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NEW VALUE AND THE COMMISSION: *HOW BIZARRE!* [*]

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It was bizarre. As the Emperor rode in splendor through the city, throngs of cheering subjects admired the Emperor's stature, the Emperor's grace—and the Emperor's clothes. It was common wisdom that the Emperor's dress was always the epitome of sartorial splendor. Then one small child, regardless of common wisdom, ingenuously exclaimed: "But the Emperor is wearing no clothes!" And, as everyone knows, the child was correct.[1]

Abiding by the principle that age is a state of mind, I feel like that child when I exclaim through this article that when the Commission, [2] in its report, [3] advocates a new value exception or corollary to the absolute priority rule, [4] it fails to clothe its proposal in meaning. Is the Commission's advocacy of new value an attempt to codify a fully articulated corollary to the absolute priority rule as the drafters appear to believe, or is the proposal simply semantic legerdemain designed to abolish the absolute priority rule as some critics may believe?

There are at least two diametrically opposed theories as to what constitutes a new value plan, one that bars the retention of an interest by old equity [5] unless the full priority rights of creditors are protected, and the other, developed after the adoption of the Bankruptcy Code, that would allow old equity to retain an interest while creditors claims are wiped out. The key to which theory would predominate under the Commission proposal may be the position of the unsecured creditors after confirmation of the plan of reorganization. If old equity's new value contribution would result in a reorganized enterprise that preserves the priority rights of creditors while enabling old equity to obtain a reasonably equivalent pro rata interest in the enterprise, the proposal would codify a corollary to the absolute priority rule and creditors would have no reason to complain. If, however, the new value contribution would wipe out the interest of existing creditors while leaving the enterprise in the hands of old equity, new value would not be a corollary; it would be an exception to the absolute priority rule having the potential of undermining absolute priority completely.

Remarkably, the Commission Report does not deal with the position of the creditors post−confirmation, although the Commission Report cites to cases where the new value plan effectively wiped out creditor's interests. Absolute priority has been the millrind, the central support of our corporate reorganization structure for almost a century. [6] It should not be eviscerated either by inadvertence or by indirection. [7]

Under present law, there is also significant confusion as to what prerequisites to a debtor's new value plan—necessity, reasonable equivalence, and substantiality [8] —are still recognized as applicable, and if they are applicable, what each one means. The Commission's proposal allows old equity to "purchase" an interest without any conditions although the proposal seems to assume that the prerequisites are applicable. [9] Even if prerequisites were meant to apply, the Commission does not attempt to determine what each means, thus perpetuating the current chaotic situation in which judges seem to be able to read prerequisites in or out of new value virtually at will.

In what may appear an attempt to temper potential opposition of creditors to its proposal, the Commission proposes the elimination of exclusivity upon the submission of a new value plan by the debtor. [10] The concept certainly has validity. It is based on the fact that absolute priority would be abridged if old equity, on account of its former equity interest, is given an interest in the debtor while creditors remain unpaid. Where old equity is in control of a debtor with the exclusive right to submit a plan, it is difficult to conclude that the interest old equity assigns to itself is not obtained on account of its prior equity interest. If, however, bidding is opened up to all upon submission of a new value plan, in theory old equity will be on the same footing as anyone proposing to purchase assets or stock of the debtor. Unfortunately, however, the proposal itself does not explain how elimination of exclusivity will work and how it would protect creditors. Among other things, it *does not* disclose how a counter−plan may be proposed by a creditor from a mechanical standpoint; *does* urge that any creditor who manages to submit a counter−plan will not be able to offset its claim against the contribution required in such a plan; [11] and *does not* explain how a creditor can be certain its plan, even if it offers more, will be confirmed by the court over the debtor's plan. Thus it is very possible that the elimination of exclusivity offers creditors very little.

This article will discuss the development and importance of the absolute priority rule and the new value principle prior to the adoption of the Bankruptcy Code. This principle will be compared to its application in post−Code cases with special reference to its function in single asset real estate cases (including a discussion of a proposal by the Small Business Working Group to furnish some protection to single asset creditors that may be injured by the application of the post−Code new value principle). It will then look into the prerequisites to absolute priority to see if they exist and if so, what they mean under current decisions. Finally, the article will review the proposal to lift exclusivity on submission of a new value plan and its effect on creditors.

The article concludes that the Commission's new value proposal produces a situation that is truly bizarre—a proposal whose effect is unknown—and urges that it *not* be adopted by Congress because without further definition, it has the potential of creating more litigation and more inconsistencies in court decisions than we face today. Not only did the Commission fail to articulate what its proposals actually do, but also, perhaps because of the short time frame allocated to the Commission to complete its report and its broad mandate to deal with the entire Bankruptcy Code, the Commission did not have the opportunity to explore the basic substantive plan confirmation issues that are the foundation for the current confusion in the courts. The article suggests some questions that must be asked in a thorough study of plan confirmation including an articulation of exactly what absolute priority and new value mean, what the purpose of exclusivity is, whether there are any prerequisites to new value plans, and why it would not make sense to have discrete plan confirmation rules for single asset as distinguished from going concern business enterprises.

Notwithstanding the foregoing objection to the new value proposal, this author wishes to make it clear that objection to one proposal does not constitute an objection to the Commission Report as a whole. The National Bankruptcy Review Commission has performed an enormous service by opening the debate on Bankruptcy Code reform and through its comprehensive report, has furthered the universal goal of the entire insolvency community—to improve the fair and effective administration and adjudication of bankruptcy issues. The Commission Report, entitled "Bankruptcy: The Next Twenty Years," will undoubtedly influence the course of bankruptcy legislation for that period and beyond, in this nation and throughout the world.

I. The Commission Proposal

It is not entirely clear that the Commission ever voted on the new value proposal contained in the Commission Report. [12] In her dissent, [13] Commissioner Jones refers to the proposal as "the five−member Commission proposal." [14] For the purposes of this discussion it will be assumed that a majority of the Commission adopted the new value proposal.

The Commission majority proposal on new value is section 2.4.15 of the Commission Report. [15] It states:

> U.S.C. § 1129(b)(2)(B)(ii) should be amended to provide that the court may find a plan to be fair and equitable that provides for members of a junior class of claims or interests to purchase [16] new interests in the reorganized debtor. [17]
>
> 11 U.S.C. § 1121 should be amended to provide that on the request of a party in interest, the court will terminate exclusivity if a debtor moves to confirm a non−consensual plan that provides for the participation of a holder of a junior claim or interest under 1129(b)(2)(B) but does not satisfy the condition set forth in 1129(b)(2)(B)(i). [18]

The proposal would thus permit the court to "cram down," (or impose) a plan over the objection of an impaired class or classes under which old equity is to "purchase" an interest in the debtor, and also provide for the termination of exclusivity upon submission of such a new value plan. [19]

The Commission justifies its new value proposal as a means to resolve open questions that lead to litigation. The Commission Report states:

> Any legal uncertainty regarding the rules of cramdown creates a turbulent environment for negotiating the reorganization of businesses. . . . [L]itigation over ambiguous cramdown rules can foreclose any possibility of reorganizing a family farm or a 'mom−and−pop' store because they cannot afford the extensive litigation that would be required. [20] . . . [F]air and clear cramdown rules are necessary to maximize the likelihood that an appropriate opportunity for reorganization is available to the parties. [21]

This article agrees fully with the sentiment that it is important to eliminate uncertainty. What is so bizarre is that the Commission Report not only fails to resolve the existing uncertainty concerning the meaning and effect of new value plans but creates new uncertainties that promise to spawn litigation for many years to come.

II. Questions Unanswered by the Commission Report

A. What New Value Principle is the Commission Advocating?

There have been two very different interpretations of the effect of a new value plan, with dramatically different consequences for the rights of creditors. Notwithstanding the fact that the *raison d'etre* for the survival of a new value principle under the Bankruptcy Code is that Congress intended that pre−Code practice be incorporated into the Code, [22] the new value principle as interpreted by courts under the Bankruptcy Code is not the same new value principle articulated under pre−Code law.

1. Absolute Priority

Absolute priority means that junior interests, especially old equity, cannot retain property in the debtor under a reorganization plan that impairs objecting senior interests. [23] It has been this principle that has governed rights to the assets of failing enterprises going back at least to 1868 when the Supreme Court determined: "Equity regards the property of a corporation as held in trust for the payment of the debts of the corporation . . . [S]tockholders are not entitled to any share of the capital stock nor to any dividend of the profits until all the debts of the corporation are paid." [24]

In more modern times it is said that absolute priority has been incorporated into bankruptcy law by the requirement that a plan be "fair and equitable." [25] The courts have held that a plan is not considered to be fair and equitable if it does not afford absolute priority. [26]

2. The New Value Principle of *Case v. Los Angeles Lumber*

In 1939, a plan in an equity receivership came before the U.S. Supreme Court in *Case v. Los Angeles Lumber Prods. Co.,* [27] which had been approved by all classes of creditors but to which one individual creditor objected. [28] The objection was based on violation of the principle of absolute priority in that old equity was given an interest (equal to 23% of the assets of the enterprise) in the reorganized corporation while creditors were not paid in full. [29] The lower court approved the plan stating that it was important "to retain the old stockholders in the business because of 'their familiarity with the operation' of the business and their 'financial standing and influence in the community'; and because they can provide a 'continuity of management.'" [30]

In what can only be described as a paean to the principle of absolute priority, the Supreme Court reversed the decision below on the ground that the plan was not fair and equitable because old equity was allowed to participate while creditors were unpaid. [31] Mr. Justice Douglas, writing for what appears to have been a unanimous court, [32] cited a series of Supreme Court decisions affirming the "'familiar rule' that 'the stockholder's interest in the property is subordinate to the rights of creditors; first of secured and then of unsecured creditors," [33] and that "'[a]ny arrangement . . . by which the subordinate rights and interests of stockholders are attempted to be secured at the expense of the prior rights of either class of creditors comes within judicial denunciation." [34] The court went on to describe this as the

> 'fixed principle' according to which . . . the character of reorganization plans was to be evaluated . . . 'if the value of the road justified the issuance of stock in exchange for old shares, the creditors were entitled to the benefit of that value, whether it was present or prospective, for dividends or only for purposes of control. In either event it was a right of property out of which the creditors were entitled to be paid before the stockholders could retain it for any purpose whatever.' [35]

Having said this, the Court pointed out that it had previously stated that creditors could be protected "through other arrangements *which distinctly recognize their equitable right to be preferred to stockholders against the full value of all property belonging to the debtor*." [36] However, these arrangements are still subject to "the rigors of the 'fixed principle.'" [37] For example, the Court noted in *Northern Pac. Ry. Co. v. Boyd,* [38] even though the stockholder bought new stock in cash, the plan violated absolute priority because the provision was not made for the unsecured creditor. [39]

Justice Douglas then made the oft quoted comments that gave birth to the new value dictum. He stated that where the *necessity* for funds exists and old equity makes a fresh contribution "and receive[s] in return a participation *reasonably equivalent to their contribution,*" [40] the creditors cannot object that they are not accorded their "*full right of priority* against the corporate assets." [41] The Court then rejected the argument that the promised contribution of expertise by old equity was reasonably equivalent to old equity's participation because it merely reflected "vague hopes or possibilities." [42] The plan could not be confirmed. [43]

As articulated in *Case,* new value was not an exception, but a natural corollary to the rule of absolute priority. [44] It implicated *both* the protection of the rights of creditors *and* the circumstances under which rights may be retained by old equity. [45] Old equity could retain an interest reasonably equivalent to its new value contribution only if creditors were accorded "their full right of priority" against the debtor's assets. [46] Old equity could not obtain its interest "at the expense of the prior rights of . . . creditors." [47] In theory, the enterprise, including its control, remained with the creditors and old equity's interest was limited to the amount of new value contributed in the proportion it bore to the interest of the creditors. [48]

