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## Considerations for Private Equity Firms When Utilizing Chapter 11 New Value Deals

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## NOTE

### CONSIDERATIONS FOR PRIVATE EQUITY FIRMS WHEN UTILIZING CHAPTER 11 NEW VALUE DEALS

*Alexandra Wilde\**

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#### I. INTRODUCTION

The new value exception<sup>1</sup> to the Chapter 11 absolute priority rule provides a narrow avenue for equity holders to retain an equity interest in a reorganized company over the objections of senior creditors and interest holders. With the increasing number of Chapter 11 reorganization filings by private equity owned companies,<sup>2</sup> private equity firms may be interested in exploring ways to retain their equity ownership in the debtor company. This Note explores the unique implications a private equity firm may encounter when attempting to utilize the new value exception as a last resort to maintain ownership in a debtor company.

Part II of this Note briefly explains how the absolute priority rule functions. Furthermore, this section discusses the case law development of the new value exception. Part III then analyzes the particular challenges and considerations a private equity firm may face when attempting to meet each of the new value exception requirements. Ultimately, this section demonstrates that private equity firms hold a unique position among debtor-reorganized companies, which may aid them in obtaining new equity ownership through the new value exception. Part IV therefore concludes that private equity firms may be able to take advantage of this exception, but they must tread cautiously in light of an absence of case law guidance and the ambiguous legislation surrounding the new value exception.

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1. Note that the new value exception is sometimes also referred to as the new value corollary. For purposes of consistency, this Note will use the term “new value exception” and will reference plans that employ the new value exception as “new value plans.”

2. For a discussion on the increase in the number of Chapter 11 filings, see Ed Flynn & Thomas C. Kearns, *Filing Trends in Bankruptcy, 2007-11*, AM. BANKR. INST. J., NOV. 12, 2011, at 72 (noting that there has been a 115.9% increase in Chapter 11 filings from 2007 to 2010).

## II. INTRODUCTION TO THE NEW VALUE EXCEPTION

To understand how the new value exception functions, it is first important to understand the basic underpinnings behind the absolute priority rule.<sup>3</sup> When a company files for Chapter 11, the company will put forth a plan to reorganize and continue to operate the company as the Debtor in Possession (“DIP”).<sup>4</sup> The DIP will work with creditors to hopefully confirm a plan that is acceptable to all parties involved.<sup>5</sup> Due to the realistic limitations of reorganizing debtors, creditors will often accept less than the full amount they are owed.<sup>6</sup> However, during the confirmation process of a Chapter 11 reorganization plan, creditors have the right to object to a proposed plan and thereby trigger the absolute priority rule.<sup>7</sup> The Bankruptcy Act requires that a creditor’s objection to a proposed plan be upheld if the plan unfairly discriminates or is not “fair and equitable” to each dissenting creditor class impaired by the proposed plan.<sup>8</sup> If a proposed plan does not allow creditors’ claims to be paid in full or if it prevents junior interests from receiving or retaining property, then the plan will be deemed neither fair nor equitable.<sup>9</sup> Therefore, the absolute priority rule generally provides that no junior creditors or interest holders may retain any interest in an indebted company prior to payment in full of senior creditor claims. Thus, for a proposed plan to be permissible under the absolute priority rule, creditor claims must be paid off in full in order of their priority status.<sup>10</sup>

When senior creditors are unwilling to accept less than the full amount they are owed, however, the new value exception to the absolute priority

3. The absolute priority rule is governed by 11 U.S.C. § 1129(b)(2)(B)(ii) (2011).

4. For additional explanation of the Chapter 11 process, see generally Lawrence P. King, *Chapter 11 of the 1978 Bankruptcy Code*, 53 AM. BANKR. L.J. 107, 110 (1979).

5. *Id.*

6. General unsecured creditors are the last in line to be paid out during bankruptcy. See 11 U.S.C. § 507 (2011). As such, they must attempt to recoup expenses and claims from what remains leftover after higher priority creditors have already collected from the debtor.

7. See 11 U.S.C. § 1129(b) (2011). This section of the Bankruptcy Act of 1978 allows creditors to object to a proposed plan and for the plan’s proponent to then “cramdown” the plan on the dissenting creditors. *Id.* As discussed below, see discussion *infra* Section III, to obtain plan confirmation, the plan proponent must have at least one impaired creditor class approve the plan, must satisfy the requirements of 11 U.S.C 1129(a) of the Bankruptcy Code save for subsection eight, must not discriminate unfairly among the impaired creditor classes and must be fair and equitable to all of the rejecting creditor classes. *Id.*

8. 11 U.S.C. § 1129(b)(1) (2011).

9. 11 U.S.C. § 1129(b)(2)(B)(i)-(ii) (2011).

