UNPUBLISHED OPINION #347

IN THE UNITED STATES BANKRUPTCY COURT

FOR THE DISTRICT OF UTAH

CENTRAL DIVISION

In re:	
MEDICAL SYSTEMS RESEARCH, INC.,	Bankruptcy Number 89B-03601
	[Chapter 11]
Debtor.	

MEMORANDUM DECISION AND ORDER

Carolyn Montgomery, Esq., E. Russell Vetter, Esq., and John E. Diaz, Esq., of Parsons Behle & Latimer, Salt Lake City, Utah, appeared for the Debtor.

William G. Marsden, Esq., of Jardine, Linebaugh, Brown & Dunn, Salt Lake City, Utah, appeared for Water & Power Technologies, Inc. and Mount Olympus Waters, Inc., creditors.

Peter Kuhn, Esq., Assistant United States Trustee, Salt Lake City, Utah, appeared for the United States Trustee.

David Miller, Esq., Special Assistant United States Attorney, Salt Lake City, Utah, appeared for the Internal Revenue Service, creditor.

This matter comes before the court on the motion for confirmation of Medical Systems Research, Inc.'s (MSRI) chapter 11 plan. The court has previously made findings on the record indicating that all elements of 11 U.S.C. section 1129[1] have been met, except those relating to section 1129(a)(8), therefore, section 1129(b)(1) is applicable. The

[1] Future statutory references are to Title 11 of the United States Code unless otherwise noted.

remaining issues are whether MSRI's plan relies on the "fresh contribution" or "new value" exception to the absolute priority rule for confirmation, whether his court adopts the exception, and if so, whether MSRI's plan satisfies the exception. I find that the plan does rely on the new value exception to the absolute priority rule, but conclude that it is not necessary, under the facts of this case, to make a determination regarding the continuing vitality of the new value exception because the contribution contemplated is not substantial and affords the equity investor participation that is not commensurate with his capital infusion.

FACTS

History of MSRI

MSRI was formed in 1981 for the purpose of developing and marketing medical products including a new surgical scrub detergent and brush concept named Steri-Stat. LeGrand K. Holbrook (Holbrook) was the initial shareholder as well as President and Chairman of the Board. MSRI's original private stock offering raised $235,000. MSRI had 24 shareholders and a total of 2,887,000 issued shares as of the date of filing. Holbrook owns 1,000,000 of the issued shares.

MSRI began marketing Steri-Stat but ran afoul of the Food and Drug Administration (FDA) and production was seriously delayed. Subsequently, a number of shareholders joined together to form a joint venture to raise funds to enable MSRI to obtain FDA approval and effectively took over management of MSRI in 1985. In 1986, the joint venture replaced management and Holbrook resigned. Later that year, Holbrook was

invited back to assist in overseeing FDA compliance and to help market the company for sale. MSRI manufactured product on a limited basis and at the same time attempted to find a buyer for the company, but its efforts were hampered by excessive debt.

MSRI filed this chapter 11 in 1989. Rehabilitation has been delayed by lack of funding and government approval to market Steri-Stat, managerial confusion over whether MSRI should be sold or should continue to manufacture the product and conflicts with equity interest holders. Subsequent to the chapter 11 filing, Water and Power Technologies, Inc. (WPT), an entity long interested in acquiring control of MSRI, obtained court approval to loan MSRI $395,000 secured by a lien on MSRI's assets superior to existing liens. When WPT would no longer advance operating funds to MSRI, the court authorized MSRI to borrow up to $15,000 from Holbrook[2], and $2,500 from Douglas Holbrook[3], and granted them unsecured administrative claims.

MSRI's Plan

After various delays, a disclosure statement was approved, circulated to creditors, and the plan came on for confirmation. At the hearing, MSRI offered and the court received, a cash flow analysis (Projection) indicating income projections and debt service payments according to the terms of the plan, for the next seven years. The Projection incorporates the plan provisions, in relevant part, for payment of administrative

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[2] The monthly financial reports on file with the court do not reflect the full $15,000 advanced by LeGrand Holbrook, but the court assumes for the purpose of this decision that the funds were in fact advanced as represented.

