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## Case Comments B. Bankruptcy Willis V. Celotex Corp

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## B. BANKRUPTCY

*Willis v. Celotex Corp.*

978 F.2d 146 (4th Cir. 1992), *petition for cert. filed* (Feb. 11, 1993)

When a debtor files a petition for relief under Chapter 11 of the Bankruptcy Code, all of the debtor's property becomes part of the debtor's bankruptcy estate.<sup>25</sup> The bankruptcy court has exclusive jurisdiction over the bankruptcy estate.<sup>26</sup> Section 362 of the Bankruptcy Code automatically stays any proceedings against the debtor or against bankruptcy property.<sup>27</sup> In addition, section 105(a) of the Bankruptcy Code authorizes bankruptcy courts to issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of the Bankruptcy Code.<sup>28</sup>

In *Willis v. Celotex Corp.*<sup>29</sup> the United States Court of Appeals for the Fourth Circuit considered whether the United States District Court for the Eastern District of Virginia had the authority to order a third party surety to pay the proceeds of a supersedeas bond to a judgment creditor. In order to determine whether the district court had jurisdiction over the bond, the Fourth Circuit considered the following three bankruptcy issues: 1) does a third party surety of a supersedeas bond have such an identity of interest with the judgment debtor that 11 U.S.C. section 362 stays proceedings against the surety, even when the surety owes an independent contractual duty to the creditor; 2) is a supersedeas bond posted by a judgment debtor who later files for bankruptcy an asset of the judgment debtor's bankruptcy estate; and 3) may a bankruptcy court stay execution against a third party surety of a supersedeas bond pursuant to 11 U.S.C.A. section 105(a) after the judgment debtor has filed for bankruptcy?

In *Willis*, a group of plaintiffs sued Celotex Corporation (Celotex) for asbestos related injuries. The Willis plaintiffs won their suit and the United States District Court for the Eastern District of Virginia awarded the Willis plaintiffs \$526,500 in damages. Celotex appealed. In order to stay execution of the judgments pending appeal, Celotex posted a supersedeas bond.

Celotex entered into a series of financial transactions in order to obtain surety for the bond. First, Celotex used corporate funds to purchase some certificates of deposit. Celotex pledged these certificates of deposit to First Florida Bank and the bank issued irrevocable letters of credit in amounts equal to or less than the certificates of deposit. The irrevocable letters of credit benefitted Aetna Casualty and Surety Company (Aetna).

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25. *MacArthur Co. v. Johns-Manville Corp.*, 837 F.2d 89, 91 (2d Cir.) (citing 28 U.S.C.A. § 1334(d) (West Supp. 1987)), *cert. denied*, 488 U.S. 868 (1988).

26. *Id.*

27. 11 U.S.C. § 362(a) (1988).

28. 11 U.S.C.A. § 105(a) (West Supp. 1992).

29. 978 F.2d 146 (4th Cir. 1992).

In return for the letters of credit, Aetna agreed to serve as surety for the supersedeas bond Celotex posted in the *Willis* case.

Celotex lost the *Willis* appeal. Before the Willis plaintiffs collected their judgment against Celotex, Celotex filed a bankruptcy petition in the United States Bankruptcy Court for the Middle District of Florida. The bankruptcy court entered an order pursuant to 11 U.S.C.A. section 105(a) precluding judgment creditors from proceeding against supersedeas bonds posted by Celotex.

A few days later in the district court, the Willis plaintiffs sought payment of the bond from Aetna. The district court decided that the bankruptcy court did not have exclusive jurisdiction over the bond because the bond was not part of the Celotex bankruptcy estate. The district court ordered Aetna to pay the proceeds of the bond to the Willis plaintiffs.

Celotex appealed the district court's decision to the Fourth Circuit. On appeal, Celotex argued that the bond was part of Celotex's bankruptcy estate and that the automatic stay provision of 11 U.S.C. section 362 therefore precluded the Willis plaintiffs from moving for release of the bond proceeds in the district court. Celotex also contended that section 362 stayed any claim against Aetna because Aetna and Celotex had an identity of interest with respect to the bond such that any proceeding against Aetna was tantamount to a proceeding against Celotex. Finally, Celotex argued that the bankruptcy court's order precluding judgment creditors from proceeding against supersedeas bonds posted by Celotex properly stayed execution against Aetna.

