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## The New-Value Paradox in Chapter 11

In a chapter 11 plan, the owner of the financial-distressed company cannot keep its equity unless creditors and senior interest-holders are paid in full. This is a core principle of bankruptcy law called the “absolute priority” rule.

Although a number of courts recognize an exception to this rule where the owner contributes “new value” for the equity, the U.S. Supreme Court has not decided whether § 1129(b) of the Bankruptcy Code implicitly includes a “new value corollary or exception” to the absolute-priority rule.<sup>1</sup> Nevertheless, the Court ruled that the adequacy of new value, if it exists, can be determined through “exposure to a market.”<sup>2</sup> Since the Court has not definitively resolved whether the new-value exception exists and Congress has not amended the Code to address it, courts remain divided on its applicability.<sup>3</sup>

Market-testing happens in multiple areas of bankruptcy and receivership law. When applied to new value, it means that a business owner seeking to keep its interest through chapter 11 must give others an opportunity to purchase that very interest. This article discusses the framework governing the new-value exception and the implications of this uncertain and paradoxical legal authority.

### Consensual vs. Nonconsensual Reorganization

Under § 1129(a), a plan can be confirmed consensually if all classes of creditors accept it. However, if nonconsensual confirmation is being sought, § 1129(b) controls what is commonly known as a “cramdown,”<sup>4</sup> which requires that the “plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.”<sup>5</sup>

The “fair and equitable” doctrine traces back to the period before the Bankruptcy Act of 1898, when large corporations, particularly railroads, were reorganized through equity receiverships in federal courts.<sup>6</sup> During this time, courts began

to require that those plans be fair to protect the interests of dissenting creditors and shareholders.<sup>7</sup> Section 1129(b)(2) provides “fair and equitable” approaches to handling dissenting claims and interest-holders, including, first and foremost, the absolute-priority rule.<sup>8</sup>

The absolute-priority rule requires that “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.”<sup>9</sup> This ensures that dissenting creditors are not forced to accept a reorganization plan that unfairly favors junior interests. However, critics argue that the rule can make it harder to negotiate reorganization plans, especially for small businesses or family-owned firms seeking to reorganize without losing ownership.<sup>10</sup>

This criticism influenced the Small Business Reorganization Act of 2019, which added subchapter V to chapter 11 and solved this problem for “small business debtors.” Under subchapter V, the absolute-priority rule is eliminated for “small business debtors” that have not more than \$3,024,725 in noncontingent liquidated non-insider primarily business debt.<sup>11</sup> Nevertheless, chapter 11 debtors that do not qualify for subchapter V relief because their debt exceeds the limit are subject to the absolute-priority rule and, in some circuits, the new-value exception.

### The New-Value Exception to the Absolute-Priority Rule

#### The New-Value Exception

Case law under the Bankruptcy Act permitted old equity to retain an interest in the reorganized entity if it contributed new capital, provided that the contribution was substantial, necessary, and in money or money’s worth.<sup>12</sup> The Supreme Court held that a reorganization plan violated the absolute-priority rule where old equity retained an interest without full payment to senior creditors, unless old equity made a new contribution, “in money or money’s worth, reasonably equivalent to the participation of the stockholder.”<sup>13</sup>



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1. See *Bank of Am. Nat. Tr. & Sav. Ass’n v. 203 N.L.S. Sales Corp.*, 526 U.S. 434, 435 (1999).

2. *Id.* at 436.

3. See *In re Banner Mail Pk’g*, 142 B.R. 911 (D. Idaho 1992), *aff’d and remanded*, 2 F.3d 800 (9th Cir. 1993) (finding new value exception survived, but see *In re Greystone II Joint Venture*, 935 F.2d 1274 (5th Cir. 1991) (questioning existence of new value exception).

4. See *Blanchette v. Connecticut Gen. Ins. Corp.*, 419 U.S. 102, 107, 95 S. Ct. 335, 42 L. Ed. 2d 320 (1974) (Douglas, J. dissenting).

5. 11 U.S.C. § 1129(b)(1).

6. See, e.g., *N. Pac. Ry. Co. v. Boyd*, 228 U.S. 482, 488–89 (1913).

7. *Id.*

8. Cf. *Bankruptcy*, ¶1129.03 (substantive requirements of § 1129(b)(1)).

9. 11 U.S.C. § 1129(b)(2)(B)(i); see *Boyd*, *supra*, 228 U.S. at 508; *Northwest Bank Worthington v. Ahlers*, 485 U.S. 197, 202 (1988).

10. See Report of ABI Commission to Study the Reform of Chapter 11, 08/34 ABI-CLE 253.

11. See 11 U.S.C. § 101(5)(D).

12. *Kansas City Terminal Ry. v. Central Union Trust Co.*, 271 U.S. 445, 453 (1926).

13. *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106, 122 (1939).