10. See *Beal Bank, S.S.B. v. Waters Edge Ltd. P’ship*, 248 B.R. 668, 678 (D. Mass. 2000) (“As to a dissenting class of impaired unsecured creditors, a plan may be found to be ‘fair and equitable’ only if the allowed value of the claim is to be paid in full, . . . § 1129(b)(2)(i), or in the alternative, if the claim is not paid in full, no junior class may receive any interest in the property, . . . § 1129(b)(2)(B)(ii).”). For further discussion on settlement of creditors during Chapter 11, see John D. Ayer et al., *What Every Unsecured Creditor Should Know About Chapter 11*, AM. BANKR. INST. J., June 1, 2004, at 5.

rule provides a solution<sup>11</sup> for equity owners who want to retain full ownership of a debtor company. The new value exception allows equity owners to contribute new value into the debtor during reorganization.<sup>12</sup> While the new value exception is not explicitly stated in the Bankruptcy Code, it arose out of case law in 1938, and its existence has since been highly debated.<sup>13</sup>

The Supreme Court initially acknowledged the new value exception's potential existence in *Case v. Los Angeles Lumber Products Co.*<sup>14</sup> when it stated in dicta that “[c]ircumstances may exist where the success of an undertaking requires that new money be furnished and where the former stockholders are the only or most feasible source of the new capital.”<sup>15</sup> The Court thus implied that equity holders might be able to retain their interest in the reorganized company, even when a senior creditor has not been paid in full, if the equity holders contribute new value necessary to a successful reorganization.<sup>16</sup> When the Bankruptcy Act was subsequently enacted in 1978, it made no explicit mention of the new value exception.<sup>17</sup> Over the years, a circuit split arose<sup>18</sup> as to whether the new value exception existed and, if so, how to determine whether a proposed plan qualified for the new value exception.<sup>19</sup>

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11. Beyond the new value exception, the Bankruptcy Act of 1978 also allows for an affirmative vote by impaired creditors to approve a proposed plan to which a class of creditors objects. For further explanation of the affirmative vote and why it may not always suffice to overcome creditor objections, see Nicholas L. Georgakopoulos, *New Value, Fresh Start*, 3 STAN. J.L. BUS. & FIN. 125, 133-34 (1997).

12. The new value contributed must be (1) new, (2) substantial, (3) reasonably equivalent to the interest received, (4) money or money's worth, and (5) necessary for the reorganization to be successful. *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106, 121-22 (1939). These requirements are more fully discussed below. See discussion *infra* Part III. Importantly, recent case law also mandates that new value plans must not grant the prior equity owners with the exclusive opportunity to acquire the debtor company. *Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 454 (1999).

13. For an example of some of the early split circuit decisions compare *In re Walden-green Assocs., Ltd.*, 150 B.R. 468, 470 (Bankr. M.D. Fla. 1993) (suggesting no existence of new value exception), with *In re Bonner Mall P'ship*, 2 F.3d 899, 918 (9th Cir. 1993) (holding viability of new value plans).

14. 308 U.S. 106, 106 (1939).

15. *Id.* at 121 n.15 (citing *In re Dutch Woodcraft Shops*, 14 F. Supp. 467, 471 (W.D. Mich. 1935)).

16. See Georgakopoulos, *supra* note 12, at 130-32.

17. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978).

18. Compare *In re Bonner Mall P'ship*, 2 F.3d 899, 916 (9th Cir. 1993) (supporting the use of the new value exception), with *In re Coltex Loop Cent. Three Partners, L.P.*, 138 F.3d 39, 43 (2d Cir. 1998) (denying confirmation of a plan based on the use of the new value exception), and *In re Bryson Props.*, XVIII, 961 F.2d 496, 504 (4th Cir. 1992).

19. In 1988, the Supreme Court had another opportunity to address the validity of the new value exception following the enactment of the modern day Bankruptcy Act in *Norwest Bank Worthington v. Ahlers*. *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 203 (1988). *Ahlers* involved two farmers who filed for Chapter 11 attempting to utilize the new value exception using future labor and management expertise as the contributed new value. *Id.* at

In 1999, the Supreme Court again had the opportunity to address whether the new value exception survived the Bankruptcy Act of 1978 in *Bank of America National Trust & Savings Ass'n v. 203 N. LaSalle Street Partnership*.<sup>20</sup> The Court noted that, while the Bankruptcy Code did not explicitly state a new value exception, the statutory text was vague enough to possibly allow for this exception.<sup>21</sup> Thus, the Court neither affirmatively confirmed nor denied the existence of the new value exception.<sup>22</sup> Although the Court suggested the new value exception survived the Bankruptcy Act of 1978 and imposed an additional market test requirement, it seems that *203 N. LaSalle* left open more questions than it resolved.<sup>23</sup> In light of the *203 N. LaSalle* decision, a number of courts have operated under the assumption that the new value exception does exist and have continued to apply the new value exception in appropriate instances.<sup>24</sup>

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197. However, the Court declined this opportunity and instead focused on the more narrow issue involving labor and management expertise. *Id.* at 203. The Court ruled that the proposed new value of labor and management expertise was simply not “money or money’s worth” as meant by any potential new value exception. *Id.* at 204-05. While the Court did not explicitly state whether the new value exception existed, its opinion suggested that the new value exception implied in *Case* might still be valid. *Id.* at 205. Thus, *Ahlers* left open the question of whether the new value exception survived the enactment of the Bankruptcy Act of 1978. For more discussion on *Ahlers*, see John D. Ayer, *Rethinking Absolute Priority After Ahlers*, 87 MICH. L. REV. 963, 965 (1989).

20. 526 U.S. 434, 434 (1999).

21. *Id.* at 449 (“The upshot is that this history does nothing to disparage the possibility apparent in the statutory text, that the absolute priority rule now on the books as subsection (b)(2)(B)(ii) may carry a new value corollary. Although there is no literal reference to ‘new value’ in the phrase ‘on account of such junior claim,’ the phrase could arguably carry such an implication in modifying the prohibition against receipt by junior claimants of any interest under a plan while a senior class of unconsenting creditors goes less than fully paid.”).