The Fourth Circuit initially decided the case on June 18, 1992, in an opinion which was published at 970 F.2d 1292. On August 7, 1992, the Fourth Circuit granted the Willis plaintiffs' petition for rehearing and withdrew the June 18th opinion. The Fourth Circuit decided the case again on October 22, 1992.

In the October opinion, the Fourth Circuit first examined whether 11 U.S.C. section 362 stayed the proceeding against Aetna. The Fourth Circuit noted that the terms of Celotex's supersedeas bond imposed a separate, independent duty on Aetna to pay the judgments. Because Aetna owed an independent contractual duty to the Willis plaintiffs, the Fourth Circuit decided that Aetna and Celotex did not have such an identity of interest that section 362 stayed proceedings against Aetna.

Furthermore, the Fourth Circuit determined that the supersedeas bond was not part of Celotex's bankruptcy estate at the time the district court ordered Aetna to pay the bond. The Fourth Circuit stated that Celotex's interest in the bond expired several weeks before the district court ordered Aetna to pay, when the Fourth Circuit upheld the damages award to the Willis plaintiffs. Therefore, the Willis plaintiffs' proceeding against Aetna was not stayed by section 362 as a proceeding against the property of the bankruptcy estate. The Fourth Circuit expressly left open the issue of whether a supersedeas bond is part of the judgment debtor's bankruptcy estate while the appeal is pending.

The Fourth Circuit then considered whether the bankruptcy court's order pursuant to 11 U.S.C.A. 105(a) properly stayed execution against

Aetna on the bond. The Fourth Circuit cited *A.H. Robins Co. v. Piccinin*<sup>30</sup> for the proposition that bankruptcy courts may enjoin actions against third parties under section 105(a) if failure to enjoin would adversely influence and pressure the debtor through the third party or if failure to enjoin would damage the debtor's ability to formulate a Chapter 11 plan.<sup>31</sup> The Fourth Circuit noted that the bankruptcy court faced a monumental task in overseeing the Celotex bankruptcy proceedings because Celotex was involved in tort suits nationwide and had already posted nearly seventy million dollars in supersedeas bonds. The Fourth Circuit also noted that the bankruptcy court had stated that a race to the courthouse by Celotex's judgment creditors would burden the reorganization process. Based on the unusual complexity of the Celotex bankruptcy proceedings, the Fourth Circuit decided that the bankruptcy court's section 105(a) order was proper under *Piccinin*. The Fourth Circuit therefore vacated the order of the district court and remanded the case for further proceedings at such time as the bankruptcy court should lift the section 105(a) stay.

The Fourth Circuit's decision in *Willis* makes it clear that bankruptcy courts may stay actions against third parties under 11 U.S.C.A. section 105(a) when such actions would further complicate massive and complex reorganization proceedings. The *Willis* decision only partially resolved a second issue: whether a supersedeas bond posted by a judgment debtor who later files for bankruptcy becomes part of the debtor's bankruptcy estate. The circuits currently are split on this issue.<sup>32</sup> While the Fourth Circuit in *Willis* decided that the debtor's interest in a supersedeas bond is terminated if the debtor loses his appeal, the court has not yet addressed whether the bond is part of the debtor's bankruptcy estate during the pendency of the appeal.

### *In Re Geris*

973 F.2d 318 (4th Cir. 1992)

In *Gatewood v. Gatewood*,<sup>33</sup> the Supreme Court of Virginia stated that if a party has a right to redeem a mortgage on real property and

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30. 788 F.2d 994 (4th Cir.), *cert. denied*, 479 U.S. 876 (1986).

31. See *A.H. Robins Co. v. Piccinin*, 788 F.2d 994, 1003 (4th Cir.) (explaining that bankruptcy court may stay proceedings against third parties in order to prevent detrimental effect on debtor or reorganization process), *cert. denied*, 479 U.S. 876 (1986).