This balance may be easier said than achieved. While much has been made of the existence of a new value exception as the result of *Case*, giving rise to the implication that it was in fact already on the slate used by Congress to draft the Bankruptcy Code, in reality, as far as we have been able to determine, it was never employed pre−Code to cram down a nonconsensual new value plan. [49] In his superb analysis of new value, Professor Ayer stated that:

> [t]here appears to be no reported case in the entire period [1939 (decision in *Case*) to 1978 (Bankruptcy Reform Act)] in which the court expressly permitted the 'debtor,' or former equity owners, to retain assets on the strength of a new value contribution and for no other reason. . . . Justice Douglas' supposed 'exception,' . . . is nowhere present as a rule of decision in Chapter X cases. New value under Chapter X, then, is an illusion. [50]

Why wasn't the new value corollary used? Perhaps it was the conceptual difficulty in applying new value so as to achieve the balance that Justice Douglas demanded. [51] There are several different approaches that can be taken to Justice Douglas' challenge to protect the creditors full right of priority while allowing old equity to retain a new value interest. I read Professor Ayer to conclude that, conceptually, it cannot be done. This *impossibility theory* is based on the conclusion that (i) any new value contribution by old equity admits that the debtor has residual equity, [52] and (ii) under absolute priority the entire residual equity belongs to the unpaid creditors. [53] Furthermore, even if it were determined that the debtor had no equity, i.e. in single asset cases where the mortgage balance exceeds the value of the asset, the Supreme Court has rejected old equity's argument that its retention of the property would cause no injury to creditors. [54] Thus, it would not be possible for old equity to retain any interest when creditors are not paid. [55] New value simply does not work.

However, there are at least two other approaches that may partially reconcile new value and creditor protection. They are based on the concept that absolute priority should not require that the unpaid creditors receive the *post−confirmation* value of the enterprise, but rather only the value of the enterprise *at confirmation*. [56] One such theory might be called a "*share the equity theory*." Under this theory, the enterprise value remains with the creditors. If old equity contributes new value it would be entitled to an interest equal to the increase in the value of the enterprise caused by the contribution. If one compares the reorganizing enterprise to a loaf of bread, each creditor would receive a slice of the bread in order of priority. The interest of old equity acquired with new value would be equal to any increase in the size of the loaf occasioned by the new value infusion. While the existing creditors share of the enterprise might thus be reduced from a percentage standpoint because of the new value contribution, it would be a percentage of a larger whole and, in theory, these creditors would be unaffected from the standpoint of value. Old equity would simply share the reorganized enterprise with existing creditors pro rata. For example, assume an enterprise had ten creditors, each (for mathematical simplicity) with the same amount of debt. If the enterprise had a value of $100,000, each creditor would have 10% of the enterprise and each 10% interest would have a value of $10,000. If old equity contributed $10,000, the enterprise value would increase to $110,000. Now each of the creditors, and old equity, would have an interest equal to approximately 9% of the enterprise, but because the pot has been sweetened, each creditor's interest would continue to be worth $10,000. [57]

In the situation described, this approach helps to reconcile the two competing interests. The problem for creditors is that what is being shared is whatever equity the enterprise has without any regard to the amount of unpaid debt. Thus, the lower the enterprise equity, the greater the amount of debt that will be unpaid while old equity participates. In the above example, if the enterprise had equity of $50,000 instead of $100,000, each creditor would have a 1/10 interest valued at $5,000 each while the $10,000 new value contribution would give old equity a 16% interest in the enterprise, worth $10,000. This result may be justified on the ground that creditors are receiving the value of the enterprise. However, if the debtor had *no* equity, under this theory the creditors might end up with nothing, losing their right of control, which the Supreme Court in *Boyd* [58] said could not happen. Thus this theory would seem to work only if there were some reasonably accurate method to value control.

Creditors would prefer a third approach, which might be called the "*share with the debt theory*." This approach also assumes that what creditors are entitled to is the value of the enterprise at, rather than post, confirmation. [59] If this enterprise value belongs to creditors, including the value of control, then the enterprise is supporting the full amount of unpaid debt, and any new value contribution must be related to the amount of that debt. The balance between the competing interests is effected by affording old equity an interest equal to the percentage obtained by comparing the new value contribution with the unpaid debts to creditors. In the above example, then, if the unpaid debts owed to the ten creditors totaled $200,000 and the equity was the same $100,000, old equity's new value contribution of $10,000 would result in the retention of an interest equal to 4.7% ($10,000 divided by $200,000). By relating the new value contribution to amount of unpaid debt, this formula can be applied even where the debtor has no equity, such as in single asset cases.

On the other hand, old equity would be discouraged from making such an offer because the percentage interest received would not, on its face, have a value equal to the contribution offered [60] assuming the valuation, over which the debtor has much control, is accurate. [61] While it could be argued that any difference between the contribution and the interest obtained represents the value of the degree of control taken by old equity, this theory, as well as the *share the equity* theory, are somewhat problematic. This tends to lend credence to Professor Ayers' conclusion that the Douglas requirements may be impossible to achieve and offers one reason why new value cramdowns do not seem to have taken place pre−Code when the Douglas requirements were observed by the courts.

What these theories tend to indicate is that there may not have been a fully conceptualized new value corollary under pre−Code law, and even if there were such a corollary, it is not at all clear how or on what basis it would be applied. The one thing that should be clear to all, however, is that under the pre−Code Supreme Court decisions it would not be possible to conclude that a plan could be confirmed under which old equity's new value contribution would result in the debtor keeping the enterprise, while wiping out the obligations owed to creditors. We shall see, however, that this is exactly what many post−Code cases permit.

B. The New New Value of Post−Code Cases

While it is not clear that new value survived the adoption of the Bankruptcy Code, [62] in order to explore how new value affects the rights of creditors, this article assumes, without agreeing, that new value lives post−Code. While the Supreme Court in *Ahlers* did not reach the issue of whether the new value corollary was incorporated in the Bankruptcy Code, [63] Justice White stated that the "statutory language and legislative history of section 1129(b) clearly bar any expansion of any exception to the absolute priority rule beyond that recognized in our cases at the time Congress enacted the 1978 Bankruptcy Code." [64] Notwithstanding this statement, many of the new value cases decided post−Code have radically expanded pre−Code interpretation of the effect of new value plans. In these cases, a new value contribution has severely reduced or effectively wiped out the interest of existing unsecured creditors while old equity was permitted to retain the property free of debts. [65] This approach appears to turn a simple corollary into an easily manipulated exception to the absolute priority rule, which can effectively destroy it.

The post−Code cases may possibly be explained by the fact that unlike the situation *Case* was addressing, old equity is *forcing* its way into the reorganized enterprise through the cramdown plan. In *Case*, all classes of creditors had approved old equity's participation by the requisite majority. The notion that old equity had a right to propose, and have confirmed, plans that would compel the transfer of interests to it, over the objection of creditors, was obviously not even contemplated by Justice Douglas. As pointed out in the Commission Report, the absolute priority rule was first invoked to protect intermediate creditors from being squeezed out by an arrangement between the senior creditors and old equity. [66] In post−Code cases, however, the debtor proposes the cramdown plan that effectively squeezes out the unpaid creditors.

Additionally, this post−Code change occurs under Chapter 11 of the Code where the debtor is normally in possession, while under pre−Code Chapter X, a trustee was appointed to manage the assets. [67] As pointed out by Judge Fenning in *In re A.V.B.I., Inc.*, [68] with the debtor in control of the books and operations, there is concern among creditors that the company is run "with the intent of unfairly squeezing out the creditors." [69] The debtor in possession, in control of the information as to the enterprise's economic viability, is the driving force behind the new value proposal. [70] No longer are we concerned about whether creditor classes can vote to include old equity; new value becomes a vehicle for preserving old equity at the expense of the creditors.

While most post−Code new value cases involved single asset real estate, which has peculiar problems of its own and is discussed below, *In re U.S. Truck Co.* [71] is a good example of a post−Code corporate case that turned the new value corollary into an exception.

1. Corporate—U.S. Truck

In December of 1982, after U.S. Truck Company filed in bankruptcy, it disaffirmed its collectively bargained agreement with the teamsters, resulting in a significant claim by the union. This contract was one of the major causes of the debtor's distressed financial situation. After disaffirmance, an interim agreement was worked out between management and labor under which the major management objection to the old contract was removed. [72] As a result, the company turned a deficit into monthly profits of $100,000 to $250,000.

Despite the profits, the bankruptcy and district courts (affirmed by the Sixth Circuit) found that the value of the company was only $100,000. The low value was based in large part on potential future problems arising because the union continued to insist on return to the onerous (to management) provisions of the old labor contract and threatened a strike if it did not get the changes it wanted in the negotiations that were to take place in the near future. [73] The Court noted that the interim contract expired shortly after the plan would have been confirmed, [74] placing the company in the difficult position of taking a strike or acceding to the union demand, either of which would have destroyed the profitability of the company. [75]

The debtor filed a plan of reorganization under which, *inter alia*, old equity would contribute $100,000 and receive all the stock of the company. [76] Most creditors would be left unimpaired, but the Teamsters' claim, in a separate class, would be paid approximately 70% of the finally determined amount. [77] While this result would seem clearly in conflict with absolute priority (old equity got the company and the creditor's full priority was reduced by 30%), the court determined that new value had survived the adoption of the Code and that because of the contribution of $100,000, the debtor's plan met section 1129(b)'s fair and equitable requirement. [78] Thus the court approved confirmation of a plan that gave 100% of the corporation to the shareholder and wiped out 30% of the debt owed to the creditor.

Application of new value to plan confirmation is obviously complex and subject to different interpretations. However, is it not at least arguable that *Case* and *U.S. Truck* present different interpretations of new value and, if so, that the adoption of either theory will significantly affect the position of the debtor and the creditor and ultimately, the fundamental requirements of the insolvency laws? Yet the Commission's proposed change does not state which interpretation it favors. Without some explanation of what the effect of old equity's "purchase" of an interest will be, enacting the Commission's proposal would leave those significant questions for determination by the courts through extensive litigation. Isn't this exactly what the Commission majority wanted to prevent? [79]

2. Single Asset Real Estate

Single asset real estate brings the issue of the meaning of new value into sharper focus. In these cases the major creditor (the mortgagee) is usually undersecured. This means that the mortgage debt exceeds the value of the collateral and even when the mortgage is stripped down, under section 506(a), [80] to the value of the collateral, there is no equity. In this situation many courts have not hesitated to ignore, or give only lip service to the absolute priority aspect of Justice Douglas' articulation of new value.

a. Cases

A few cases may serve as examples of cases where such plans were proposed or confirmed. In *Phoenix Mutual Life Ins. Co. v. Greystone III Joint Venture (In re Greystone III Joint Venture)*, [81] the mortgage debt was $9.3 million, but the court determined that the value of the collateral had declined to $5.8 million. This left the mortgagee with a secured claim equal to the value of the collateral, and an unsecured claim for the deficiency, $3.5 million. Other debt equaled $145,000 in taxes and $10,000 in trade debt.