22. As discussed further below, the Court did impose additional restrictions on the use of any potential new value exception, including a market valuation test and not allowing the old equity owner to have the exclusive opportunity to obtain equity in the reorganized debtor. *203 N. LaSalle*, 526 U.S. at 456, 458.

23. For more discussion about the confusion created by the decision in *203 N. LaSalle*, see Alexander F. Watson, *Left for Dead?: The Supreme Court’s Treatment of the New Value Exception in Bank of America National Trust & Savings Association v. 203 North LaSalle Street Partnership*, 78 N.C.L. REV. 1190, 1194 (2000); see also Harvey R. Miller et al., *Leaving Old Questions Unanswered and Raising New Ones: The Supreme Court Furthers the New Value Controversy in Bank of America National Trust & Savings Ass’n v. 203 North LaSalle Street Partnership*, 30 U. MEM. L. REV. 553, 581 (2000).

24. See, e.g., *In re Trikeenan Tileworks, Inc.*, Nos. 10-13725-JMD, 10-13726-JMD, 10-13727-JMD, 2011 WL 2898955, at \*4 (Bankr. D.N.H. July 14, 2011) (analyzing a new value plan under the assumption of the new value exception’s existence); *In re 68 West 127 St., LLC*, 285 B.R. 838, 848 (Bankr. S.D.N.Y. 2002) (stating that new value plans, while not outright endorsed in *203 N. LaSalle*, still carried considerable validity and that the debtor therefore had the right to make the case for its plans that used the new value exception); *In re Situation Mgmt. Sys.*, 252 B.R. 859, 860 (Bankr. D. Mass. 2000) (allowing a debtor to employ a new value plan but terminating its exclusivity period). For additional discussion on cases confirming new value plans post *203 N. LaSalle*, see Georgakopoulos, *supra* note 12, at 137-44. Further, the amendments imposed on Chapter 11 by the Bankruptcy Abuse Consumer and Protection Act (“BAPCPA”) provide an exception for individual debtors under 11

### III. HOW PRIVATE EQUITY FIRMS CAN MAKE USE OF THE NEW VALUE EXCEPTION

Even in circuits that support the new value exception, confirmation of a plan that employs the new value exception is difficult to obtain.<sup>25</sup> There are stringent requirements imposed on what constitutes an acceptable form of contribution from a former equity holder wishing to qualify for the new value exception. The contribution must be 1) “new”; 2) “substantial”; 3) “reasonably equivalent to the interest received”; 4) “money or money’s worth”; and 5) “necessary” for the reorganization to be successful.<sup>26</sup>

Plans utilizing the new value exception are most commonly employed in single-asset real estate cases where the mortgage debt is in excess of the real property’s value.<sup>27</sup> Recently, however, at least one private equity firm has successfully employed the new value exception to obtain control of a reorganized debtor.<sup>28</sup> Private equity firms that hold an equity interest in a reorganized debtor and are interested in utilizing the new value exception may face several obstacles, as their holdings typically involve more complicated facts and creditor schemes than single-asset real estate cases. Thus, while it is possible for private equity firms to receive plan confirmation using the new value exception, there are difficulties private equity firms should consider.

The greatest hurdle likely to be encountered by private equity firms seeking to file for the new value exception is the lack of guidance regarding which standard should be applied for several of the exception’s requirements. It seems that some of these requirements, such as the

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U.S.C. § 1129(b)(2)(B)(ii). BAPCPA allows individual debtors to retain property even if an unsecured creditor class receives less than the full amount of their claims.

25. A 1996 article focused on a narrow sample of proposed new value plans suggested that, although proposed new value plans increased from 1986 to 1996, only a small fraction of them were actually confirmed. See Georgakopoulos, *supra* note 12, at 137-39.

26. *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106, 121-22 (1939). Note that *Case* originally only named three of these principles: that the contribution be new, reasonably equivalent to the interest received, and necessary for the reorganization’s success. *Id.* However, many jurisdictions have also adopted the substantial and money or money’s worth requirements as well. See, e.g., *In re A & F Elec. Co.*, No. 07-01377, 2007 WL 5582063, at \*11 (Bankr. M.D. Tenn. Aug. 22, 2007) (analyzing a new value plan using all five requirements); *In re Sovereign Group 1985-27, Ltd.*, 142 B.R. 702, 708-10 (Bankr. E.D. Pa. 1992) (employing all five requirements in the court’s analysis of the proposed plan).

27. See, e.g., *Single Asset Proposals*, NAT’L BANKR. REV. COMMISSION, available at <http://govinfo.library.unt.edu/nbrcreport/16sare.html> (last visited April 6, 2012).