32. Compare *Grubb v. Federal Deposit Ins. Corp.*, 833 F.2d 222, 224-26 (10th Cir. 1987) (citing *Mid-Jersey* and refusing to exonerate bonds posted by bank prior to its insolvency) and *Mid-Jersey Nat'l Bank v. Fidelity-Mortgage Investors*, 518 F.2d 640, 643 (3d Cir. 1975) (stating that supersedeas bond posted by debtor pending appeal did not become part of his bankruptcy estate) with *Sheldon v. Munford*, 902 F.2d 7, 8 (7th Cir. 1990) (stating that § 362 does stay proceedings against supersedeas bond because debtor has stake in bond and noting split in circuits) and *Borman v. Raymark Indus., Inc.*, 946 F.2d 1031, 1034-35 (3d Cir. 1991) (discussing criticism of *Mid-Jersey* but resting decision on other grounds).

33. 75 Va. 407 (1881).

does in fact redeem, the redeeming party is entitled to subrogation of the mortgage.<sup>34</sup> *Gatewood* increased the list of parties having a cognizable property interest in the estate by adding parties who have an inchoate dower interest in property subject to a mortgage.<sup>35</sup> Subsequently, in *In re Bialac*,<sup>36</sup> the United States Court of Appeals for the Ninth Circuit held that a debtor in bankruptcy had a preforeclosure right to redeem collateral because of the debtor's one-sixth ownership interest in the property and refused to lift the automatic stay provision of the federal Bankruptcy Code.<sup>37</sup>

In light of these holdings, the Fourth Circuit in *In re Geris*<sup>38</sup> considered whether a bankrupt guarantor, who is not an owner, has an equitable interest in property such that the automatic stay provision of the federal Bankruptcy Code<sup>39</sup> would preclude foreclosure on the property by a creditor. In *Geris*, the adversary complainants in bankruptcy—Saratoga Group, Ltd. (Saratoga) and shareholders R. Donald Honeycutt and Sidney Worley, Jr.—protested the foreclosure and sale of property owned by them and guaranteed by the bankrupt party. The complainants alleged that the creditor's foreclosure on the real property violated the federal automatic stay provision and was therefore void.

In May 1987, Saratoga purchased real property in Manassas, Virginia, from Samuel J. Geris, Sr., for \$717,102.75. Geris was one of three principal shareholders of Saratoga. Saratoga financed this purchase by taking a \$400,000 loan from Peoples National Bank (PNB), secured by a first deed of trust and guaranteed by Geris. For the remaining amount, Saratoga executed a note to Geris for \$317,102.75, which was due in April 1988 and secured by a second deed of trust. Subsequently, Geris pledged the note to Blakely Bank and Trust (BB&T). BB&T demanded payment from Saratoga in the spring of 1988. In order to secure BB&T's release, Saratoga and Geris arranged a second loan for \$300,000 from PNB, secured by another Deed of Trust and guaranteed by Geris.

In June 1988, Geris sold his interest in Saratoga to the other principal shareholders, Honeycutt and Worley. In exchange, Honeycutt and Worley agreed to indemnify Geris as to all corporate liability incurred as either a guarantor or principal. In May 1990, Geris filed a Chapter 11 petition in bankruptcy. At approximately the same time Saratoga defaulted on the \$400,000 loan from PNB. In July 1990, PNB foreclosed on the property and sold it at public auction.

The bankruptcy court exercising jurisdiction over the Geris Chapter 11 proceeding held that the automatic stay provision did not apply to the Manassas property because the bankrupt party, Geris, did not own the

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34. *Gatewood v. Gatewood*, 75 Va. 407, 411 (1881).

35. *Id.* at 412-13.

36. 712 F.2d 426 (9th Cir. 1983).

37. *In re Bialac*, 712 F.2d 426, 431-33 (9th Cir. 1983).

38. 973 F.2d 318 (4th Cir. 1992).

39. 11 U.S.C. § 362(a)(6) (1988).

property and only the bankrupt party is entitled to the protection afforded by the automatic stay provision. Thus, the bankruptcy court dismissed the complaint for failure to state a claim for which relief could be granted. The United States District Court for the Eastern District of Virginia affirmed the bankruptcy court's order denying relief.