The debtor's plan proposed a $500,000 new value contribution by the partners of the debtor, which would be applied to payment of unsecured creditors and 3% of the mortgagee's deficiency claim. The rest of the claim would be wiped out. The plan was confirmed by the bankruptcy court and affirmed by the district court. In the Fifth Circuit, the plan was rejected, *inter alia*, on the ground that there was no new value principle incorporated into the Bankruptcy Code; however, on rehearing that part of the opinion was withdrawn. [82]

Unlike many other single asset cases, the *Greystone* bankruptcy court gave thoughtful and sincere attention to the issue of how to achieve Justice Douglas' challenge to balance the rights of existing creditors and old equity. Judge Leif Clark recognized that while the creditor is entitled to the control of the debtor, old equity is entitled to compensation in exchange for the new value. [83] This balance, he felt, could not be determined by looking only to whether old equity received value equal to its contribution. It was also necessary to consider "the 'value' of senior rights threatened by the capital infusion." [84]

It is here, however, where Judge Clark's attempt to reconcile these rights collides with the reality that it may have been impossible to do so in the context of the type of plan the debtor submitted. The Court's conclusion that senior interests received compensatory treatment consistent with absolute priority has a *deus ex machina* quality. Compensatory treatment was found, it would seem, primarily because of old equity's superior management, the relatively short duration of the plan, and the application of the new value to the operation and maintenance of the asset serving as security for the creditors' secured claim. However, superior management echoes the sweat equity theory of *Ahlers*, [85] and the plan's short duration in itself cannot be found on the asset column of the balance sheet. [86] As for the secured claim, after confirmation the lien provides sufficient remedies if the borrower fails to maintain the property or pay the debt. In any case, the full right of priority issue here is not related to the secured claim but to the unsecured debt, and, at the end of the day, the *Greystone* new value plan would wipe out the unpaid deficiency claim. [87] Judge Clark's genuine effort to reconcile these conflicting principles in single asset cases, however, illustrates that new value must be looked at from both the creditors' and debtor's point of view, and that the balancing of the interests of both parties is extremely complex—a complexity one would have expected the Commission to have dealt with.

In *Bonner Mall Partnership v. U.S. Bancorp Mortgage Co. (In re Bonner Mall Partnership),* [88] the secured claim was $6.6 million and the property value $3.4 million, leaving the creditor with a $3.4 million unsecured claim. The debtor's plan proposed to contribute $200,000 and receive all the issued common stock of a new corporation owning the property subject to the stripped down $3.2 million mortgage. Unpaid unsecured creditors would share 300,000 shares of preferred stock "valued," somehow, at $300,000, equal to 10% of the unsecured deficiency claim, [89] thus wiping out the remaining portion of unpaid debt. The issue before the Ninth Circuit, however, did not involve the meaning of new value. The question was whether new value survived the adoption of the Bankruptcy Code. The court concluded that it had survived and remanded the case to the bankruptcy court to determine whether the plan met confirmation standards. [90]

Bank of America v. 203 N. LaSalle Street Partnership (In re 203 N. LaSalle Street Partnership), [91] unlike *Bonner Mall,* represents the "full monte" approach to single asset plan confirmation, dealing with virtually every one of the requirements of section 1129. [92] On the issue of new value, the case held that new value survived the adoption of the Bankruptcy Code *and* that the proposed plan met the confirmation standards of section 1129(b). [93] The debtor's sole asset was ownership of fifteen floors of an office building. The asset was valued at $54.5 million but was encumbered by a mortgage held by Bank America of over $93 million, leaving Bank America with a deficiency claim of $38.5 million. Other debts of the partnership included a second mortgage of some $11 million held by a partner of the debtor, $2.3 million in real estate taxes and $90,000 in trade debt.

The plan apparently provided that nothing would be paid on the unsecured deficiency claim until a future sale or refinancing (not expected for 7−10 years). [94] At that time, fifty percent of the "net value of the property either as realized in a sale, or as appraised at the time of any refinancing" [95] would be paid in the following order: first to the unsecured deficiency claim of over $38 million *without interest*; second to repay the new value contribution; third to pay the general partner on the second mortgage *with 10% interest* and finally to the debtor's partners in proportion to their new value contributions. It was agreed that the primary purpose of the filing of the petition in bankruptcy was to avoid $20 million in tax liability that would be occasioned by a foreclosure of the property. [96] The court concluded that if a sale or refinancing were to take place in ten years at the then value of the property as determined by the court, and if that amount were discounted at 12%, the payment on the deficiency claim would amount to 16%. [97] Thus the confirmed plan wiped out 84% of the deficiency claim. The Court of Appeals panel, over a strong dissent by Judge Kanne, affirmed this result without even dealing with Justice Douglas' precondition to old equity's retention of an interest—according creditors their full right of priority. [98]

The new value proposals in the foregoing plans have to raise some concern as to whether they comport with the word or spirit of the *Case v. Los Angeles Lumber* articulation. Shouldn't this issue be resolved *before* Congress acts? [99]

b. Congressional Intent

What is especially remarkable about the new, new value approach in single asset real estate cases is that it produces virtually the exact result the language of the Bankruptcy Code had been designed to prevent.

In *In re Pine Gate Associates, Ltd*. [100] and its progeny, decided under chapter XII of the former Bankruptcy Act, the courts allowed debtors to retain their mortgaged property upon payment to the non−recourse mortgagee [101] of the depressed (due to the mid−70's real estate recession) value of the collateral. [102] Debtors attempted to retain the collateral through this means in order to avoid a foreclosure, which would result in recapture of accelerated depreciation with serious tax consequences for the sophisticated real estate investor limited partners. [103] In direct response to the perceived inequity of the *Pine Gate* line of cases, Congress was asked to restore absolute priority to real estate arrangements under the new combined chapter 11 of the Bankruptcy Code. [104] Recognizing that single asset real estate differed from normal business reorganizations because there was no business to preserve, no employees' jobs to be protected, and no product or service that would not continue to be performed or produced, Congress enacted a package of protection insuring that the mortgagee may have an unsecured claim for the deficiency and providing absolute priority for each dissenting impaired class of creditors, including the unsecured class. [105]

The key to the door of protection afforded by Congress for the nonrecourse undersecured mortgagee in single asset situations was the absolute priority given to the unsecured class of creditors. New value, as it has been applied in many post−Code single asset cases, turns that key on its head to lock this door of protection. It restores the *Pine Gate* rule—but in much more sinister form. In both situations the debtor keeps the property. The difference is that in *Pine Gate,* the mortgagee received cash equal to the court determined value of the collateral whereas in new, new value cases, the mortgagee receives only a mortgage with a face amount equal to the court determined value of the collateral. [106]

Any reading of the legislative history and contemporary comments will reveal that this retention of property by old equity without paying the deficiency claim of the mortgagee is exactly the opposite of what Congress intended. [107]

Indeed the statutory language was designed to prevent the debtor in single asset cases from ever retaining the property when the mortgagee's deficiency claim is unpaid. Section 1129(b)(2) [108] requires that the mortgagee's secured claim have a value as of the effective date of the plan equal to the value of the collateral. [109] Since the only asset is the single property, a new value plan submitted by the debtor represents a bid for the property, which indicates a value [110] in excess of the amount of the secured claim. [111] The statutory language would have the effect of preventing confirmation of any plan over the objection of the secured creditor in any instance where the value of the collateral is greater than the secured claim. [112] This is illustrative of Professor Ayer's impossibility theory, discussed earlier, as applied to the secured claim. [113]

It should be apparent that the new, new value cases represent a distinct change in course from the direction intended by Congress in 1978. Perhaps the Commission majority believes that Congress' direction *should* be changed. Perhaps it has reasons to revisit the mortgagee protection provisions of chapter 11. This should spark a debate of major proportions. The Commission Report, by not stating what type of new value it is supporting, makes such a debate extremely difficult.

c. Small Business Working Group Pay Down Proposal

The Small Business, Single Asset and Partnership Working Group had single asset cases within its jurisdiction, but the new value issue was in the hands of the Chapter 11 Working Group. While accepting the judgment of the chapter 11 Working Group on new value, in order to afford single asset mortgagees some protection against the affect of new value plans in light of the tremendous ambiguities already discussed, the Small Business Working Group proposed a "clear, objective standard for new value plans in SARE [single asset real estate] cases." [114] Rather than focus on the usual requirements for a new value plan, the Group proposed to add a requirement that no new value plan could be confirmed unless the plan pays down the secured portion of the debt to 80% of its market value. [115]

Assuming a mortgage of $10 million on property with a value of $7 million, the mortgagee would have a secured claim of $7 million and an unsecured claim of $3 million. A plan would be fair and equitable as to the secured claim if the mortgage were stripped down to the $7 million value of the collateral and the stripped down mortgage had a value as of the effective date of the plan of $7 million. [116] Under the proposal the new value plan could be confirmed only if it provided for a payment of $1.4 million to reduce the mortgage to $5.6 million.

Without dealing with the meaning of new value and its effect on unsecured creditors (the Chapter 11 Working Group's domain) the Small Business Group provided a measure of protection for the mortgagee. True, the mortgagee's unsecured claim may still be wiped out and old equity may be able to retain the property; but the mortgagee will at least have an 80% loan to value mortgage, which would be more likely to approximate the value of the collateral than a 100% loan to value mortgage.

The problem with this suggestion is that we are dealing with something like a Rube Goldberg cartoon. [117] The new value proposal is separate and distinct from the pay down proposal and the enactment of one does not mean the other will be enacted. The pay down proposal itself is virtually meaningless unless Congress also enacts the Small Business Group's other proposal to amend the Bankruptcy Code's definition of "single asset real estate" to eliminate the portion of the current definition of "single asset real estate" that limits it to those cases where secured debts do not exceed $4 million. [118]

The worst scenario is that the Small Business Working Group's proposal will not be enacted, or not be enacted in a way that will cover most single asset cases, but will serve as a diversion that will draw the attention of creditors away from the serious and fundamental problems posed by the new value ambiguities, and facilitate the enactment of the Commission proposal on new value. This could have a serious impact on the very nature of capital accumulation in the Nation. While one must applaud the initiative of the Single Asset Working Group, there remain grounds for concern about the rights of unsecured creditors, and doubt that, in the end, the proposal will be able to resolve the new value problem for real estate lenders.

C. The Prerequisites to New Value Plans

—*Are there Any and What do they Mean?*

As articulated by Justice Douglas, a new value plan might be confirmed if the full priority rights of creditors were confirmed *and* if the new value plan met certain prerequisites—necessary to the success of the undertaking; reasonably equivalent to old equity's contribution; and in money or money's worth. [119] The Commission proposal gives junior interests the right to "purchase new interests in the reorganized debtor" without conditioning that right on any specific prerequisites. The explanation in the Commission Report indicates that the current prerequisites are expected to apply. [120] However, given the objections by Commissioner Jones to the proposal's silence on prerequisites, [121] it is remarkable that they were omitted. The problem is compounded by the fact that in post−Code cases dealing with new value plans, the prerequisites of necessity and reasonable equivalence have often been ignored, distorted, or dissolved into an additional amorphous requirement of substantiality [122] leaving open the question of whether in fact any meaningful prerequisites to new value exist.

1. Substantiality

The requirement that a contribution be substantial is not found in the *Case* prerequisites. It was added in post−Code cases as a corollary to the requirement of necessity, [123] or as a substitute for all the factors. [124]

Skewering the prerequisites toward substantiality seems, on its face, like a sublime *non sequitur*. If the contribution is a mere token amount, it is difficult to conceive that it is necessary for success; but does it follow that if a contribution is substantial it is automatically necessary to the success of the undertaking? Can it ever be said that the interest retained by old equity will always be reasonably equivalent to any substantial contribution that is offered?