28. Kenner & Co.’s acquisition of Atrium Corp. through Chapter 11 provides a recent example. Kenner & Co. was the existing equity holder of Atrium and partnered with a second private equity firm, Golden Gate Private Equity, Inc., where both private equity firms contributed \$169.2 million in new equity in exchange for 92.5% of stock in Atrium’s reorganized entity. For a firm release, see *Kenner & Co., Inc. in its Acquisition of Atrium Corp. through a Chapter 11 Reorganization Plan*, HUGHES HUBBARD, available at <http://www.hugheshubbard.com/Representation-of-Kenner—Co-Inc-in-its-acquisition-of-Atrium-Corp-through-a-Chapter-11-reorganization-plan> (last visited April 6, 2012). The proposed plan was confirmed by the United States Bankruptcy Court for the District of Delaware. *Id.*

requirement that the contributed new value must be “new” and essentially a present contribution paid to purchase old equity, are rather straightforward. However, as discussed below, other requirements do not have clear, bright-line standards and therefore require more thorough analyses.

### A. *The Contribution Must Be Substantial*

Whether a private equity firm fulfills the second requirement that the contribution be substantial will vary based on the individual circumstances of each case. For this requirement, bankruptcy courts typically look to two or more of the following factors:

the size of the contribution; its relation to the amount of unsecured claims against the estate; its relation to the plan’s distribution to unsecured creditors; its relation to the amount of pre-petition claims; its relation to a normal market contribution; and the amount of debt to be discharged.<sup>29</sup>

Thus, this requirement attempts to prevent new value contributions from exceeding the value of the debt by only a nominal amount through a comparison of the contribution-to-debt ratio.<sup>30</sup> In structuring the new value amount, private equity firms must be aware of the new value’s ratio to the unpaid debt and ensure this figure is not de minimis.<sup>31</sup> The additional considerations listed above also suggest that private equity firms should pay close attention to the amount of the unsecured claims that will be paid under the proposed plan.

As the contribution-to-debt ratio is not the only factor courts consider in determining substantiality, courts may also look to whether the private equity firm used its “best efforts” to provide a substantial amount.<sup>32</sup> This may be examined by inquiring into the financial records of the plan’s proponent.<sup>33</sup> Private equity firms must therefore also be careful not to underutilize their available funds as many firms have vast pools of available funds. Cambridge Associates recently released a study stating that United States private equity firms have \$445 billion of uncommitted capital available.<sup>34</sup> While the amount of capital each individual firm has available var-

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29. *In re Haskell Dawes, Inc.*, 199 B.R. 867, 875 (Bankr. E.D. Pa. 1996).

30. Bankruptcy courts have looked at the ratio of the proposed new value contribution to the outstanding debt. Compare *In re Sovereign Group 1985-27 Ltd.*, 142 Bankr 702, 710 (Bankr. E.D. Pa. 1992) (holding contribution with 3.6% ratio was not substantial), and *In re Woodbrook Assocs.*, 19 F.3d 312, 320 (7th Cir. 1994) (holding contribution with 3.8% ratio was not substantial), and *In re Snyder*, 967 F.2d 1126, 1131-32 (7th Cir. 1992) (holding contribution with 2.7% ratio was not substantial), with *In re Duval Manor Assocs.*, 191 B.R. 622, 635-36 (Bankr. E.D. Pa. 1996) (holding contribution with 4.2% ratio was substantial), and *In re Union Meeting Partners*, 165 B.R. 553, 570 (Bankr. E.D. Pa. 1994) (holding contribution with 5.9% ratio was substantial). See also *In re Haskell Dawes, Inc.*, 199 B.R. at 876-77 (discussing the substantiality requirement and contribution-to-unpaid debt ratios).

31. See cases cited *supra* note 32.

32. See *In re Haskell Dawes, Inc.*, 199 B.R. at 875-77.

33. See *id.* at 877.

34. Matthew Bristow, *\$445 Billion Cash Available at US Private Equity Firms*, J. REC., May 10, 2010, available at <http://journalrecord.com/2010/05/10/445-billion-cash-available-at>

ies, this staggering figure may make it difficult for private equity firms to claim lack of access to free capital as a reason for a lower contribution amount. If possible, private equity firms should stress the amount of unpaid claims that have the potential to be paid under their proposed plan compared with the less likely potential for these claims to be paid under competing bids in the market.<sup>35</sup> This strategy might allow private equity firms to avoid disclosing detailed financial statements of their holdings and capital availability by instead placing focus back on the contribution-to-debt ratio and the ability of the private equity firm to pay off a higher proportion of claims than other competing bidders.<sup>36</sup>

### B. Equity Holders Must Meet the Reasonably Equivalent Standard

The third requirement, that the contribution be reasonably equivalent to the interest received, aims to prevent old equity holders from receiving something “on account of” their junior claims.<sup>37</sup> Equity holders must not receive an interest in a reorganized debtor “on account of” their prior ownership interest, as this could allow them to skirt the absolute priority rule simply “by offering token cash contributions.”<sup>38</sup> To determine whether the contribution is reasonably equivalent to the interest received, the court may examine the value of the debtor after reorganization.<sup>39</sup> However, courts are cognizant of the difficulties and uncertainties related to valuing a corporate debtor.<sup>40</sup> Some courts, for example, have placed the

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us-private-equity-firms/. Some of the largest private equity firms reportedly had over \$10 billion in uncommitted capital in 2010. This phenomena may be credited to how private equity investments are structured (typically they tie up investment money for roughly ten years but must invest the full amount during the fund’s first three to five years and then promptly reinvest funds once returns are received. The criticism is that there are not enough attractive deal opportunities to sustain the number of private equity firms and investors in the marketplace, and deals are simply taking too long to occur. See Julie Creswell, *On Wall Street, So Much Cash, So Little Time*, N.Y. TIMES, June 23, 2010, available at <http://www.nytimes.com/2010/06/24/business/24private.html>. For a good introduction on private equity funds, see generally *Public Value: A Primer on Private Equity*, PRIVATE EQUITY COUNCIL, 2007, available at [http://www.pegcc.org/wordpress/wp-content/uploads/pec\\_primer\\_layout\\_final.pdf](http://www.pegcc.org/wordpress/wp-content/uploads/pec_primer_layout_final.pdf).