On appeal, Saratoga argued that Geris had an equitable interest as a guarantor for the debt that the Manassas property secured. Saratoga reasoned that because Geris would have been liable for any deficiency on the sale of the Manassas property, Geris should have had the right to redeem the debt in order to maximize the sale of the property. Saratoga relied on *In re Bialac* for the proposition that the right to redeem was a property interest of the Geris estate and was therefore afforded the protection of the automatic stay provision of the federal Bankruptcy Code.

The Fourth Circuit first noted that Geris did have a material interest in the sale of the Manassas property. The Fourth Circuit reasoned, however, that it could not accept Geris's interest as sufficient to trigger the automatic stay because the foreclosure rights of secured creditors in any property that is also secured by a bankrupt guarantor would be cut off. The Fourth Circuit refused to allow such a result and affirmed the bankruptcy court's denial of relief.

Whether courts shall afford a debtor in bankruptcy the protection of the automatic stay provision due to a foreclosure sale of property for which the debtor in bankruptcy has previously guaranteed was an issue of first impression in the Fourth Circuit. The Fourth Circuit's holding protects secured creditors' foreclosure rights on real property collateral. Although the Fourth Circuit stated that the bankrupt debtor did have a valid material interest in the sale, the court also noted that in this instance the bankrupt debtor was already indemnified by the owners of the property. The Fourth Circuit did not indicate whether a guarantor's interest in maximizing the sale of property under foreclosure could ever trigger the federal automatic stay provision. Thus, the Fourth Circuit's refusal to extend protection of the automatic stay may be limited to situations in which the guarantor has a right to indemnity from the owners.

#### *In Re Coker*

973 F.2d 258 (4th Cir. 1992)

An ongoing debate in bankruptcy law concerns the interpretation of 11 U.S.C. section 506(a).<sup>40</sup> Section 506(a) sets forth the standard for the valuation of a creditor's allowable secured claim stating as follows:

An allowed claim of a creditor secured by a lien on property in which the estate has an interest . . . is a secured claim to the

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40. See *In re Balbus*, 933 F.2d 246, 248-50 (4th Cir. 1991) (discussing conflicting interpretations of § 506(a) in bankruptcy courts).

extent of the value of such creditor's interest in such property . . . and is an unsecured claim to the extent that the estates interest in the value of such creditor's interest . . . is less than the amount of such allowed claim. Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property. . . .<sup>41</sup>

Courts have interpreted this section inconsistently when deciding whether the costs (for example, broker's fees, title insurance, and financing costs) of selling the secured property should serve to lessen the value of the debtor's interest and thus lessening the value of the creditor's secured claim.<sup>42</sup> Chapter 13 bankruptcy, however, does not require the sale of residual property.<sup>43</sup> Some courts have held that even when debtors do not intend to sell the property, they can nonetheless deduct the costs of a "hypothetical" sale from the value of their interest.<sup>44</sup> Other courts, by contrast, do not allow deductions for hypothetical costs.<sup>45</sup>

The inconsistent interpretations of section 506(a) result from the tension between the first and second sentences of the section.<sup>46</sup> The first sentence stresses the value of the creditor's interest, and implies that because the creditor can only realize this value through a sale of the secured property, the true value to the creditor must reflect a deduction for the costs of a sale.<sup>47</sup> The second sentence, however, places an emphasis on the "purpose of the valuation" and the "proposed disposition or use of the property." This emphasis suggests that if the debtor does not intend to sell the property, a court should not allow a deduction for costs of a hypothetical sale in a valuation under section 506(a).<sup>48</sup> Against this background, the Fourth Circuit interpreted section 506(a) in *In re Coker*.<sup>49</sup>

In *In re Coker*, plaintiffs David and Elizabeth Coker owned real estate in Virginia Beach, Virginia. The real estate was encumbered by two deeds

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41. 11 U.S.C. § 506(a) (1988).

42. See *Balbus*, 933 F.2d at 248 (noting that § 506(a) interpretational conflict concerns whether courts can allow deductions of hypothetical sales costs from value of creditor's secured claim).

43. See *In re Coker*, 973 F.2d 258, 260 (4th Cir. 1992) (recognizing that Chapter 13 allows debtors to retain their homes by reaffirming mortgage debt).

44. See *In re Smith*, 92 B.R. 287, 289-90 (Bankr. S.D. Ohio 1988) (holding that deduction for costs of sale is allowed even when debtor does not intend to sell property); *In re Claeys*, 81 B.R. 985, 990-92 (Bankr. D.N.D. 1987) (same).