When substantiality is viewed from the standpoint of the standards the courts use to determine whether the new value is substantial, the skewering appears to have the effect of eliminating all prerequisites to new value confirmation. The courts appear to agree that there is no mathematical formula that may be employed to determine substantiality and that the determination should be made based on "common sense," especially in single asset cases. [125] They don't seem to be able to pin down, however, what mix of factors should be used in making the "common sense" determination. One approach is to look to whether the proposed contribution is substantial in relation to the total unsecured debt. [126] This presents a dilemma. If we judge substantiality by new value's relationship to the amount of unsecured debt, then it would follow that the proceeds of the contribution should go to pay the unsecured debt. However, if the funds go to pay the unsecured debt, it is difficult to argue that the contribution is necessary or essential to the success of the enterprise.

Another approach is to look at the dollar amount of the contribution in relation to contributions that have been rejected by other courts as insufficient. In *LaSalle*, the contribution was found to be substantial in absolute terms because it "dwarfs" those involved in other cases. [127] Perhaps somewhat inconsistently, the court also supports the *Snyder* conclusion that substantiality will depend "on the circumstances of the individual case." [128] Finally, the court looked to new value's "impact on the case," [129] the court indicated that the contribution equaled 20% of the tax liability the partners were avoiding and permitted a "substantial" return on the bank's deficiency claim. [130]

The disturbing thing here is not the conclusion, which may well be correct, that there is no mathematical formula to determine substantiality. Rather it is that, at least in some courts, the prerequisites to new value of *Case* seem to be metamorphosing into a single unstructured, undefinable prerequisite of substantiality. Such a standard leaves a court to define substantiality in any manner it sees fit.

a. Necessity

Some of the courts that still adhere to the "necessity" prerequisite have made a not so subtle shift in what "necessary" means. In pre−Code law, necessity appeared to be based on the essential needs of the business being reorganized. In *Kansas City Terminal Ry. v. Central Union Trust Co.*, [131] for example, the Supreme Court recognized that additional funds may be "*essential* to the success of the undertaking and it may be impossible to obtain them unless stockholders are permitted to contribute" [132] and, in articulating the new value principle in *Case*, Justice Douglas quotes, with approval, the "essential to the success of the undertaking" language. [133]

In many post−Code cases, however, new value no longer has to be essential to the success of the undertaking. Instead some courts refer to the new value being essential to the success of the debtor's *plan*. The language of *LaSalle* is illustrative. The Seventh Circuit approved the bankruptcy court's determination that "the infusion of new capital was necessary for the successful implementation of the plan." [134] This would not seem to be what Justice Douglas had in mind when he referred to the success of the "undertaking." [135] By this switch in the meaning of necessity, virtually every offer of new value by old equity is "necessary" since new value is proposed to enable the old equity to obtain the property. Without the new value, the plan could not be confirmed.

U.S. Truck [136] is another example of the new definition of necessity. There the $100,000 payment for the stock could only have been necessary because of the risks occasioned by the pending union negotiations. Had absolute priority been followed, and the stock in the new enterprise given to the union in compensation for its claim of up to $5 million, there would have been no *necessity* for the $100,000 contribution because the union presumably would have been able to resolve the impasse with itself. Thus the contribution was essential or necessary *only* if old equity were permitted to own all the stock of the reorganized enterprise. [137]

Therefore, when dealing with whether a contribution is necessary, it is important to ask "necessary for what" or "necessary for whom?" The Commission Report does not provide an answer to this question.

2. Reasonable Equivalence

If old equity's interest is limited to one reasonably equivalent to the new value contribution, the determination of reasonable equivalence will depend in large measure on the valuation of the enterprise. However, that value may differ depending on who will own the debtor. For example, as noted above in connection with the prerequisite of necessity, the court in *U.S. Truck* [138] limited the value of the company to $100,000, primarily because there was a significant possibility of labor difficulties that would reduce the value of the company. However, the holder of the unpaid claim was the union involved in the potential labor dispute. If absolute priority had been adhered to, the stock would be given to the Union and, undoubtedly, the Union would not strike against itself. With the stock in the Union's hands, the value of the company would certainly have exceeded the $100,000 value set by the court. As a result, old equity's contribution of $100,000 would not have been reasonably equivalent to 100% of the value of the stock. The question, then, is whether reasonable equivalence only relates to the value of the company in the hands of old equity, or whether it must also be determined based on the company's value if absolute priority had been observed without implementation of a new value plan. The Commission Report gives no answer, effectively leaving that determination to the litigation it seeks to prevent. [139]

In single asset cases there is usually no equity in the property. As a result, debtors have argued in the past that retention of the property does not deprive the creditor of its full right of priority because what the debtor proposes to retain is worthless. This no−value theory was clearly rejected by the Supreme Court. Long ago, in *Boyd*, [140] the Court stated that "control" itself was an asset that constituted value and that such value belonged to the creditors, not old equity. [141] If creditors were denied control they would not have been given their full right of priority. More recently, in 1988, the Supreme Court reaffirmed this determination in *Norwest Bank Worthington v. Ahlers*, [142] when Mr. Justice White stated that "we join in the consensus of authority which has rejected this 'no value' theory." [143]

Despite these decisions, however, the no−value theory did not go gentle into the night. [144] It has had a partial resurrection in the area of reasonable equivalence. If control represents value, it can be argued that the plan may be confirmed if the new value is reasonably equivalent to the value of the control. The amount old equity must pay for control is not easily calculable, however, leaving the determination in each case to the predilections of individual judges. Some have found reasonable equivalence based on the fact that with no equity, control was not worth much. In *LaSalle*, for example, the bankruptcy court invoked no−value in disposing of the reasonable equivalence issue. "[T]he contribution is easily the equivalent of the interests retained by the debtor's partners. Indeed, on the market, those interests are worthless." [145]

The issue becomes whether, without statutory language, the courts will recognize or give some credence to reasonable equivalence, and whether, in light of the lack of equity in single asset cases, there is any standard to determine the value of the control that old equity retains as a result of the contribution.

a. What Prerequisites?

As we review the state of the law with respect to the prerequisites to new value, we see the following: (1) the Commission does not propose any specific statutory prerequisites to new value; (2) to some courts the prerequisites required in *Case* no longer apply but are subsumed within a new requirement of substantiality; (3) the requirement of substantiality is so amorphous that it serves as a virtual blank check for approval of any new value plan; and (4) where the prerequisites of reasonable equivalence and necessity are recognized, they are easily circumvented when they are tested only by their impact on the debtor or the debtor's plan.

All of the above tends to indicate how ephemeral the *Case* prerequisites are in the hands of modern courts and how significant the failure of the Commission to propose a codification of these prerequisites may be.

III. Elimination of Exclusivity: Half a Loaf?

The Commission proposes that when the debtor moves to confirm a non−consensual new value plan the court will terminate exclusivity on request of a party in interest. This makes sense. It is difficult to argue that old equity is not obtaining its new value interest on account of its old equity when the debtor has the exclusive right to propose a plan. [146] When bidding is open to all, old equity is receiving no special right by virtue of its prior interest. It is unclear that the Commission proposal to open bidding only after an often extended period of exclusivity and the submission of a new value plan avoids this problem. Furthermore the proposal, coupled with the comments in the Commission Report, would not seem to accomplish the objective of protecting the absolute priority rights of creditors.

In her strong dissent from this proposal, [147] Hon. Edith Hollan Jones points out, *inter alia*, the following defects in the proposal: (1) the proposal lifts exclusivity but does not require the court to permit solicitation and distribution of a creditor's plan; [148] (2) no provision was made to permit creditors to have access to information without signing of a confidentiality agreement with the debtor that may prohibit disclosure of the debtor's operational information; [149] (3) by waiting until the debtor attempts a cramdown, the resolution of the case will be delayed as the creditor attempts to obtain information from the debtor−in−possession and devise a competing plan, thus increasing expense and professional fees; [150] and (4) those voting on the debtor's original plan will not be aware that a competing plan will be proposed after exclusivity is lifted. [151]

Creditors who may think that, despite these problems, the risks posed by the new, new value cases have been effectively papered over by the exclusivity proposal, should understand that the proposal gives no assurance that their competing plan will be confirmed by the court. Remember, the first part of the Commission's proposal makes the new value plan "fair and equitable" and thus confirmable. [152] Will a court confronted with two fair and equitable plans—one submitted by the debtor and a second submitted by the creditor—necessarily select the creditor's plan even if it is richer than the debtor's plan? One can think of a host of rationalizations for rejecting the creditor's proposal: the creditor's plan might provide for liquidation; employees might be adversely affected; the debtor might be denied a "fresh start."

Even in single asset cases where there is no business to protect, no employees whose jobs may be saved, and no prospect that the property will not continue to be operated, there is no assurance the fresh start concept will not sway a court to approve the debtor's plan. What if, for example if the plan is essential to enable the debtor to avoid substantial tax liabilities, a result "consistent with the Bankruptcy Code"? [153]

Single asset mortgagees should also understand that the Commission drafters made clear in their comments that creditors submitting a competing plan should not be permitted to offset the debt owed to them against their bid for the property. [154] The Commission Report finds that (1) the "credit bid" may not bear any relation to the actual value of the property; [155] and (2) that a secured creditor with a security interest in some of the assets of the business should not be able to credit bid and obtain the entire business with going concern value in excess of what otherwise would be the creditors allowed secured claim. [156] Since the competing plan deals with the entire enterprise, and the amount that may be offset in a credit bid is limited to the unpaid debt, it is difficult to understand this argument without further explanation. Furthermore, it is not clear exactly what constitutes credit bidding from the Commission Report's standpoint. For example, does the Commision's argument suggest that creditor's may not propose a plan that would convert debt into equity?

Even the stated reasons for rejecting credit were to have some validity in a large business reorganization where the security interest may not cover all of the debtor's property, they have no validity in connection with single asset real estate where there is no business, no going concern value, and only one asset encumbered 100% by the secured claim. Under sections 365(k) and 1129(a)(2), where property subject to a lien securing an allowed claim is sold under the plan, the mortgagee has the right to bid at any such sale of the property, and if it is the successful bidder, offset its claim against its bid. Is the Commission proposing to change these provisions? Or will the Commission argue that it is proposing no change, either because the "business," not the property, is being sold and the business is not subject to a lien, or because the proposal provides only for the removal of exlcusivity rather than sale of property? In either case the Commission can not change the fact in single asset cases, what is being bid for is the single asset and what is being purchased by virtue of the plan is the asset subject to the lien.

Prohibition of "credit bidding" may serve as a poison pill to the submission of competing plans in single asset cases. Assume, for example, that there is a mortgage on single asset real estate of $1.5 million and the value of the property is $1 million. There are trade debts of $10,000 and a second mortgage held by a general partner of $200,000. The debtor proposes to cramdown a $100,000 new value plan in which its partners keep the property. Exclusivity is lifted and the mortgagee in a competing plan proposes to invest $200,000 over the mortgage. Is the Commission suggesting that if the court should accept the mortgagee's plan, the mortgagee (already having lost $500,000) would have to contribute an additional $200,000 over its mortgage to obtain the property? If the mortgagee makes the contribution, would the $200,000 have to be used to pay junior creditors (trade creditors and old equity's general partner)? If the answer is yes, how realistic is it that a mortgagee would propose such a plan? If the answer is no, and the funds are retained for the property (now owned by the mortgagee) isn't this, in fact, credit bidding? Would the submission of a competing plan by the creditor that would apply the new value the creditor offers to the payment of the secured debt constitute credit bidding? Without a satisfactory resolution of these questions, any prohibition of "credit bidding" could very well act as a bar to the submission of competing plans when exclusivity is lifted.