35. For more discussion on the market test, see *infra* Section III(E).

36. This idea ties in with the market test, discussed *infra* Section III(E). This approach may allow private equity firms to make positive use of the market test by directly comparing any superior ability of their plan to service debt over competing bidders and plans.

37. *In re Haskell Dawes, Inc.*, 199 B.R. at 877.

38. *In re Graphic Commc’ns, Inc.*, 200 B.R. 143, 150 (Bankr. E.D. Mich. 1996).

39. *Id.* (“An important factor in determining whether the new cash contribution is reasonably equivalent to the future participation is the value of the reorganized debtor.”). See also *In re Trevarrow Lanes, Inc.*, 183 Bankr. 475, 489 (Bankr. E.D. Mich. 1995) (discussing how, if the contribution amount is substantially less than the participation right’s market value, this may indicate an interest is being received on account of the old equity owner’s prior interest, unless other plausible explanations for the price discrepancy exist).

40. *In re Trevarrow Lanes, Inc.*, 183 Bankr. at 489-90 (“The valuation of a corporate debtor is a complex task . . . .” [quoting *In re Potter Material Serv., Inc.*, 781 F.2d 99, 104 (7th Cir. 1986)]); see also *In re Bjolmes Realty Trust*, 134 B.R. . 1000, 1008 (Bankr. D. Mass. 1991) (noting the uncertainties of stock valuation in this context).



corporate valuation burden on the plan proponent and have denied confirmation without evidence of the debtor's post-reorganization value.<sup>41</sup>

In light of this shifted burden, private equity firms may have a special understanding and advantage in providing corporate-debtor valuation estimates. Private equity funds frequently employ valuation methods in deciding whether to invest equity in a company.<sup>42</sup> As their business rests on reaping returns from increasing a company's value, private equity firms carefully examine a potential investment's value and the ability to significantly improve company returns.<sup>43</sup> Therefore, private equity firms likely already have reliable valuation strategies they can employ to meet this requirement.

What may, however, pose a problem for private equity firms is their choice in valuation strategies. Recent changes to accounting rules allow for flexibility in valuing investments and can thus lead to varied results.<sup>44</sup> Opponents to a proposed new value plan may therefore refute valuation evidence simply based on a variation between different valuation techniques or different assumptions used for valuation techniques. As the disparity in valuation seems to be common among private equity firms at this point in time,<sup>45</sup> courts may be faced with evaluating conflicting complex valuations provided by private equity firms and plan opponents. One solution may be to substitute or supplement valuation methods with the use of the market test requirement imposed by *203 N. LaSalle*.<sup>46</sup>

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41. *In re Graphic Commc'ns, Inc.*, 200 B.R. at 150-51 (stating that the failure to provide evidence of the reorganized debtor's value was grounds for denial of the equity holder's proposed new value contribution). *See also* Montgomery Court Apartments of Ingham County, Ltd, Ltd., 141 B.R. 324, 345-46 (Bankr. S.D. Ohio 1992) (stating evidence must be provided to establish that the value of future participation in the reorganized debtor is reasonably equivalent to the new value contribution in order to obtain confirmation); *In re S.A.B.T.C. Townhouse Ass'n, Inc.*, 152 B.R. 1005, 1011 (Bankr. M.D. Fla. 1993) (denying confirmation when no evidence was produced establishing the new value contribution was reasonably equivalent to the interest received).

42. For a discussion on the use of valuation methods employed by private equity firms, *see generally* *International Private Equity and Venture Capital Valuation Guidelines*, INT'L PRIVATE EQUITY & VENTURE CAP. VALUATION BD., August 2010, *available at* [http://www.privateequityvaluation.com/fileadmin/user\\_upload/pdfs/110130\\_International\\_PE\\_VC\\_Valuation\\_Guidelines\\_Sep\\_2009\\_Update.pdf](http://www.privateequityvaluation.com/fileadmin/user_upload/pdfs/110130_International_PE_VC_Valuation_Guidelines_Sep_2009_Update.pdf).

43. *See generally* Brian Gallagher, *Investment Valuations in Private Equity Buyouts*, in PRIVATE EQUITY MATHEMATICS (Oliver Gottschalg ed, 2009) (discussing the role of the investment valuation process), *available at* <http://www.twinbridgecapital.com/press/PrivateEquityMathematics.pdf>.

44. *See* Julie Creswell, *A Portfolio's Price*, N.Y. TIMES, Jan. 4, 2011, *available at* <http://www.nytimes.com/2011/01/05/business/05value.html?pagewanted=all> (discussing varied results based on differing valuation techniques, including how changes to accounting standards have affected variations).

