, (b) the debtor can consummate a plan without discrimination, (c) the discrimination is proposed in good faith, and (d) the extent of discrimination is directly proportional to its rationale. *See generally* Denise R. Polivy, *Unfair Discrimination in Chapter 11: A Comprehensive Compilation of Current Case Law*, 72 Am. Bankr. L.J. 191, 196-208 (1998) (discussing cases applying the various tests).

Several courts have adopted some form of the unfair discrimination test ("Markell test") articulated by Bruce A. Markell in his article *A New Perspective on Unfair Discrimination in Chapter 11*, 72 Am. Bankr. L.J. 227, 249 (1998). *See, e.g.*, *In re Armstrong World Indus., Inc.*, 348 B.R. 111 (D. Del. 2006); *In re Quay Corp., Inc.*, 372 B.R. 378 (Bankr. N.D. Ill. 2007); *In re Exide Techs.*, 303 B.R. 48 (Bankr. D. Del. 2003). The Markell test was first applied by a bankruptcy court in *In re Dow Corning Corp.*, 244 B.R. 705 (Bankr. E.D. Mich. 1999), *aff'd in relevant part*, 255 B.R. 445 (E.D. Mich. 2000), *aff'd in part and remanded*, 280 F.3d 648 (6th Cir. 2002). Under the Markell test, a rebuttable presumption that a plan unfairly discriminates will arise when the following elements exist:

(1) a dissenting class; (2) another class of the same priority; and (3) a difference in the plan's treatment of the two classes that results in either (a) a materially lower percentage recovery for the dissenting class (measured in terms of the net present value of all payments), or (b) regardless of percentage recovery, an allocation under the plan of materially greater risk to the dissenting class in connection with its proposed distribution.

Id. at 710. The burden then lies with the plan proponent to rebut the presumption by demonstrating that "outside of bankruptcy, the dissenting class would similarly receive less than the class receiving a greater recovery, or that the alleged preferred class had infused new value into the reorganization which offset its gain." *Id.*

Platinum Corral

Platinum Corral, L.L.C. ("PCL") is a Golden Corral restaurant franchise headquartered in North Carolina. At the time it filed for bankruptcy in 2021, PCL's two members were its CEO and president, L. William Sewell, III ("Sewell"), who held an 87.5% ownership interest, and John Pierce, who owned the remaining interests.

Beginning in 2014, PCL faced a significant cash crunch and needed to obtain financing to meet operating expenses. Sewell made a series of loans to the company from 2014 to 2017 aggregating approximately $11 million. The proceeds were used to pay PCL's operating expenses as well as payroll, sales, and property taxes. Other former members of PCL also made loans to PCL during this period, all of which were repaid in full.

In 2018, PCL and Sewell entered into a formal loan agreement to refinance the various loans made by Sewell. The debt was evidenced by an unsecured payable-on-demand promissory note (together with all renewals, "Note 1") dated December 31, 2017, in the principal amount of $10.975 million with interest accruing (but not payable until called) at 6% per annum. Each year thereafter, PCL executed a renewal note to reflect the year-end updated loan balance after deducting payments made during the previous year and adding unpaid accrued interest.

In December 2017, PCL refinanced a portion of its $17.1 million debt to third-party lenders by obtaining $16.2 million in secured financing from Pacific Premier Bank ("PPB"). After no third-party lender was willing to loan the additional funds needed to refinance the remainder of PCL's debt, Sewell provided the company with $900,000, which was evidenced by a second unsecured payable-on-demand promissory note dated January 2, 2018 (together with all renewals, "Note 2"), accruing interest at the rate of 6% per annum. Like Note 1, Note 2 was renewed at the end of each year to reflect the outstanding loan balance. Both Note 1 and Note 2 were reflected in PCL's books and records as "loans."

PCL filed for chapter 11 protection on April 20, 2021, in the Eastern District of North Carolina. Sewell filed separate unsecured claims based on Note 1 ($13,767,050) and Note 2 ($910,283).

PCL proposed a chapter 11 plan that included 13 classes of claims and interests. Class 11 contained unsecured claims consisting of trade debt and contract rejection damages claims, which were estimated to be $6.5 million. The plan proposed to distribute $1.2 million to the creditors in the class over five years. Sewell's claims based on Note 1 and Note 2, which were subordinated to the claims of all other creditors, were placed in a separate class (Class 12). The plan provided that the Class 12 claims would be deemed satisfied upon plan confirmation by the issuance of 100% of the equity in the reorganized company to Sewell in exchange for Sewell's agreement to provide $100,000 in new capital. Certain other unsecured claims, including claims under PCL's Golden Corral franchise agreement and its food service distribution agreement, and PPB's unsecured deficiency claim, were placed into Classes 4, 8, and 9. PCL's old equity (Class 13) would be canceled under the plan.

Only Class 11 voted to reject the plan.

PCL's unsecured creditors' committee objected to confirmation of the plan. Among other things, the committee argued that: (i) by giving value to Class 12 without paying Class 11 creditors in full, the plan violated the absolute priority rule and was therefore not "fair and equitable"; (ii) the $100,000 payment promised by Sewell did not satisfy the new value exception in the absence of a market test of PCL's value as a going concern; (iii) the plan unfairly discriminated against the Class 11 creditors; and (iv) Sewell's claims based on

concern, (iii) the plan unfairly discriminated against the Class 11 creditors, and (iv) Sewell's claims based on Note 1 and Note 2 should be recharacterized as capital contributions.