Although the concept of open bidding is attractive, the Commission's proposal does not open the bidding until a new value plan is proposed, does not provide for a method by which lifting exclusivity would appear to work, provides no assurances that the competing bid will be accepted, and leaves open too many questions to be seriously considered as much more than a gimmick that can only divert attention away from a thorough and thoughtful analysis of the absolute priority rule and the new value principle in light of the questions unanswered by the Commission. From the creditors' standpoint, lifting exclusivity may not be half a loaf at all—it may be the crusty end of the bread. [157]

Conclusion

The Commission Report does not answer the following questions with respect to new value: What new value principle is it espousing, the new value of *Case* or the new value of some of the post−Code cases? How will the Commission's new value affect single asset real estate? How will it affect the absolute priority rule? Are the *Case* prerequisites applicable? If they are, what is the meaning of "necessary," "substantial," and "reasonably equivalent? How will the lifting of exclusivity work? Why is credit bidding barred from single asset cases?

This article concludes that it is impossible for Congress to decide on the validity of the Commission proposal without some certainty as to what is being proposed. When Congress comes to grips with the issues of new value and absolute priority, it must deal with the basic problems thus far unanswered satisfactorily by the courts , the Congress and the Commission. In dealing with these problems, four suggestions are offered.

First, if we are to follow a course similar to the Commission's proposals, it will be necessary to articulate exactly what the effect of a new value plan should be, and with some degree of particularity, what prerequisites are necessary for such a plan to be confirmed.

Second, it is suggested that Congress be willing to go beyond common wisdom to seek solutions that may be different from those proposed. For example, why not, as some have suggested, eliminate exclusivity altogether? If that is done, there would be no need for a provision giving old equity the right to purchase an interest. There are numerous constituencies that are involved in many Chapter 11 cases—the unpaid creditors, old equity, old management, and to a growing extent, the public [158] (including the recipients of services or products, employees and the economy). Why should old equity be able to have an exclusive right to submit a plan? If mechanism can be created to provide access to relevant information for all parties in interest and resolve the credit bidding problem, will we not have true open bidding for the debtor, allow old equity to participate not on account of its prior interest but as any other bidder, and go a long way toward avoiding the ambiguities and issues involved in new value cases?

Third, it must be determined how interests in the reorganized entity will be distributed to protect the priority rights of creditors without unreasonably chilling the bidding for the enterprise. To make this determination, it may first have to be decided whether and when a bid for the enterprise represents the value of the enterprise at confirmation, or the value after confirmation (as well as whether and when these valuations differ). [159]

Fourth, a full and thoughtful review should be made of the concept that Single Asset Real Estate belongs in chapter 11. What is sacred about the one−size−fits−all approach when we see how the one size does not stretch to accommodate the major differences between going concern businesses (where all the constituencies discussed above are often represented) and single asset real estate ownership entities (where in most cases the debtor and creditor are the real players)? Would not different strokes for different folks make achieving solutions to the problems discussed in this article much easier and, in the end, greatly reduce the litigation the Commission seeks to avoid?

The point is that orderly plan confirmation process is too important to the economic health of the nation to be dealt with through quick fix legislation. The Commission with such a short term and broad mandate probably could not have done much more than it did. What it did accomplish is at least to raise and sometimes to focus the new value issues. Now it is up to Congress and the insolvency specialists to come up with workable and in depth solutions. To this author, however, it seems incredible that Congress should be asked to enact legislation embodying the Commission's proposals as submitted.

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On October 21, 1997, I was driving home after the portion of the Commission Report dealing with new value at last came off my computer. My car radio was tuned to my favorite local station, WLIR, which was playing the title song of OMC's latest album, "How Bizarre," then at the height of its popularity. As I thought about the Commission proposal on new value, I began to appreciate the juxtaposition, and had to agree with Pauley Fuemana. "How Bizarre. How Bizarre. How Bizarre."

FOOTNOTES:

[*] *Cf.* OMC, *How Bizarre*, *on* How Bizarre (Mercury Records 1996).Back To Text

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author's own and do not necessarily represent the views of the American Bankrutpcy Institute or any other organization with which he is associated. The author wishes to thank his reserach assistant, Daniel L. McAuliffe; the editors and staff of the ABI Law Review; and Robin Phelan and other colleagues for their assistance and sound advice.Back To Text

[1] *See* Hans Christian Anderson, The Emperor's New Clothes (1949).Back To Text

[2] The National Bankruptcy Review Commission was established by Title VI of The Bankruptcy Reform Act of 1994, Pub. L. No. 103−394. Back To Text

[3] *See* Nat'l Bankr. Rev. Comm'n, Bankruptcy: The Next Twenty Years, Final Report (1997) [hereinafter Commission Report].Back To Text

[4] The new value proposal would permit junior parties to "purchase" an interest in the enterprise even though senior interests are not paid in full. The absolute priority rule generally holds that no junior interest may retain an interest in the debtor unless all seniors are fully compensated. S*ee* Collier on Bankruptcy ¶ 1129.04 [4][a][i], at 83 (Lawrence P. King et al. eds. 15th ed. rev. 1997) (stating absolute priority rule requires all senior interests be fully compensated before junior interests may retain an interest).Back To Text

[5] The term "old equity" refers to the owners of the enterprise (e.g. stockholders of a debtor corporation or the partners of a partnership in bankruptcy) whose property is subject to distribution under a chapter 11 plan. Under the absolute priority rule, these parties are not entitled to retain property unless all creditors are paid in full or fully compensated. *See* Louisville Trust Co. v. Louisville, N.A. & C. Ry. Co., 174 U.S. 674, 684 (1899) (stating any arrangement of parties where subordinate shareholders' rights come before creditors' rights is subject to "judicial denunciation").Back To Text

[6] *See generall*y Bruce A. Markell, *Owners, Auctions, and Absolute Priority in* Bankruptcy Reorganizations, 44 Stan. L. Rev. 69, 74−90 (1991).Back To Text

[7] Professor White states that he is not confident from a review of post−Code case law that "the new value exception will not tear a large hole in the fair and equitable rule and will not invite exactly the abuses that the fair and equitable rule is to prevent." James J. White, *Absolute Priority and New Value*, 8 Thomas M. Cooley L. Rev. 1, 13 (1991).Back To Text

[8] *See, e.g.,* In re 203 N. LaSalle St. Partnership, 126 F.3d at 964 (noting old equity is allowed to participate in reorganization on "'account of' a new, substantial, necessary and fair infusion of capital"). Back To Text

[9] For example, the Commission Report states that the "court retains a significant independent role in reviewing the debtor's new value plan: the plan must satisfy the *Case v. Los Angeles Lumber Products* factors . . ." Commission Report, *supra* note 3, at 563.Back To Text

[10] *See id.* at 562Back To Text

[11] *See* Commission Report, *supra* note 3, at 563−64 (discussing "credit bidding"). This is difficult to understand. Is the Commission saying that creditors may not propose a plan that provides for the conversion of debt to equity? Does it mean that when a creditor submits a plan, which, at least in single asset cases, seems to constitute a bid for the property, sections 1129(b)(2)(a)(ii) and 363(k) do not apply? *See* discussion infra Part III.Back To Text

[12] A review of the minutes of the meeting of September 19, 1996 (attended by five of the nine Commissioners) at which the new value proposal was "adopted," indicates that no formal vote was ever taken, although it was clear that of the nine member Commission, the three person Article 11 Working Group had previously supported the proposal unanimously. *See* National Bankruptcy Review Commission *Chapter 11 Working Group Proposal Number One − Absolute Priority* (visited Nov. 25, 1997) <http://www.abiworld.org/legis/review/minutes/sep96min.html#chap11prop1>. Judge Jones submitted a

memorandum in opposition and Commissioner Shepard also expressed concern with the proposal, the minutes stating that he "found the new value exception 'disagreeable' . . . [N]oting the absence of four Commissioners at this session, he said that he was not prepared to vote on the proposal." *Id.* He also pointed out that Commissioner Jones had urged that a vote not be taken. *Id.* The minutes then state: "In keeping with prior practice, Chair Williamson observed that it was not necessary to take a formal vote such as a roll call or 'show of hands.' Accordingly, he said that given the unanimous support of the Chapter 11 Working Group for the proposal and noting the opposition of Commissioners Jones and Shepard, the proposal would be considered adopted." *Id.* The minutes report that the Chair stated that "he did not consider today's action to constitute a final vote as that will not occur until the Commission approved its final report." *Id.* We have not located any subsequent vote on the final report. *See* National Bankruptcy Review Commission (visited January 4, 1998) <http://www.abiworld.org/legis/ review/index.html> (stating final recommendations from National Bankruptcy Review Commission's final report).Back To Text

[13] *See* Hon Edith H. Jones, *Dissent From Specific Proposals: III Absolute Priority and Exclusivity,* Commission Report, *supra* note 3, ch. 5, Individual Commissioner Views 16−29 [hereinafter *Dissent*]. Perhaps due to time constraints, all dissenting opinions, including that by Judge Jones, are not placed after the majority opinions to which they object, but are found in a separate Chapter 5 of the Commission Report entitled, "Individual Commissioner Views." Chapter 5 has neither a table of contents nor an index, and the pages of the Chapter are not consecutively numbered. Thus, it is somewhat difficult to find any specific dissent and virtually impossible to cite to any of them with even a modicum of "bluebook" style. Judge Jones' dissent on "new value" is found on page 16−29 of her more comprehensive dissenting memorandum entitled "Dissent from Certain Commission Recommendation on General Issues in Chapter 11." It is located somewhere close to three fourths of the way into Chapter 5.Back To Text

[14] *See id.* at 19. Interestingly, the Commission Report does not appear to show who supported or dissented from any proposal. Thus, a unanimous decision is not differentiated from a 5−4 decision, although it is possible to determine the vote by reviewing the Commission meeting minutes. The Commission staff stated in a telephone conversation that this is a result of Commission policy not to indicate the votes. The staff points out, however, that what votes there were could be discerned by reviewing the minutes of each of the meetings, which are found on <http://www.abiworld.org>.Back To Text

[15] *See* Commission Report, *supra* note 3, at 545.Back To Text

[16] The word "purchase" has a broad meaning and generally includes any means of obtaining an interest in property by grant, devise or even gift. *See* U.C.C. §1−201(32) (defining "purchase" as including "taking by sale, discount, negotiation, mortgage, pledge, lien, issue or re−issue, gift or any other voluntary transaction creating an interest in property"). Thus the implications from the choice of this word may go well beyond what one might normally expect.
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[17] *See* Commission Report, supra note 3, at 545.Back To Text

[18] *See* id.Back To Text

[19] The Commission maintains that "[b]y putting forth the general principle that continued involvement of old equity is not precluded *per se* in nonconsensual plans, while ensuring adequate valuation and the opportunity for competition, the proposed rules will provide appropriate guidance in both large and small cases for fair and balanced negotiations." Commission Report, supra note 3, at 565. A reading of the majority proposal does not disclose to this author how "adequate valuation" is ensured. Indeed, it is this question and the related question of what, if any, portion of the debtor's value remains with the existing creditors that is the major unanswered question in the Commission Report.Back To Text

[20] *See* Commission Report, supra note 3, at 547. This concern may be overblown. Family farmers need not choose Chapter 11. They have their own chapter of the Bankruptcy Code, Chapter 12, where absolute priority has been eliminated, making the new value issue somewhat moot. Furthermore, it is difficult to believe that there are an overwhelming number of Chapter 11 cases involving "mom−and−pop stores." *See* id.Back To Text