45. *See id.*

46. For additional discussion on the market test requirement, *see infra* Section III(E).

### C. *The Contribution Must be Money or Money's Worth*

The fourth requirement, that the contribution of new value must be money or money's worth, also merits additional analysis by private equity firms hoping to take advantage of the new value exception. The new value contribution must be exchangeable in the marketplace for something of value to creditors today.<sup>47</sup> Thus, the contribution must be measurable in today's monetary terms and cannot be based on future earned amounts or intangibles.<sup>48</sup> For instance, future anticipated salary or labor and management expertise are not considered money or money's worth for the purposes of satisfying the contributed new value requirements.<sup>49</sup>

For many private equity firms, their ability to raise capital eases the burden of satisfying this requirement as they often have access to actual funds. A private equity firm may, for instance, be able to use investor funds to inject new consideration into a debtor in lieu of investing in a new venture.<sup>50</sup> An obstacle with this approach, however, would be convincing investors to reinvest in a failing company in which the private equity firm has previously placed equity without seeing positive returns. A private equity firm may potentially have more success if it already has access to a reserve of free capital and does not need to raise additional funds. Alternatively, if investment money is tied up in the debtor company and other ventures, the private equity firm might consider pairing up with one or more private equity firms to contribute money or money's worth through combined efforts.<sup>51</sup>

### D. *The New Value Must Be Necessary to the Reorganization Effort*

Finally, private equity firms should give special consideration to the fifth requirement that the contributed new value be necessary to the reorganization. The contribution must be "necessary for an effective reorganization" of the debtor and thereby increase the chances of a successful reorganization.<sup>52</sup> In this analysis, courts may look to the proportion of the

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47. *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 204 (1988).

48. *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106, 122-23 (1939) (stating that intangibles do not satisfy the new value exception because "[t]hey reflect merely vague hopes or possibilities"). *See also In re Stegall*, 85 B.R. 510, 514 (C.D. Ill. 1987) ("[T]he courts require that any contribution of new capital must be made 'up front,' and not in the form of future payments.").

49. *See, e.g., Ahlers*, 485 U.S. at 204 (1988). (stating that future labor, management, or expertise have never been sufficient to qualify for the new value exception).

50. Alternatively, a private equity firm could also attempt to use credit bidding in this type of scenario.

51. For instance, a club deal, where several private equity firms are involved in the investment, might prove to be a useful strategy in this context. The use of club deals has become increasingly common; in 2006, thirty percent of overall deals in the United States were club deals. *How Do Private Equity Investors Create Value?*, ERNST & YOUNG, 2007, at 5 available at [http://www.nvp.nl/data\\_files/how\\_do\\_private\\_equity\\_investors\\_create\\_value\\_ernstyoung\\_global\\_report\\_final.pdf](http://www.nvp.nl/data_files/how_do_private_equity_investors_create_value_ernstyoung_global_report_final.pdf).

52. *In re SLC Ltd. V*, 137 B.R. 847, 855 (Bankr. D. Utah 1992).

contribution that will be used toward reorganization efforts compared with the amount used to pay off existing debt.<sup>53</sup> In order to prove that the contribution is necessary to the continued operation of the reorganized company, the contribution typically may not be solely or largely used to satisfy claims.<sup>54</sup> What courts have found to fulfill the “necessary” requirement has varied, although there seems to be a general consensus that this requirement will be “met if: (i) the contribution will be used to fund repairs or improvements to the debtor’s property that are necessary to its reorganization; or (ii) the contribution is needed to enable the debtor to make payments due under the plan of reorganization and continue operating.”<sup>55</sup>

This requirement may create an issue unique to private equity firms proposing a plan that employs the new value exception: it creates the assumption that these firms do not wish to use a credit bid to retain ownership during the bankruptcy process.<sup>56</sup> As a result, this may prevent a private equity firm from writing off its own debt through use of the new value exception. As private equity firms typically use both equity and debt to purchase a company,<sup>57</sup> a firm could theoretically pay off a substantial amount of its own debt by infusing new value into the debtor company. At least one prior court decision has stated that using new value contributions to pay off existing debt is only permissible in instances where the creditor provides a service integral to the reorganized company’s continued operations.<sup>58</sup> As the debt taken on by the private equity firm is merely a form of

53. See, e.g., *In re Sovereign Group 1985-27, Ltd.*, 142 B.R. 702, 708 (E.D. Pa. 1992) (discussing how a \$135,000 new value contribution that only used \$15,000 toward reorganization efforts was an insignificant amount that did not facilitate reorganization efforts).

54. *In re Mortgage Inv. Co. of El Paso, Tex.*, 111 B.R. 604, 620 (Bankr. W.D. Tex. 1990) (discussing how the use of the contribution to solely pay off creditors was not necessary to continued operations of the reorganized debtor). However, when debt payment is necessary for the continued operation of the reorganized company, this may provide a legitimate basis for using a greater portion of funds toward debt repayment. See *In re Sovereign Group 1985-27, Ltd.*, 142 B.R. at 708.

55. *In re Haskell Dawes, Inc.*, 199 B.R. 867, 873 (Bankr. E.D. Pa. 1996).

56. The right to put in a credit bid is located under Section 363 of the Bankruptcy Code. 11 U.S.C. § 363(k) (2011). Typically, secured lenders have the right to place a credit bid instead of a cash bid for its collateral claim during the bankruptcy process. *Id.* The debt used in a private equity firm financing will often include a senior, secured loan portion and a junior, unsecured portion. Steven N. Kaplan & Per Strömberg, *Leveraged Buyouts and Private Equity*, 23 J. ECON. PERSP. 121, 125 (2009).