[3] Douglas Holbrook is LeGrand Holbrook's brother. He is not listed as a pre-petition shareholder.

claims of $56,000 by the end of the plan's first year and payment of tax claims of $17,781 by the end of the plan's fourth year. WPT's impaired secured claim in the approximate amount of $400,000 is to be paid in full in monthly installments beginning at confirmation and concluding at the end of the plan's fifth year.

MSRI has unsecured creditors with claims totalling approximately $2,027,492. Unsecured claims will be paid beginning two years after the effective date, from monthly deposits of 10% of MSRI's net profits with annual disbursement on a pro rata basis for a period of five years or until unsecured creditors have received 10% of their claims. MSRI estimates that it will contribute approximately $2,000 per month toward payment of unsecured claims.

Upon confirmation, all existing stock in MSRI will be cancelled. The reorganized debtor will be authorized to issue 50,000 shares of new stock at par value of $1.00. MSRI will issue 2,500 shares to Douglas Holbrook and 15,000 shares to Holbrook as payment of their administrative claims. The plan is silent as to whom, or if, the remaining shares will be issued, but the Projection does not reflect any additional capital infusion during the next seven years. It appears that Holbrook will be the only employee of the reorganized debtor. Holbrook will receive a salary of $5,000 per month and will continue to serve as an officer and director of the reorganized debtor.

The plan provides that Holbrook will loan up to $150,000 to MSRI post confirmation, at 7% interest, secured by all of MSRI's assets. The loan is essential to the feasibility of MSRI's plan. The Projection amortizes the loan by payment of quarterly

interest payments, then 26 equal monthly payments of principal and interest beginning in the second year until WPT is paid in full. *See, In re Sawmill Hydraulics, Inc.*, 72 B.R. 454 (Bankr. C.D. Ill. 1987)(since reorganized debtor, not shareholders, was repaying borrowing, shareholders were not making capital contribution.) This loan to the reorganized debtor is not the equivalent of a fresh contribution infusion and is not included in the fresh contribution analysis because MSRI projects payment of the loan in full. *Compare with, In re Landau Boat Co.*, 13 B.R. 788 (Bankr. W.D. Mo. 1981)(New investors required to loan additional sums to debtor on 90-day terms. Where there was no evidence that debtor had the ability to repay, such loans were found to constitute substantial new contribution in light of risk of non-payment).

The Projection indicates that MSRI will not have a positive gross margin until the fifth month after the effective date of the plan and will rely on the $150,000 loan from Holbrook for operating expenses as well as debt service for a substantial period post confirmation. The Projection also indicates cumulative cash flow after operating expenses and payment of plan debt service as follows:

year 3 = $35,381
year 4 = $174,248
year 5 = $324,508
year 6 = $550,002
year 7 = $776,326

No evidence was presented regarding the present value of the cumulative cash flow MSRI would enjoy in years three through seven. MSRI estimates the value of its assets at confirmation to be $383,000, but that the liquidation value would be zero.

The unsecured class, consisting of the 111 claimants in the approximate amount of $2,027,492, voted to reject MSRI's plan. Although voting was complicated by a nonconforming ballot, the class consisting of all allowed equity interest holders in MSRI either rejected or is deemed to have rejected the plan.[4]

DISCUSSION

Jurisdiction

These confirmation issues are within the core of this court's jurisdiction pursuant to 28 U.S.C. section 157(b)(2)(L), and the court can enter a final order. The court considered the arguments of counsel, independently reviewed applicable case law, and based thereon reaches the following determination.

MSRI's Plan Relies on the New Value Exception

MSRI's plan does not specifically identify the payment of Holbrook's administrative claim by the issuance of stock in the reorganized debtor as a fresh contribution exception to the absolute priority rule. Instead, MSRI argues that the plan simply anticipates the satisfaction of Holbrook's section 503(b)(1) claim by the issuance of stock, which is not a payment "on account" of his pre-petition stock interest.