45. See *In re Usry*, 106 B.R. 759, 760-62 (Bankr. M.D. Ga. 1989) (holding that hypothetical sales costs are not deductible); *In re 222 Liberty Assocs.*, 105 B.R. 798, 802-04 (Bankr. E.D. Pa. 1989) (same).

46. See *In re Balbus*, 933 F.2d 246, 248 (4th Cir. 1991) (identifying conflict between first and second sentences of § 506(a) as source of interpretational inconsistencies); *Liberty Assocs.*, 105 B.R. at 803 (same).

47. See *Liberty Assocs.*, 105 B.R. at 803 (discussing argument for valuation based on first sentence of § 506(a)).

48. See *id.* (discussing argument for valuation based on second sentence of § 506(a)).

49. 973 F.2d 258 (4th Cir. 1992) (addressing interpretational conflict of § 506(a)).

of trust securing notes totalling \$91,504.87. The defendant, Sovran Equity Mortgage Corp. (Sovran), held a note secured by the junior deed of trust worth \$9,504.87. In 1991, the plaintiffs petitioned for Chapter 13 bankruptcy and moved to avoid Sovran's junior deed of trust. The plaintiffs introduced testimony showing that the appraised value of the property less estimated selling costs (real estate commissions, discount points, and closing costs) was less than the total secured debt of \$91,504.87, thus, pursuant to section 506(a), Sovran's claim was not fully secured.

In addition to rejecting the plaintiffs' low market value estimate of \$91,500 (opting instead for Sovran's estimate of \$95,000), the bankruptcy court held that a deduction for selling costs was not allowed where, as in the plaintiffs' case, the bankrupt party's plan of rehabilitation does not include the selling of the property. The bankruptcy court, therefore, denied the plaintiffs' motion, finding the claims of Sovran fully secured. The district court affirmed the decision of the bankruptcy court and the plaintiffs appealed to the United States Court of Appeals for the Fourth Circuit.

The Fourth Circuit upheld the decisions of the lower courts. In so holding, the *Coker* court recognized the inconsistencies of the interpretations of section 506(a), noting that a court's decision on the propriety of deducting hypothetical selling costs turned on which of the two sentences in section 506(a) the court emphasized. Courts relying on the first sentence, stressing the value of the creditor's interest in the estate's interest in the property, conclude that it is proper to deduct hypothetical selling costs. Courts relying on the second sentence, emphasizing the purpose of the valuation and the proposed disposition of the property, do not allow the hypothetical sales cost deduction. In expressing its approval of reliance on the second sentence of section 506(a), the *Coker* court noted that this interpretation adheres to the guideline of statutory interpretation suggesting that all provisions of a statute should have effect. To allow hypothetical deductions, the court reasoned, ignores the "purpose of the valuation," and the "proposed disposition of the property," thus leaving no field of operation for the second sentence of section 506(a).

The *Coker* court found that the case of *In re Balbus*, wherein the Fourth Circuit addressed the interpretation of section 506(a) from a different perspective, controlled its decision. In *Balbus*, the creditor, rather than the debtor, argued for the deduction of hypothetical sales costs in order to raise the amount of unsecured debt above the \$100,000 jurisdictional limit for a Chapter 13 bankruptcy. The bankruptcy court in *Balbus* disallowed the deduction and the Fourth Circuit affirmed. In so holding, the court in *Balbus* analyzed the second sentence of section 506(a) using a two-pronged approach. The first prong focuses on the purpose of the valuation. The court concluded that because the purpose of the valuation was to determine jurisdiction, the no-deduction approach provided the more definite basis. The second prong focuses on the proposed use or disposition of the property. Because the debtor in *Balbus* did not intend to sell the property, the court concluded that this prong also prescribed the no-deduction approach.



Applying the *Balbus* analysis to the case at hand, the *Coker* court found that under prong one, the "purpose of the valuation," the purpose was to determine the secured portion of Sovran's claim. The court found this "purpose" consistent with the mandate of the first sentence of section 506(a) requiring a determination of the true value of the creditor's interest. The second prong, "the proposed use or disposition" of the property, therefore, presented the controlling question. The *Coker* court concluded that because the debtors did not intend to sell the property, it must deny the deduction of hypothetical sales costs.