[21] *See* id. at 547. The actual Working Group Proposal #1 that was considered by the Commission contained the following language: "*Any* recommendation made by the Commission that would settle this uncertainty [conflicting case law in small cases] would have a salutary effect on Chapter 11 cases." Chapter 11 Working Group Proposal #1: Absolute Priority and Exclusivity at 19 (September 4, 1996 draft) <http://www.abiworld.org/legis/review/proposals/apr.html> (emphasis added). This implies that the Commission proposal settles uncertainty, an idea with which this article strongly disagrees. It more than implies that if the proposal were to settle uncertainty it deserves enactment whether the proposal produces a beneficial result or not, an idea with which this article even more strongly disagrees. Fortunately, the quoted language appears to be absent in the Commission Report.Back To Text

[22] *See* In re Snyder, 967 F.2d 1126, 1129 (7th Cir. 1992) (noting Congress' failure to codify new value exception does not establish its elimination); *see also* In re 203 N. LaSalle St. Partnership, 126 F.3d 955, 965 (7th Cir. 1997) (stating past bankruptcy practices can not be abandoned absent clear indication Congress intended to break from those practices). *Back To Text*

[23] *See* 7 Collier, supra note 4, ¶ 1129.04[4][a][i], at 84 (Lawrence P. King et al. eds., 15th ed. rev. 1997) (stating "[a] plan of reorganization may not allocate any property whatsoever to any junior class on account of the members' interest or claim in a debtor unless . . . senior classes receive property equal in value to . . . their allowed claims.").Back To Text

[24] Railroad Co. v. Howard, 74 U.S. 392, 409−10 (1868). In that case an insolvent railroad had seven million dollars in mortgage bond obligations. An outside purchaser offered to pay $5.5 million for all the assets of the railroad if the transfer could be accomplished expeditiously. Apparently in order to get the cooperation of the stockholders in the quick, friendly, foreclosure of the mortgages, the bondholders agreed to allocate a portion of the proceeds to pay the stockholders 16% on their stock. Certain municipal bondholders whose bonds had been guaranteed by the railroad (the guarantee obligation was subordinate to the obligation owed to the mortgage bondholders) objected to the payment to the stockholders. The Supreme Court affirmed the courts below in holding that the assets derived from the sale of the railroad were a fund in trust for the benefit of creditors. *See* id. at 414. By agreeing to take less than all the assets in partial payment of the debt, the bondholders had, in effect, compromised their claim and as a result the amount of the sale proceeds earmarked for stockholders belonged to the other creditors. Old equity was not permitted to participate in that fund unless creditors were paid in full. *See* id. The decision that the agreement to take less constituted a compromise of the secured creditor's claim may have been something of a stretch. When the same issue came up 125 years later in the SPM bankruptcy, the First Circuit found that a similar agreement constituted either an assignment of the claim or a subordination. *See* Unsecured Creditors' Comm. v. Stern (In re SPM Mfg. Corp.), 984 F.2d 1305, 1318n.13 (1st Cir. 1993). The Court held that the bankruptcy court had not authority to abrogate the agreement between the secured creditor and the unsecured creditors committee (under which a portion of the proceeds to which the secured creditor was entitled would be given to unsecured creditors who were subordinate to the prior claim of the IRS). *See* id. at 1312. The argument was raised that rather than transferring its interest, the creditors committee had "carved out" or "divested itself" of a portion of its lien (similar to the "compromise" conclusion of *Howard*) giving the bankruptcy court the right under its equity powers to determine who was best entitled to the proceeds (the bankruptcy court had ordered that the money be paid to the IRS to the extent it had priority). *See* id. at 1318. What also follows from the argument—that the compromise would result in a distribution in violation of absolute priority, as determined in *Howard*—does not seem to have been raised. The First Circuit rejected the :compromise" argument on the ground that "no appeal was taken from the bankruptcy court's ruling that . . . [the mortgagee] was entitled to receive the entire sale proceeds" and because under Massachusetts law an assignment of a debt would not change the claim's priority or alter the debtor's obligation to pay the debt. *See* id. The decision did not distinguish , or cite, *Howard*. Back To Text

[25] *See* Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106, 115, 118 (1939) (defining proper use of term "fair and equitable" in reorganization proceeding).Back To Text

[26] *See* id. The words, "fair and equitable" appeared in reorganization law with the enactment of section 77 of the Bankruptcy Act dealing with railroad insolvencies. Section 77(e), Act of March 3, 1933, 47 Stat. 1474. Under this provision, a plan could be confirmed only if the judge found it to be, *inter alia*, "fair and equitable." The first non−railroad corporate reorganization statute, section 77B of the Bankruptcy Act, was enacted one year later, and like section 77, it specifically set forth "fair and equitable" as the standard that all plans had to meet. Act of June 7, 1934,

ch. 424, 48 Stat. 911, 912−25 (creating section 77B of 1898 Act). This standard was incorporated in the Chandler Act amendments in 1938. Act of June 22, 1938, ch. 575, 52 Stat. 840 (1938), *repealed by* Bankruptcy Reform Act of 1978, Pub. L. No. 95−598, 92 Stat. 2549. It was not until the decision in *Case*, however, that it was determined authoritatively that "fair and equitable" meant "absolute priority." 308 U.S. at 115. During the period between the earlier cases articulating the priority rights of creditors and *Case*, two conflicting theories, "relative priority" and "absolute priority" were developed. Relative priority would permit interests to be given to classes of creditors and stockholders in the reorganized enterprise provided that the relative preference of all classes of creditors and stockholders that existed prior to the reorganization would be preserved. This would allow stockholders to receive interests in the reorganized company even if the value of the enterprise were less than the claims against its assets. *See* James C. Bonbright & Milton M. Bergerman, *Two Rival Theories of Priority Rights of Security Holders in a* Corporate Reorganization, 28 Colum. L. Rev. 127, 130−32 (1928) (distinguishing alternative theories of relative priority from absolute priority). They concluded that the doctrine of absolute priority would probably not adapt well to corporate organizations. Id. at 165. However, Bonbright later reversed his position and concluded that the arguments for using the doctrine of absolute priority in corporate reorganizations were more persuasive than the arguments for using the doctrine of relative priority. *See* 2 James C. Bonbright, Valuation of Property: A Treatise on the Appraisal of Property for Different Legal Purposes, n.64, at 867 (1937). John Gerdes found the relative priority doctrine unsound and unfair because it permitted participation by classes that no longer had any equity in the enterprise. John Gerdes, General Principles of Plans of Corporate Reorganization, 89 U. Pa. L. Rev. 39, 57−58 (1940). *But see* Churchill Rodgers & Littleton Groom, Reorganization of Railroad Corporations Under Section 77 of the Bankruptcy Act, 33 Colum. L. Rev. 571, 572−73 (1933) (questioning suggestions to abolish the relative priority doctrine "without any definite suggestions of how the absolute priority doctrine would be made to work").

In *Case*, the Supreme Court resolved the controversy by making it clear that fair and equitable meant "absolute priority." 308 U.S. at 115. If there were any doubt that absolute priority was the law, Justice Douglas appeared to eliminate it in his next decision on this subject. *See* Consolidated Rock Prods. v. Du Bois, 312 U.S. 510, 520 (1941) (maintaining that strict absolute priority was test of fairness and equity of reorganization plan). *See, e.g.*, Arthur H. Dean, A Review of the Law of Corporate Reorganizations, 26 Cornell L.Q. 537, 559 n.63 (1941) (suggesting absolute priority rule requires security holders be given new securities with market value equal to full amount of their respective claims); Jerome Frank, *Epithetical Jurisprudence and the Work of the Securities and Exchange Commission in the Administration of Chapter X of the Bankruptcy Act*, 18 N.Y.U. L.Q. Rev. 317, 339−40 (1941) (noting that informal conclusions as to value were necessary in order to determine propriety of allocation of new securities among respective classes of security holders); DeForest Billyou, *Priority Rights of Security Holders in* Bankruptcy Reorganization: New Directions, 67 Harv. L. Rev. 553, 567−68 (1954) (discussing absolute priority rule of *Boyd*, requiring significant features of investment contract, is that of absolute priority in classical sense).Back To Text

[27] 308 U.S. 106 (1939).Back To Text

[28] The bondholders approved by 92.81%; the Class A stock by 99.75% and the Class B stock by 90%. The objecting creditor held $18,500 face amount of the almost four million dollars in bonds. Id. at 115. Back To Text

[29] *See* id. at 115.Back To Text

[30] 308 U.S. at 112−13 (quoting *In re* Los Angeles Lumber Prods. Co., 24 F.Supp. 501 (1938), *rev'd*, Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106, 112−13 (1939)). Back To Text

[31] Interestingly, had the Bankruptcy Code been in effect at the time, this plan would have been approved. Justice Douglas took pains to explain that the court was constrained to reject the plan under § 77B (f) of the Bankruptcy Act (Chapter X of the Bankruptcy Act superseded § 77B) because "Congress has required both that the required percentages of each class of security holders approve the plan and that the plan be found to be 'fair and equitable'. The former is not a substitute for the latter. . . . Accordingly the fact that the vast majority of the security holders have approved the plan is not the test of whether the plan is a fair and equitable one." Case, 308 U.S. at 114. Under the Bankruptcy Code, the fair and equitable requirement applies only to dissenting impaired classes of creditors. Since all classes approved the plan in *Case*, it would have been confirmed under the Code. See 11 U.S.C. § 1129(b)(1) (1994).

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[32] Justice Butler took no part in the consideration or disposition of the case. *See* Case, 308 U.S. at 132.Back To Text

[33] *See* Case, 308 U.S. at 116 (stating stockholder and bondholder agreements are valid if execution of said agreement does not subordinate creditor's claims to stockholders); Northern Pac. Ry. Co. v. Boyd, 228 U.S. 482, 504 (1913) (noting that creditors are entitled to assets of debtor before stockholders).Back To Text

[34] *See* Case, 308 U.S. at 116.Back To Text

[35] Id. at 116 (quoting Northern Pac. Ry. Co. v. Boyd, 228 U.S. 482, 508).Back To Text

[36] Id. at 117 (quoting Kansas City Terminal Ry. Co. v. Central Union Trust Co. 271 U.S. 445, 454) (emphasis added).Back To Text

[37] Id. (quoting Kansas City Terminal Ry. Co., 271 U.S. at 454).Back To Text

[38] 228 U.S. 482 (1913).Back To Text

[39] Case, 308 U.S. at 117. Back To Text

[40] *See* id. at 121 (emphasis added).Back To Text

[41] Case, 308 U.S. at 117 (quoting Kansas City Terminal Ry. Co. v. Cent. Union Trust Co., 271 U.S. 445, 456) (emphasis added).Back To Text

[42] *See* id. at 123. Illustrative of the bizarre nature of court decisions in this area, some 45 years after *Case*, the Eighth Circuit confirmed a debtor's plan providing for old equity participation on the ground that the debtor promised to supply expertise and devote efforts to the success of the farm in the future, citing *Case* as authority! *See* Norwest Bank Worthington v. Ahlers (In re Ahlers) 794 F.2d 388 (8th Cir. 1986). The Supreme Court reversal was unanimous (Mr. Justice Kennedy not participating). *See* Norwest Bank Worthington v. Ahlers (In re Ahlers), 485 U.S. 197 (1988).Back To Text

[43] *See* Case, 308 U.S. at 123−24. Back To Text

[44] *See* id.Back To Text

[45] *See* id. at 115−16.Back To Text

[46] *See* id. at 122 (noting that old equity could only purchase stock under certain circumstances, so as to protect creditors' priority).Back To Text

[47] Id. at 116 (quoting Louisville Trust Co. v. Louisville, New Albany & Chicago Ry. Co., 174 U.S. 674, 684).Back To Text