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[4] Included with the nonconforming ballot was correspondence by equity interest holders objecting to confirmation because of Holbrook's retention of equity in MSRI. The objection was procedurally improper and not served upon MSRI's counsel. However, MSRI has been given an opportunity to respond to the objection, as well as the issues raised by the court relating to the ability to confirm the plan in light of the absolute priority rule.

MSRI's characterization over-simplifies the analysis. In effect, the plan vests 83% of the equity in the reorganized debtor in Holbrook in return for his pre-confirmation unsecured loan to MSRI of $15,000. Since the result of the plan falls squarely within the provisions of section 1129(b), it would be inappropriate for the court to look to the form of the plan over the substance of the result. It is well settled that creditors are entitled to the benefit of new value, whether it is present or prospective, for dividends or only for purposes of control. *Northern P.R. Co. v Boyd,* 228 U.S. 482, 508 (1913). In light of the rejection of the plan by the unsecured and equity interest holders classes, it is incumbent upon the court to determine whether the plan is fair and equitable with respect to each class of claims or interest that is impaired under, and has not accepted, the plan.

Application of the New Value Exception

The debate regarding whether the new value exception to the absolute priority rule remains viable after enactment of the 1978 Code is a topic of much litigation, scholarly debate and judicial pondering. *Phoenix Mutual Life Ins. Co. v. Greystone III Joint Venture (In re Greystone III Joint Venture)*, 948 F.2d 134 (5th Cir. 1991).[5] The Supreme Court refused to resolve the issue in *Northwest Bank Worthington v. Ahlers*, 485 U.S. 197, 108 S.Ct. 963 (1988). The Court applied the doctrine without determining whether the doctrine was

[5] Most recently, fresh contribution issues have arisen in cases with a single asset encumbered by one secured creditor with a bifurcated code created deficiency claim that is sufficient to control voting in the unsecured class. In contrast, this is a case with a class consisting of over 100 unsecured creditors that have, for their own reasons, voted against the plan. In addition, it appears that other equity interest holders have voted against the plan. Regardless of the factual context in which the issue arises, any interpretation of the doctrine should be narrowly construed in light of the general principal that all the debtor's property should be shared by creditors before equity participates.

still viable after passage of the Bankruptcy Code in 1978.[6] *Ahlers*, 485 U.S. at 203 n. 3, 108 S.Ct. at 967 n. 3. Employing the same technique and assuming *arguendo*, that MSRI's plan based on the new value exception is authorized by the Code, the court must determine if the plan is fair and equitable in light of the equitable judicial exception reiterated in *Case v. Los Angeles Lumber Products Co.,* 308 U.S. 106, 121 (1939). In *Case*, the court required that the contribution must comply with the following requirements: 1) it must be necessary to the success of an effective reorganization; 2) it must be made in money or money's worth; and 3) the contribution must be commensurate or reasonably equivalent to the securities received. *Case*, 308 U.S. at 121-22. In application, the elements that the contribution be in money or money's worth and that it be commensurate or reasonably equivalent to the securities received, are really sub-elements of the concept that the contribution must be substantial.

Necessity

In *Case* the court did not specify at what point the contribution must be necessary, i.e., whether the contribution must be made at confirmation or, as in this case, before confirmation and paid as an administrative claim. Instead, the Court simply stated "[w]here that necessity exists and the old stockholders make a fresh contribution and receive

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[6] Following enactment of the Bankruptcy Code, bankruptcy courts at first appeared to assume the survival of the new value exception, whether or not they applied it. *Teamsters Nat'l Freight Indus. Negotiating Comm. v. U.S. Truck Co. (In re U.S. Truck Co.)*, 800 F.2d 581, 588 (6th Cir. 1986); *In re Aztec Co.*, 107 B.R. 585,588 (Bankr. M.D. Tenn. 1989); *In re Eaton Hose & Fitting Co.*, 73 B.R. 139, 140 (Bankr. S.D. Ohio 1987); *In re Sawmill Hydraulics, Inc.*, 72 B.R. 454, 456 (Bankr. C.D. Ill. 1987); *Brown v. Brown's Indus. Uniforms (In re Brown's Indus. Uniforms)*, 58 B.R. 139, 141 (Bankr. N.D. Ill. 1985); *In re Jartran, Inc.*, 44 B.R. 331, 366-68 (Bankr. N.D. Ill. 1984) *In re Landau Boat Co.*, 13 B.R. 788, 792 (Bankr. W.D. Mo. 1981); *Buffalo Sav. Bank v. Marston Enters. (In re Marston Enters.)*, 13, B.R. 514, 518 (Bankr. E.D.N.Y. 1981).

in return a participation reasonably equivalent to their contribution, no objection can be made." *Case*, 308 U.S. at 119.