In support of its conclusion, the *Coker* court noted that an advantage of Chapter 13 bankruptcy is that debtors can retain their homes by reaffirming the mortgage debt. The court reasoned that it is anomalous to allow debtors to reduce their mortgage debt based on the costs of a hypothetical sale of their property when Congress designed Chapter 13 specifically to allow debtors to avoid a sale. Allowing hypothetical deductions, the court reasoned, would allow debtors to "eat with the hounds and run with the hares."<sup>50</sup>

The Fourth Circuit's decision in *Coker* is significant in that it solidifies the position set forth in *Balbus*.<sup>51</sup> Prior to *Coker*, the applicability of the *Balbus* interpretation of section 506(a) to cases where the debtor, rather than the creditor, sought to deduct hypothetical sales costs was not entirely clear.<sup>52</sup> Having applied the *Balbus* analysis to *Coker*, the Fourth Circuit has firmly established its position in the interpretational debate of section 506(a).

### *In Re Bryson Properties, XVIII*

961 F.2d 496 (4th Cir.), cert. denied, 113 S. Ct. 191 (1992)

The absolute priority rule in bankruptcy reorganization provides that a reorganization plan must dispense all senior claims before a junior claim receives or retains property. A traditional exception to this common law rule is the new capital exception rule. The new capital exception rule entitles shareholders to make a contribution of capital to the debtor in return for an equivalent amount of equity.<sup>53</sup> In 1978 Congress codified the common-law absolute priority rule into the Bankruptcy Code,<sup>54</sup> but made no mention of the new capital exception. Whether the codified absolute priority rule includes the new capital exception has been the subject of controversy. The United States Supreme Court questioned the

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50. *In re Coker*, 973 F.2d 258, 260 (4th Cir. 1992).

51. *See id.* at 260 (holding that *Balbus* controlled court's decision).

52. *See id.* (noting that holding in *Balbus* addressed § 506(a) issue from different perspective).

53. *See Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106, 121 (1939) (ruling that stockholders of debtor may contribute new capital and retain their equity interest as exception to absolute priority rule).

54. 11 U.S.C. § 1129(b)(2)(B)(ii) (1988).

continued viability of the new capital exception but failed to decide whether the 1978 Bankruptcy Code abolished the exception.<sup>55</sup> The bankruptcy courts are divided on this issue,<sup>56</sup> and at least two federal circuit courts have explicitly chosen not to address the issue.<sup>57</sup>

In *In re Bryson Properties, XVIII*,<sup>58</sup> the United States Court of Appeals for the Fourth Circuit addressed whether the codified absolute priority rule includes the new capital exception. In this case, Bryson Properties XVIII (Bryson) purchased a commercial complex that was subject to a mortgage held by Travelers Insurance Company (Travelers). Bryson subsequently defaulted on the mortgage and filed for reorganization under Chapter 11 of the Bankruptcy Code. At the time of Bryson's Chapter 11 filing, Travelers's claims consisted of a secured claim equal to the value of Bryson's interest in the commercial complex and an unsecured deficiency claim. Bryson's reorganization plan divided the claims and interests of its creditors, including Travelers's, into eight classes. In addition, the plan provided Bryson's partners with the opportunity to contribute capital in return for continued control of the partnership. The bankruptcy court confirmed the plan over the objection of Travelers. Travelers appealed to the United States District Court for the Middle District of North Carolina which affirmed the bankruptcy court's decision. Travelers then appealed to the Fourth Circuit arguing that the plan was not fair and equitable to either its secured claim or its unsecured claim, and, therefore, the lower courts erred in confirming the plan.

On appeal, Travelers first argued that the plan used an incorrect discount rate which understated the present value of its secured claim. The court disagreed, finding the discount rate appropriate. Travelers then argued that the plan wrongly separated the unsecured claims in order to manipulate the confirmation vote. The Fourth Circuit agreed with Travelers and determined that Bryson violated the fair and equitable requirement through its manipulation of the voting classes. In so deciding, the

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55. *Northwest Bank Worthington v. Ahlers*, 485 U.S. 197, 203 (1988) (questioning continued viability of new capital exception, however refusing to rule on issue).