57. Typically, a private equity firm will raise capital and invest this together with borrowed funds. See *Public Value: A Primer on Private Equity*, PRIVATE EQUITY COUNCIL, 2007, at 9, available at [http://www.pegcc.org/wordpress/wp-content/uploads/pec\\_primer\\_layout\\_final.pdf](http://www.pegcc.org/wordpress/wp-content/uploads/pec_primer_layout_final.pdf) (discussing the business goals of private equity funds).

58. *In re Sovereign Group 1985-27, Ltd.*, 142 B.R. at 708 (stating that “[p]artial payment of a pre-petition debt might be necessary to the reorganization where the money is paid to a creditor with whom the Debtor needs to continue a relationship to ensure successful reorganization” and noting that partial payment of pre-existing debt to a creditor did not satisfy this requirement).

financing for the purchase of the company,<sup>59</sup> it cannot easily be said that paying off its own debt related to financing the purchase of the debtor is integral to continued operations.<sup>60</sup> Thus, private equity firms should be wary of using the new value exception to both retain their equity ownership *and* favorably pay off their own debt.

#### E. New Value Plans Must Survive a Market Test

In addition to the above five requirements, the Supreme Court's decision in *203 N. LaSalle* imposes a market test on plans claiming to fall under the new value exception. While *203 N. LaSalle* stated that some type of market test was required to obtain confirmation under the new value exception, the Court's decision declined to rule on which specific type of market test would satisfy this requirement.<sup>61</sup> What the Court did make clear was that plans must not provide junior interest holders with the exclusive opportunity to purchase new equity free from competition and without market valuation.<sup>62</sup> Subsequent cases have rejected plans where equity holders have retained the exclusive right to obtain ownership of the reorganized company and where the plan was not market tested through a public auction or competing plan.<sup>63</sup> Typically, two methods for satisfying the market test have been proposed: 1) allowing other bidders to offer their own competing plans ("competing plans method") or 2) allowing other bidders to offer competing bids under the proposed plan as is ("auc-

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59. See Steven N. Kaplan & Per Strömberg, *supra* note 58, at 124-25 (discussing how private equity firms typically finance transactions using sixty to ninety percent debt financing).

60. If the *Sovereign Group* decision is followed, it may be difficult for private equity firms to write off their own debt through the new value exception. However, there may be room for argument that private equity firms must pay off a larger portion of the debt in order to make the reorganization successful. Although this argument appears to be untested, the private equity firm might be able to argue that the debt is extremely overwhelming to the debtor company and payment of a large portion of the debt claim is necessary to increase the likelihood of the reorganization's success. This, however, would only be feasible if the debt used to purchase the debtor company was owed by the debtor company itself, and not the private equity firm.

61. Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 458 (1999) ("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 is a question we do not decide here.").

62. *Id.* at 456-58.

63. See, e.g., *In re Global Ocean Carriers Ltd.*, 251 B.R. 31, 48 (Bankr. D. Del. 2000) (rejecting a plan where the largest shareholder had the exclusive right to decide the reorganized company's owner and the equity price, without any type of public auction or competing plan to serve as a market test); *In re CGE Shattuck, LLC*, Nos. 99-12287-JMD, CM 99-747, 1999 WL 33457789, at \*6 (Bankr. D.N.H. Dec. 20, 1999) (rejecting a plan where "one hundred percent of the new value to be paid for the equity interests in the reorganized debtor is coming from a new entity organized by a pre-petition equity holder who alone, or with its affiliates, is contributing a majority of the new value" and stating that petitioners could amend to provide for a competitive market test to satisfy the *203 N. LaSalle* standards).

tion method”).<sup>64</sup> While some circuits have suggested a preference for which market test to use, others have not done so.<sup>65</sup> Thus, private equity firms need to be aware of any jurisdictional market test preferences.

One of the biggest concerns a plan proponent faces under the market test is the loss of exclusivity.<sup>66</sup> As the use of the new value exception now opens plans up to competing bids and parties, plan proponents must be well aware of any anticipated competitors and offers. Private equity firms may have a unique knowledge of any anticipated competing offers, however, as they generally have spent a vast amount of time and resources on market research related to the prior purchase of the debtor company.<sup>67</sup>

Additionally, private equity firms also need to be aware of the limitations of using stalking horse bidders, friendly bidders, or straw persons to satisfy the market test. Courts have been relatively cautious when such bidders have been employed to satisfy the market test and have carefully analyzed the relationship between the plan proponent and the additional bidder.<sup>68</sup> As satisfaction of this rule has not been fully developed, private equity firms may need to tread cautiously and carefully analyze the market for any potential competing bids that may arise.<sup>69</sup>

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64. For a summary of 203 *N. LaSalle* and the market test it imposed, see Marvin E. Jacob & Jacqueline B. Stuart, *New Value Plans Under Chapter 11*, WEIL, Nov. 1999, available at <http://www.weil.com/news/pubdetail.aspx?pub=4218>.

65. Compare, e.g., *In re Global Ocean Carriers Ltd.*, 251 B.R. 31, 49 (Bankr. D. Del. 2000) (allowing both auctions and competing plans with no favorable distinction), with *In re Situation Mgmt. Sys., Inc.*, 252 B.R. 859, 865 (Bankr. D. Mass. 2000) (stating that a competing plan is preferable to an auction).