This court already found that it was necessary for MSRI to borrow $15,000 from Holbrook under the provisions of section 364(b). Under the facts of this case, no different standard need be applied between the standard employed by the court in granting the motion for post-petition borrowing and the requirement that the fresh contribution be necessary. The monthly cash flow was insufficient to meet MSRI's operating expenses and the funds were necessary to provide a retainer so that MSRI could retain counsel. *See, generally In re Tallahassee Assocs. L.P.*, 132 B.R. 712, 718 (Bankr. W.D. Pa. 1991). Therefore, MSRI's plan has met the necessity element.

Money or Money's Worth

The case law generally indicates that the new value must be substantial, but that test has several aspects. One element of the test that the contribution is substantial is that it must be in money or money's worth. *Ahlers*, 485 U.S. at 204, 108 S.Ct. at 966. Holbrook made his $15,000 administrative loan to MSRI in money or money's worth. Holbrook does not claim that his managerial expertise or experience is a substitute for cash.

Commensurate Contribution

The second facet of the substantiality test is that the participation accorded to those making the capital infusion must be commensurate with or reasonably equivalent to the capital infusion. *In re Greystone III Joint Venture*, 102 B.R. at 577 (Bankr. W.D. Tex. 1989), *reversed on other grounds* 948 F.2d 134 (5th Cir. 1991). To determine if the capital

infusion is commensurate with the equity interest retained, it is necessary to remember that even if the debts of MSRI far exceed the current value of its assets, Holbrook, in retaining or acquiring an 83% equity interest in the reorganized debtor, retains "property." *Ahlers,* 485 U.S. at 197, 207-09, 108 S.Ct. 963. 969-70 (1988). This court must evaluate not only the value of the equity in MSRI that is to be acquired by Holbrook, but also the "value" of senior rights threatened by the capital infusion, and in so doing must value all aspects of MSRI.

MSRI indicated that the value ascribed to its assets on a non-liquidation basis is $383,800. Of that figure, $350,000 is attributed to the Abbreviated New Drug Application (ANDA), the basis of Steri-Stat, and related intangible property. It is from this existing asset, in large part, that the long term value of the reorganized debtor arises. The ANDA has established value and it is not dependent upon new or speculative research and development.

MSRI has value even though it has a "negative equity" at the present time. That value will be increased as payments are made on debt service according to the plan. *Tallahassee Assocs.*, 132 B.R. at 719-20. It is also appropriate to capitalize the prospective earnings recited in the Projection to determine the relative value of Holbrook's newly acquired equity. *Consolidated Rock Products, Co. v. DuBois,* 312 U.S. 510, 61 S.Ct. 675, (1941). In the case at bar, no evidence was presented to the court as to an appropriate capitalization rate to be applied to the stream of earnings projected by MSRI over the next seven years. MSRI's evidence did indicate that the cumulative cash flow, or retained

earnings, in the third year of operation after confirmation would be $35,000, advancing to $776,000 in the seventh year. The Projection indicates that sufficient revenue would be available in year seven to retire all debt service, as well as repay in full the $150,000 loan from Holbrook to MSRI. Stated another way, the Projection indicates that Holbrook will not only control the reorganized debtor and receive a $5,000 per month salary, but his $15,000 cash infusion will have doubled in three years. By the seventh year, his investment, without applying any present value discount, would have increased 51 times in value. In effect, Holbrook will own 83% of the assets of MSRI free of encumbrances as well as the going concern value of the reorganized debtor. Although the court has no appropriate capitalization rate to apply to this kind of enterprise, it is apparent that the present value of the cumulative cash flow significantly exceeds Holbrook's $15,000 investment.