56. *Compare In re Woodscape Ltd. Partnership*, 134 B.R. 165, 175 (Bankr. D. Md. 1991) (holding statute does not bar new capital exception); *In re 222 Liberty Assocs.*, 108 B.R. 971, 984-85 (Bankr. E.D. Pa. 1990) (holding exception exists when there is present contribution with showing of necessity for contribution); *In re Snyder*, 99 B.R. 885, 888 (Bankr. C.D. Ill. 1989) (holding that new capital exception exists until higher court eliminates) *with In re Outlook/Century Ltd.*, 127 B.R. 650, 656 (Bankr. N.D. Cal. 1991) (holding that plain language of statute makes exception no longer viable); *Piedmont Assocs. v. Cigna Property & Casualty Ins. Co.*, 132 B.R. 75, 79 (N.D. Ga. 1991) (holding that statutory language and congressional intent preclude exception); *In re Lumber Exch. Ltd. Partnership*, 125 B.R. 1000, 1008 (Bankr. D. Minn. 1991) (holding that confirmation unfair when debtor's shareholders given right to retain or acquire interest through cash contribution), *aff'd on other grounds*, 134 B.R. 354 (D. Minn. 1991).

57. *See In re Greystone III Joint Venture*, 948 F.2d 134, 139 (5th Cir. 1992) (refusing to rule on issue); *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1361-63 (7th Cir. 1990) (questioning viability of exception but ruling it inapplicable to facts *sub judice*).

58. 961 F.2d 496 (4th Cir.), *cert. denied*, 113 S. Ct. 191 (1992).

court did not need to address any further issues. However, citing the need for judicial economy, the Fourth Circuit addressed the final issue of whether the codified absolute priority rule included the common-law new capital exception.

Travelers argued that the reorganization plan violated the absolute priority rule. The plan satisfied the partners' junior claim prior to settlement of Travelers's senior claim. The Fourth Circuit examined the legislative history of the absolute priority rule and found it inconclusive. The court then scrutinized the plain words of the Bankruptcy statute. The Fourth Circuit determined that the partners' retention of interest violated the absolute priority rule as specified in the statute because the equity holders had the exclusive right to retain their interest prior to satisfaction of Travelers's claim. Bryson argued that even though it retained an interest prior to the satisfaction of Travelers's claim, no violation existed because the codified absolute priority rule included the previously recognized new capital exception. The court explained that the bankruptcy court wrongly confirmed unless the absolute priority rule includes the new capital exception.

The Fourth Circuit analyzed the new capital exception in light of the principles of fairness and equity which guide the confirmation process. A court may confirm a reorganization plan over the objection of one claimant if the plan is fair and equitable to the dissenter.<sup>59</sup> The absolute priority rule was developed to assure fairness to the objecting party. The Fourth Circuit reasoned, therefore, that if the rule includes the new capital exception, the exception must also assure fairness. The court found that Bryson's plan did not meet the fairness requirement and determined that the new capital exception did not apply. According to the Fourth Circuit, by giving itself the exclusive right to contribute capital and thereby the right to first recovery, Bryson unfairly deprived Travelers of an equal opportunity to satisfy its claim. According to the Fourth Circuit, fairness and equity dictated that even if the new capital exception existed, it would not be applicable under these circumstances. The court implied that only under narrow circumstances would the new capital exception be viable.

The United States Courts of Appeal have hesitated to overrule the new capital exception. The Fifth Circuit refused to rule on the issue deciding a similar case on other grounds.<sup>60</sup> The Seventh Circuit questioned the viability of the new capital exception, but failed to overrule the exception.<sup>61</sup> In *Bryson*, the Fourth Circuit failed to definitively conclude whether the exception remains viable. In dictum, the court reasoned that if the exception were viable, then principles of fairness and equity would

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59. 11 U.S.C. § 1129(b)(1) (1988).

60. See *In re Greystone III Joint Venture*, 948 F.2d 134, 139 (5th Cir. 1992) (refusing to rule on new capital exception issue).

61. See *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1341, 1361-63 (7th Cir. 1990) (questioning viability of exception but ruling it inapplicable to facts).