[48] *See* id. at 121; *see also* Edward S. Adams, *Toward a New Conceptualization of the Absolute Priority Rule and its* New Value Exception, 1993 Det. C.L. Rev. 1445, 1459 (1993) (noting that old equity retains ownership equal to new investment).Back To Text

[49] This may seem surprising in light of "common wisdom" that permits a United States circuit court of appeals to conclude in 1997 that "[t]he new value corollary has been a major source of new funding in reorganizations for the past fifty years." In re 203 N. LaSalle St. Partnership, 126 F.3d 955, 966 (7th Cir. 1997). A few years earlier, the same circuit stated: "There is nothing in either the text or the legislative history of section 1129(b) that can be said to demonstrate a clear intent to modify seventy−five years of judicial construction of the absolute priority doctrine or its

new value exception." In re Snyder, 967 F.2d 1126, 1129 (7th Cir. 1992). The *Snyder* court was also incorrect on the non−modification of absolute priority since section 1129(b), unlike pre−Code law, limits absolute priority to dissenting impaired classes in cramdown situations. Back To Text

[50] John D. Ayer, Rethinking Absolute Priority After Ahlers, 87 Mich. L. Rev 963, 1016 (1989). And, Professor Markell stated that "[i]n the Chapter X arena, no shareholder was ever able to convince a court that she contributed sufficient value to be able to retain an interest. Indeed, until the code's adoption in 1978, no reported case seems to have adopted Justice Douglas' *dicta* as its holding." Markell, supra note 6, at 93.Back To Text

[51] *See* Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106, 121 (1939) (explaining that balance must be achieved between stockholder contribution and giving creditors full right of priority to assets).Back To Text

[52] *See* Ayer, supra note 50, at 1015 (stating that any value or equity retained by debtor is value for creditors, precluding shareholder participation in reorganization).Back To Text

[53] *See id.* at 1015 (noting there is no equity for stockholders to purchase if creditors are entitled to going concern value). Back To Text

[54] *See* Norwest Bank Worthington v. Ahlers (In re Ahlers), 485 U.S. 197, 207−08 (1988) (explaining that property retained by stockholders has value, even when debts far exceed assets); Northern Pac. Ry. Co. v. Boyd, 228 U.S. 482, 508 (1913) (noting creditors are entitled to value of shares issued to old equity).Back To Text

[55] *See* Ayer, supra note 50, at 1011−16 (discussing that "going concern value" cannot be part of old equity's value because creditors are entitled to entire going concern value, thus leaving no equity for stockholders to buy). Professor Markell illustrates this seeming dilemma with the following example:

> [i]f a company which is otherwise worth $200 incurs $150 of debt in its plan of reorganization, then its post−confirmation value will reduce to $50. *Case* would seem to require the owner in this example to pay $50 for the debtor's equity. But if creditors receive nothing more than the $150 in reorganization debt, the reasonable equivalence requirement is not met. The contribution of $50 raised the post−confirmation value to $100. If no further value is given to creditors, the owner will have purchased the debtor for $50 less than its post−confirmation value.

Markell, *supra* note 6, at 97.

He suggests that it would therefore be necessary to transfer the $50 to the creditors, which illustrates the dilemma: if the new value were given directly to creditors, it would be unlikely that the funds were *necessary* for the survival of the enterprise. If the new value were pumped into the enterprise and the increased value were reflected in the share of the enterprise held by unpaid creditors, it would be difficult to see what, if anything, old equity would receive for its new value contribution.Back To Text

[56] Professor Ayer would probably contest that there is any difference between the value of the enterprise at the time of confirmation as compared with the value after confirmation of a new value plan. "Given that no one would pay $10 for a company with a net worth of zero, then the offer of a $10 payment has to be taken as an 'admission' that the company is worth more . . . ." Ayer, supra note 50, at 1014. This may be correct when we are discussing an offer to buy particular property, or the proposal of a new value plan in most single asset cases where the essence of the plan is the purchase of property, but when we look at the debtor as a going business enterprise, it can be argued that the new value infusion increases the value of the enterprise, so that the enterprise after confirmation is worth more than the enterprise pre−confirmation.Back To Text

[57] *See* Salvatore G. Gangemi & Stephen Bordanaro, Note, *The New Value Exception: Square Peg in a* Round Hole, 1 Am. Bankr. Inst. L. Rev. 173, 194 n.130 (1993). Back To Text

[58] Northern Pacific Ry. v. Boyd, 228 U.S. 482 (1913).Back To Text

[59] This assumption may have been intimated by Justice Douglas in Group of Inst'l Investors v. Chicago, M., St. P. & P. R. Co.., 318 U.S. 523, 566−67 (1920), where he stated:

> It is sufficient that each security holder in the order of his priority receives from that which is available for the satisfaction of his claim the equitable equivalent of the rights surrendered. That requires a comparison of the new securities allotted to him with the old securities which he exchanges to determine when the new are the equivalent of the old . . . .

If one is looking to the value of the securities surrendered, the securities would seem to represent the value of the enterprise at, but not after, confirmation.Back To Text

[60] This may not violate Justice Douglas' prerequisite of reasonable equivalence, since it seems to be a limit on the size of old equity's interest rather than a floor. "Where . . . old stockholders make a fresh contribution and receive in return a participation reasonably equivalent to their contribution, no objection can be made." 308 U.S. at 121.Back To Text

[61] *See* Walter J. Blum & Stanley A. Kaplan, *The Absolute Priority Doctrine in* Corporate Reorganization, 41 U. Chi. L. Rev. 651, 656−57 (commenting that the valuation process is "highly conjectural and even speculative" leading to criticism that it is arbitrary, perverse and subject to abuse).Back To Text

[62] In reality, it is unlikely that the new value corollary applies under the Bankruptcy Code. Even putting aside that the articulation of new value in *Case* was only dictum and that the new value principle had not been used pre−Code to cramdown a plan, there is substantial legislative history to indicate that the new value was deliberately omitted from the Code. In July of 1973, the Commission on the Bankruptcy Laws of the United States ("Code Commission") completed a three year study and submitted its report. H.R. Doc. No. 93−137 Parts I and II, 93rd Cong. 1st Sess. (1973). The report discussed the nature, development, justification and deficiencies of the absolute priority rule as it had been applied under the Bankruptcy Act, declaring that it had become a "straight jacket," Part I at 256−57, because, as applied, it did not permit old equity to participate, with the agreement of the requisite majority of all classes of creditors. The Code Commission's solution was to modify the absolute priority rule by permitting juniors to participate by making a contribution "important to the operation of the reorganized debtor . . . under the plan" on a basis reasonably approximating the value of their contribution. *See* Code Commission Bill, H.R. Doc. No. 93−137, Part II, 93d Cong., 1st Sess. (1973) at 242, § 7−303(4)). The language of the proposed change was broad enough to include the type of "sweat equity" contribution rejected in *Case.*

This proposal created a storm of criticism, *see, e.g.* Victor Brudney, *The Bankruptcy Commission's Proposed "Modifications" of the* Absolute Priority Rule, 48 Am. Bankr. L.J. 305, 337 (1974); Walter J. Blum & Stanley A. Kaplan, *The Absolute Priority Doctrine in* Corporate Reorganizations, 41 U.Chi. L. Rev. 651 (1974); Note, *The* Proposed Bankruptcy Act: Changes in the Absolute Priority Rule for Corporate Reorganizations, 87 Harv. L. Rev. 1786, 1817 (1974)) and was rejected by Congress. In its place, Congress modified the absolute priority rule to provide that it applied only to dissenting impaired classes of creditors, thus freeing classes of creditors to admit junior interests by the requisite majority vote. If this Bankruptcy Code provision had been found in section 77B (later Chapter X) of the Bankruptcy Act, the *Case* plan would have been confirmed and the issue that gave rise to the creation of the new value corollary would never have arisen. Thus the purpose that gave rise to the *Case* articulation of new value was obviated by the Bankruptcy Code. Congress clearly considered a provision that would have incorporated new value, in strengthened form, into the Code and rejected it. Although those arguing that the new value corollary survived the adoption of the Bankruptcy Code do so on the basis of the fact that "Congress . . . does not write 'on a clean slate.'" Dewsnup v. Timm, 502 U.S. 410, 419 (1992), the facts would seem to indicate that Congress had erased new value from its slate when it began to write.

In Ahlers, 485 U.S. 197 (1988), the United States took the position that new value did not survive the adoption of the Bankruptcy Code (Brief for the United States as Amicus Curiae Supporting Petition at 17−20). The Supreme Court acknowledged, but did not rule on this issue, having decided that the debtor's plan could not be confirmed even if there were a new value corollary or exception. However, as noted by Professor Ayer, Justice White "may have overruled the new value exception whether he intended it or not." Ayer supra note 50, at 1011−1012. He noted that by rejecting the debtors' argument that the plan caused no injury to creditors because the farm had no value, the Court concluded, *sub silentio,* that anything retained by old equity belonged to unpaid creditors. Id. at 1014−15.Back To Text

[63] *See* Ahlers, 485 U.S. at 203 n.3.Back To Text

[64] Id. at 206.Back To Text

[65] The Supreme Court stated in *Dewsnup v. Timm*, that courts will not interpret the Code "to effect a major change in pre−Code practice" without legislative history to that effect. 502 U.S. at 419. Yet the new value the courts now apply would seem quite different from that envisioned under pre−Code law. If there is a major change from pre−Code practice it may be the new, new value exception as applied in many of these cases. *See* In re 203 N. LaSalle St. Partnership, 126 F.3d 955, 976 (7th Cir. 1997) (Kanne, J., dissenting) (noting "[t]he majority, due to its uncritical adherence to *Dewsnup*, creates an anachronism by cutting and pasting pre−Code practice into a fundamentally different bankruptcy context"). Back To Text

[66] *See* Commission Report, supra note 3, at 547.Back To Text

[67] *See* In re A.V.B.I., Inc., 143 B.R. 738, 743 (Bankr. C.D. Cal. 1992) (stating all section 77B cases had court appointed trustees while most Chapter 11 cases utilize debtor−in−possession).Back To Text

[68] 143 B.R. 738 (Bankr. C.D. Cal. 1992).Back To Text

[69] Id. at 743.Back To Text

[70] *See* id.Back To Text

[71] Teamsters Nat'l Freight Indus. Negotiating Comm. v. U.S. Truck Co. (In re U.S. Truck Co.), 800 F.2d 581 (6th Cir. 1986).Back To Text

[72] The rejected contract had required management to own the trucks that the union members drove. The new agreement provided for the so−called owner/operator system under which the driver would own the vehicle and lease it to the company. *See* U.S. Truck, 800 F.2d at 583.Back To Text

[73] *See* In re U.S. Truck Co., 47 B.R. 932, 942−43 (E.D. Mich. 1985). The court also offered a second reason for the low valuation, which is quite revealing: the union might have a claim for up to $5 million for breach of contract caused by the disaffirmance that might lower the value of the corporation. This indicates that one purpose for the confirmation of the new value plan was to reduce the creditor's claim substantially. *See* id. This is at odds with the statements in *Case v. Los Angeles Lumber Prods. Co.*, that notwithstanding the infusion of new capital the creditors were entitled to their full right of priority. *See* Case, 308 U.S. 106, 121−22 (1939). Actually, the size of the creditor's claim should not have affected the value in any case. Absolute priority does not mandate that creditors be paid. It only requires that nothing go to old equity *unless* the creditors are paid. Thus, if the stock were given to the creditor rather than old equity, the transfer would have eliminated the creditor's claim. *See* 11 U.S.C. § 1141(c) (1994) (providing property under plan will be "free and clear of all claims and interests of creditors, equity security holders, and of general partners in the debtor").Back To Text