Holbrook's new value contribution must be analyzed in light of the value of senior rights being threatened. In is important to remember that many of the early cases that established the new value exception dealt with the relation of various classes of equity interests. *Kansas City Terminal Ry. Co. v. Central Union Trust Co.*, 271 U.S. 445, 46 S. Ct. 549 (1926). In this case accurate valuation of the interest of the unsecured or the equity class is impeded by lack of a capitalization rate. However, it is important to note that Holbrook's new value contribution was made by advances to MSRI as an administrative claim granted under the noticing provisions of Fed. R. Bankr. P. 4001(c) rather than with notice to all creditors and equity interest holders. Limited notice was appropriate for the purpose of granting an unsecured administrative claim, but notice did not go to all equity

interest holders. Neither did the plan offer all equity interest holders the opportunity to exchange old equity for new if the interest holder could make a substantial contribution.

The class ballot filed by some of the equity interest holders makes calculating the voting for this class difficult, but the class rejects or is deemed to reject pursuant to section 1126(g) under any circumstance. Holbrook believes that other equity interest holders would not have participated in advancing new capital to MSRI even if the opportunity had been afforded to them. Notwithstanding Holbrook's belief, it appears inequitable to allow Holbrook the only opportunity to participate in the future profits of MSRI and to deny the same opportunity under similar terms to other equity interest holders.

The court should also review Holbrook's contribution in relation to the amount of pre-petition claims. *In re Kendavis Indus. Int'l, Inc.,* 91 B.R. 742, 749 (Bankr. N.D. Tex. 1988). The pre-petition debt set forth in the plan exceeds $2,060,000. Holbrook's contribution is .0073% of that amount. The contribution is also insubstantial in light of the debt sought to be discharged through this plan. The amount paid to unsecured creditors is 10% or 10% of net profits for five years.[7] Based only upon the 10% of claims figure, $1,824,743 in unsecured debt will be discharged. Holbrook's contribution represents .0082% of that amount. Other cases have found infusions equal to 2% of pre-petition debt and 4% of discharged debt not to be substantial new value contributions. *In re Pullman Constr. Indus. Inc.,* 107 B.R. 909, 950 (Bankr. N.D. Ill., E.D. 1990).

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[7] The cash flow analysis indicated the amount paid to unsecured creditors was projected to be approximately $100,300. Ten percent of the unsecured claims would be approximately $202,700.

The court previously found that Holbrook's cash infusion was necessary to MSRI's rehabilitation. However, none of the funds will go to repay prepetition creditors. All the funds were apparently used prior to the confirmation hearing to fund MSRI's monthly operation. In order to retain an equity position, the cash infusion should inure to the benefit of prepetition creditors. In *Tallahassee Assocs.*, the court concluded that: "The unfairness and inequitability of the proposed treatment of PFC [an under-secured creditor] is exacerbated by the fact that *none* of the infused capital would go to satisfy creditors, in particular PFC". *Tallahassee Assocs.*, 132 B.R. at 720. Holbrook's contribution has not been used to pay creditors and granting Holbrook an equitable interest in MSRI based on this contribution produces the same inequitable result.

CONCLUSION

The court analyzed the risk-reward of Holbrook's cash infusion versus the creditors' entitlement to control over the venture by virtue of the operation of the absolute priority rule. In the final analysis, the entire exercise is an attempt to objectively determine whether the treatment of the rejecting class under the plan is fair and equitable. It is apparent that the participation proposed to be afforded to Holbrook is not commensurate with his capital infusion, and that the amount is not substantial either in light of the value to be received, the pre-petition debt, or the debt to be discharged. Without reaching a determination of whether the new value exception remains viable, it is apparent that this plan may not be confirmed. Therefore, it is hereby

ORDERED, that confirmation of MSRI's Fourth Amended Plan of Reorganization is denied.

DATED this 5 day of February, 1992.

JUDITH A. BOULDEN
United States Bankruptcy Judge