66. See Hieu T. Hoang, *The New Value Exception to the Absolute Priority Rule After In re 203 N. LaSalle Street Partnership: What Should Bankruptcy Courts Do, and How Can Congress Help?*, 149 U. PA. L. REV. 581, 598 (2000) (“[W]henever a debtor gives up exclusivity, it potentially opens the way for a liquidation plan to be filed by a secured creditor. This penalizes the unsecured creditors, who will receive nothing if the assets are liquidated in cases involving undersecured creditors.” [internal quotations omitted]). For additional discussion on concerns regarding the loss of exclusivity, see THOMAS J. SALERNO, 8 *BANKRUPTCY LITIGATION AND PRACTICE* 135-41 (4th ed. 2008).

67. For a short discussion on the deal origination process and the importance of careful deal selection, see Oliver Smiddy, *The Dark Art of Deal Origination*, FIN. NEWS, Aug. 6, 2006, available at <http://www.efinancialnews.com/story/2006-08-07/the-dark-art-of-deal-origination>; see also *Differentiation in a Hyper-Competitive Market*, WHARTON PRIVATE EQUITY REV., available at [http://knowledge.wharton.upenn.edu/papers/download/PrivateEquity07\\_online.pdf](http://knowledge.wharton.upenn.edu/papers/download/PrivateEquity07_online.pdf).

68. See, e.g., *In re Global Ocean Carriers Ltd.*, 251 B.R. 31 (Bankr. D. Del. 2000) (rejecting a plan where all of the reorganized company’s equity was to be sold to the majority shareholder’s daughter); but see *In re Greenwood Point, LP*, 445 B.R. 885, 911-13 (Bankr. S.D. Ind. 2011) (allowing an equity holder’s wife to obtain new equity based on a careful analysis of the wife’s individual credentials and contribution amount).

69. Alternatively, a private equity firm truly concerned about competing bids may be better off foregoing use of the new value exception and employing a different strategy. For instance, the private equity firm could use a credit bid to obtain control or could attempt to break up the groups of unsecured creditors to obtain more votes for the approval process.

## IV. CONCLUSION

While the existence of the new value exception has been debated over the years, its use and acceptance is still seen throughout courtrooms across the country. As the number of Chapter 11 filings by has increased,<sup>70</sup> private equity firms may begin to look at the new value exception as a means to retain their equity interest in a reorganized company over the objections of senior creditor and interest holders. The unique considerations that private equity firms face may actually aid in a firm's successful use of the new value exception. As the law surrounding the use of the new value exception continues to develop, a careful approach to the use of the new value exception may be the best means for private equity firms to employ until further guidance is provided through subsequent court decisions or from the legislature.

Ultimately, the uncertainty surrounding the use of the new value exception may encourage private equity firms to use credit bids or some other alternative means, such as workouts with creditors, to retain their interest in a debtor company. While the legal requirements surrounding the use of the new value exception to the absolute priority rule provide a helpful framework for analyzing the potential success of a new value deal, private equity firms may want to step outside this analysis to determine what makes the most sense for their firm as to whether or not to employ this strategy.

For private equity firms, the use of the new value exception may only make sense when the firm can obtain its core business goal: reaping large returns on investments.<sup>71</sup> In many cases, the private equity firm may simply choose to take the loss on the debtor company as it seems quite possible that both the firm and its investors may be wary of reinvesting in the failed company. As such, valuation models may be employed not only to analyze the potential success of obtaining confirmation under the new value exception but also to indicate whether another round of equity investment in the debtor company makes sense over other potential investments. Private equity firms' successful use of the new value exception,

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70. Ed Flynn & Thomas C. Kearns, *supra* note 2, at 12 (noting that there has been a 115.9% increase in Chapter 11 filings from 2007 to 2010). *See also* Clair Spencer, *PE Portfolio Chapter 11 Filings Increase, PeHUB*, FINANCIER WORLDWIDE, August 19, 2009, available at <http://www.financierworldwide.com/article.php?id=4779> (noting the increase in Chapter 11 filings by private-equity-backed companies in 2009). *See also* Per Strömberg et al., *Private Equity and the Resolution of Financial Distress*, 3-4 (European Corporate Governance Institute Finance Research Paper Series, Working Paper No. 331, 2012), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1787446](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1787446) (discussing the higher likelihood of default by private-equity-backed companies as compared with non-private-equity-backed companies).

71. *See* Sue Troy, *What is Private Equity?*, CBS NEWS, March 5, 2007, available at [http://www.cbsnews.com/8301-505125\\_162-51055860/what-is-private-equity/](http://www.cbsnews.com/8301-505125_162-51055860/what-is-private-equity/) (stating the goals of a private equity firm). *See also* *Public Value: A Primer on Private Equity*, PRIVATE EQUITY COUNCIL, 2007, at 7-8, available at [http://www.pegcc.org/wordpress/wp-content/uploads/pec\\_primer\\_layout\\_final.pdf](http://www.pegcc.org/wordpress/wp-content/uploads/pec_primer_layout_final.pdf) (discussing the business goals of private equity funds).

therefore, may certainly be possible, but whether private equity firms will employ the new value exception during bankruptcy more frequently than they currently do will likely play out on a case-by-case basis.