The Bankruptcy Court's Ruling

The bankruptcy court denied confirmation of PCL's chapter 11 plan.

Applying the *AutoStyle* factors (as approved by the Fourth Circuit in *Dornier Aviation*), U.S. Bankruptcy Judge Joseph N. Callaway ruled that Note 1 was properly classified as a claim, but that Note 2 should be recharacterized as equity. Among other things, he found that, although both obligations were labeled "promissory notes," bore interest, and were payable upon demand, the loans evidenced by Note 1 were made at a time when PCL had other available sources of funding and the loan proceeds were used to pay operating expenses, indicating that the Note 1 obligation was a bona fide loan. According to Judge Callaway, "virtually nothing indicates Note 1 would not be legally enforceable as a matter of law in a state court collection action." *Platinum Corral*, 2022 WL 127431, at *7.

By contrast, Judge Callaway explained, the Note 2 loan was made by Sewell so that PPB could receive a first lien on all of PCL's assets to secure new financing, and the Note 2 loan proceeds were used to refinance operating debt when no third-party lender was willing to make a loan to PCL, given the lack of any encumbered assets to secure financing. "The use of funds to pay off a loan secured by the Debtor's assets," he wrote, "is a capital contribution." *Id.* Judge Callaway accordingly ruled that Sewell had an allowed unsecured claim based on Note 1 in the amount of approximately $13.7 million, but Sewell's claims based on Note 2 would be recharacterized as equity.

Judge Callaway then examined whether separate classification of the unsecured Note 1 claim (Class 12) and unsecured trade and contract rejection claims (Class 11) was permissible. He ruled that it was, finding that the primary purpose behind the split was not to manipulate class voting by manufacturing an accepting impaired class (gerrymandering). In particular, Judge Callaway explained, there were "ample business plan reasons to divide non-insider trade debt and insider note debt," and the unsecured claim division was made in good faith. *Id.* at *9. Moreover, he noted, classifying all unsecured claims together and giving the same treatment to all creditors in the class would be problematic because: (i) creditor recoveries in an "all-encompassing unsecured class" would be reduced drastically; and (ii) unsecured creditors other than Sewell neither wanted to hold equity in the reorganized company, nor were they eligible to do so, because Golden Corral had the right to determine who could become a member of a franchise company.

However, because PCL's plan proposed to distribute new equity to Class 12—containing the recharacterized Note 2 claim—but did not pay in full the claims in dissenting Class 11, Judge Callaway held that the plan violated the absolute priority rule. He also noted that the new member interests to be issued to insider Sewell, to the exclusion of any other stakeholder, were a potentially valuable property right (projected to be worth approximately $2.8 million) if PCL returned to pre-pandemic profitability levels during the five years after plan confirmation.

Judge Callaway next ruled that Sewell's $100,000 cash contribution in exchange for the new equity interests did not satisfy the new value exception. He explained that: (i) the testimony of PCL's financial expert that the new equity was worthless was unconvincing; and (ii) there was inadequate evidence to establish the reorganized company's value as a going concern without conducting the market valuation test mandated by the Supreme Court's ruling in *LaSalle*.

Judge Callaway noted that the market test can be waived. Waiver might be warranted, for example, if plan exclusivity had expired or a marketing effort would be futile because there were no other eligible buyers or if eligible purchasers declined to bid. Judge Calloway also acknowledged that Sewell might be the best (or even the only) candidate to guide reorganized PCL into a successful future. However, without any evidence of futility or the absence of qualified bidders, he determined that the plan could not be confirmed.

Finally, Judge Calloway found that PCL's chapter 11 plan was not fair and equitable to creditors in dissenting Class 11 because Sewell (the sole Class 12 creditor) would receive all of the upside potential after confirmation if PCL's retained earnings projections were met or exceeded.

He accordingly denied confirmation of PCL's plan and directed the company to file an amended plan remedying the defects.

Outlook

Platinum Corral illustrates some of the difficulties associated with successfully reorganizing closely held businesses in chapter 11. Frequently, the only stakeholders willing and able to continue operating the reorganized business are its existing owners, without whom both secured and unsecured creditors are likely to realize far less recovery on their claims. In many such chapter 11 cases, a pre-bankruptcy owner's efforts to retain control of a debtor that cannot pay its creditors in full are frequently thwarted by the Bankruptcy Code's cram-down confirmation requirements, especially where creditor payouts are meager and any new capital infusion is deemed inadequate. This is precisely what happened in *Platinum Corral*.

Interestingly, the debtor in *Platinum Corral* was not eligible to file for bankruptcy as a "small business debtor" under subchapter V of chapter 11 because its secured and unsecured debts exceeded $7.5 million (*see* 11 U.S.C. §§ 101(51)(D) and 1181(a) (as temporarily amended by the CARES Act of 2002 and the Bankruptcy Relief Extension Act of 2021)). Had it qualified as a small business debtor under subchapter V, neither the absolute priority rule nor the remainder of section 1129(b) of the Bankruptcy Code would have applied to PCL's chapter 11 plan. *See* 11 U.S.C. § 1181(a). Although subchapter V provides that a nonconsensual plan must not discriminate unfairly and must be fair and equitable with respect to dissenting classes, the definition of "fair and equitable" in subchapter V does not include the absolute priority rule. *See* 11 U.S.C. § 1191.

The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.

AUTHOR(S)

Paul M. Green
Jones Day

Mark Douglas
Jones Day

© Mondaq® Ltd 1994 - 2022. All Rights Reserved.