[74] *See* U.S. Truck, 47 B.R. at 942.Back To Text

[75] *See* id. (noting potential problem of union attempting to regain original terms of national agreement during negotiations for new agreement at expiration of current agreement in March of 1985).Back To Text

[76] *See* U.S. Truck, 800 F.2d at 587.Back To Text

[77] *See* U.S. Truck, 47 B.R. at 944−45, app.a, art. I. Back To Text

[78] *See* id. at 941.Back To Text

[79] *See* supra note 21 and accompanying text (discussing Commission's attempt to resolve uncertainty surrounding new value plans).Back To Text

[80] *See* 11 U.S.C. § 506(a) (1994).Back To Text

[81] 995 F.2d 1274 (5th Cir. 1991).Back To Text

[82] *See* Phoenix Mutual Life Ins. Co. v. Greystone III Joint Venture (*In re* Greystone III Joint Venture), *petition for reh'g and suggestion for hearing en banc*, 995 F.2d 1284, 1285 (5th Cir. 1992) (Jones, J., dissenting).Back To Text

[83] *See* Greystone, 102 B.R. at 578.Back To Text

[84] *Id.* at 579.Back To Text

[85] *See* Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 204 (1988) (stating debtor's promise of future labor and management skills has no monetary value).Back To Text

[86] *See* Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106, 122−23 (1939) (noting that items such as financial standing and continuity of management have no monetary value and have no place in asset column of balance sheet).Back To Text

[87] *See* Greystone, 102 B.R. at 581.Back To Text

[88] 2 F.3d 899 (9th Cir. 1993).Back To Text

[89] *See* id. at 905. The preferred stock was convertible to common stock after payment of the mortgage. *See* id.Back To Text

[90] The case came up on a petition for relief from the stay by the mortgagee claiming that the debtor had no equity in the property and the property was not necessary for an effective reorganization under section 362(d)(2), the latter requirement meaning that there would have to be a possibility that an effective reorganization could be confirmed within a reasonable time. *See* Bonner Mall Partnership, 2 F.3d at 902. To determine whether such a reorganization was possible, the court gave the debtor 30 days to propose a plan. *See* id. In response the debtor proposed the above−described plan. *See* id. at 905. The Bankruptcy Court nevertheless dismissed the case, having determined that the new value exception did not survive the adoption of the Bankruptcy Code. *See* id. at 902. The District Court reversed. *See* id. Thus the question came to the Ninth Circuit as to whether the new value exception survived the adoption of the Bankruptcy Code. See Bonner Mall Partnership, 2 F.3d at 901. After certiorari was granted by the Supreme Court, U.S. Bancorp Mortgage Co. v. Bonner Mall Partnership, 510 U.S. 1039 (1994), the case was settled. But new value continues to live in the Ninth Circuit. See U.S. Bancorp Mortgage Co. v. Bonner Mall Partnership, 513 U.S. 18, 20 n.1 (1994) (denying motion to vacate Ninth Circuit judgment).Back To Text

[91] 126 F.3d 955 (7th Cir. 1997).Back To Text

[92] *See* id. at 960.Back To Text

[93] *See* id. at 959−60. The Seventh Circuit has been the source of numerous decisions on absolute priority and new value. Up until *LaSalle*, however, no decision squarely addressed the issue, but many gave intimations that the Circuit would come out one way or another when the issue was decided. It seemed that the result in the Circuit might depend on which panel of judges heard the case. For example, in Official Creditors' Comm. v. Potter Material Serv. (In re Potter Material Serv. Inc.), 781 F.2d 99 (7th Cir. 1986), Judge Harlington Wood assumed the validity of the new value principle when the court allowed the confirmation of a new value plan to stand. On the other hand, in In re Stegall 865 F.2d 140 (7th Cir. 1989), Judge Posner, in a delightful opinion, questioned whether the new value principle survived

the Bankruptcy Code in holding that old equity's offer of sweat equity did not constitute new value. Again, in Kham & Nate's Shoes No. 2 v. First Bank, 908 F.2d 1351, 1361 (7th Cir. 1990), Judge Easterbrook implied very strongly that the new value exception no longer existed after the codification of the absolute priority rule in the Bankruptcy Code. Then, in In re Snyder, 967 F.2d 1126 (7th Cir. 1992), Judge Cudahy assumed the validity of the new value rule in rejecting the debtor's plan as not meeting the requirements for such a plan and in In re Woodbrook Assocs., 19 F.3d 312 (7th Cir. 1994), District Judge Zagel, sitting by designation, and writing for a panel composed of himself, Chief Judge Posner, and Judge Cummings, rejected a new value plan because the proposed contribution did not satisfy the new value requirements, reserving decision on the viability of the new value exception or corollary. Back To Text

[94] *See* Bank of Am., Ill. v. 203 N. LaSalle St. Partnership, 195 B.R. 692, 705 (N.D. Ill. 1996), *aff'd* 203 N. LaSalle St. Partnership, 126 F.3d 955 (7th Cir. 1997).Back To Text

[95] *See* In re 203 N. LaSalle St. Ltd. Partnership, 190 B.R. 567, 576 (Bankr. N.D. Ill. 1995), aff'd, Bank of Am., Ill. v. 203 N. LaSalle St. Partnership, 195 B.R. 692 (N.D. Ill. 1996).Back To Text

[96] "This plan, and indeed, the entire bankruptcy case, was filed by the debtor primarily to avoid the severe tax consequences to the debtor's partners of a foreclosure sale of the debtor's property. The principal of the general partner estimated the collective tax liability of the partners, in the event of foreclosure, at $20 million."

Id. Bank America attempted to argue that this fact showed that the plan was not filed in good faith as required by section 1129(a)(3). Lasalle, 126 F.3d at 969. The *LaSalle* courts found that (1) good faith was not tested by the debtors subjective intent, but by the content and effect of the plan of reorganization, (citing In re Madison Hotel Assocs., 749 F.2d 410, 424−25 (7th Cir. 1984)); and (2) even if subjective motivation were germane, "the desire to avoid significant tax liabilities, if legal, is a result consistent with the Bankruptcy Code." LaSalle, 126 F.3d at 969.

There is no objection from this quarter to the concept that the receipt of tax benefits as the result of bankruptcy does not violate the principle of good faith. However, what seems to have been ignored in the discussion of tax avoidance is that here the debtor seeks not just to avoid tax liabilities but to avoid tax liabilities *at the expense of existing creditors.* This fact may not affect the debate over the good faith requirement in section 1129(a)(3), but it should be considered in determining the parameters of new value. If the new value approach of many post−Code cases is accepted, then we are not dealing with just the debtor and the IRS. The debtor is able to confirm a plan that will have the effect of avoiding tax liabilities only by eliminating a substantial portion of its debt to its lender. If there is a public purpose to providing relief from the tax consequences of foreclosure, the appropriate way for Congress to handle that would be by amendment to the Internal Revenue Code. Whether the Bankruptcy Code should be the vehicle for accomplishing a tax result at the expense of creditors is an area to be considered thoughtfully. Unfortunately, these effects of new value do not seem to have been a concern in the Commission Report. Back To Text

[97] *See 203 N.* LaSalle St. Ltd. Partnership, 190 B.R. at 585.Back To Text

[98] *See 203 N.* LaSalle St. Partnership, 126 F.3d at 969−70. Judge Kanne dissented on the theory that there is no new value exception in the code. Id. at 970 (Kanne, J., dissenting).Back To Text

[99] Professor Markell sums it up:

> Some courts have stated that the new value principles apply only when creditors are paid in full. Others assert that any contribution will suffice if the debtor is insolvent. Still others claim that some link between the contribution and the debt discharged by the plan must exist to trigger the new value rule. In short, interpretative chaos reigns.

Markell, supra note 6, at 93−94 (citations omitted).Back To Text

[100] 2 Bankr. Ct. Dec. (CRR) 1478 (Bankr. N.D. Ga. 1976).Back To Text

[101] Under prior tax law, the non−recourse nature of the mortgage was a tax favor to the borrower given by the lender. In order for the limited partners to make use of the entire mortgage as part of their tax basis, it was necessary to exculpate the partnership. *See* I.R.C. §§ 1245, 1250 (1976) (current version at 26 U.S.C. § 1245, 1250 (1994)). Back To Text

[102] Chapter XII had afforded no absolute priority protection but provided some alternative protection to crammed down mortgagees. The protection alternative that figured so prominently in the *Pine Gate* line of cases was found in section 461(11) of Chapter XII, which required that dissenting classes had to be paid in cash the value of the debt owed to them before a plan could be imposed. Since the mortgage was non−recourse, the court concluded that the value of the debt equaled the value of the collateral—in the depressed market conditions at the time. *See Pine Gate*, 2 Bankr. Ct. Dec. (CRR) at 1478.Back To Text

[103] In State Mut. Life Assurance Co. of Am. v. KRO Assoc. (*In re* KRO Assoc.), 4 Bankr. Ct. Dec. (CRR) 462, 470 (Bankr. S.D.N.Y. 1978), there were approximately $14 million in mortgages on the property. The court, using a 20% capitalization rate, found the value of the property to be $895,000. Id. The court suggested that tax avoidance should not be equated with tax evasion, and therefore, avoidance is not a valid basis to dismiss a Chapter 12 plan. *See* id. at 468. This is echoed in current decisions. *See, e.g.,* LaSalle, 126 F.3d at 969 (stating that "the desire to avoid significant tax liabilities, if legal , is a result consistent with the Bankruptcy Code").Back To Text

[104] *See, e.g., Hearings on S. 2266 and H.R. 8200 before the Subcomm. on Improvements in the Judicial Machinery of the Senate Comm. on the Judiciary*, 95th Cong., 853 855−56 and 864−876 (1977) (statement of John J. Creedon, American Council of Life Insurance).Back To Text

[105] Specifically, section 506(a) bifurcates the undersecured mortgagee's claim into a secured claim for the value of the collateral and an unsecured claim for the deficiency. Section 1111(b) provided for conversion of the non−recourse claim into a recourse claim for the purpose of plan confirmation, thus assuring that the mortgage could have a claim for the unsecured debt as determined under section 506(a). Section 1129(b)(1) required absolute priority for every dissenting impaired class of creditors. The package was designed to protect the mortgagee in the single asset situation where the deficiency claim represented almost all of the unsecured class, but not the mortgagee in a large business reorganization where the deficiency claim would normally be lost in a sea of unsecured claims and the mortgagee's vote would not control the class.Back To Text

[106] Whether the resultant 100% loan to value mortgage can under any circumstances have a value equal to the value of the collateral is the subject of serious question. *See, e.g.,* infra note 116.Back To Text

[107] *See* S. Rep. No. 95−598, at 65 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5851 (stating section 1111 "answers the nonrecourse loan problem and gives the creditor an unsecured claim for the difference between the value of the collateral and the debt in response to the decision in" *Pine Gate*); *see also* In re DRW Property Co. 82, 57 B.R. 987, 990 (Bankr. N.D. Tex. 1986) (stating Congress enacted section 1111(b) to restore "benefit of the bargain" to nonrecourse secured creditors).Back To Text

[108] 11 U.S.C. § 1129(b)(2) (1994).Back To Text

[109] Section 1129(b)(2)(A)(i)(II) provides that the plan is fair and equitable as to secured dissenting impaired classes if each holder of a claim in the class receives "deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property."Back To Text

[110] Conceptually, it can be argued that this conclusion is inconsistent with the predicate for the two theories (*share the equity* and *share with the debt*) under which it has been suggested that the Douglas principle of protection of creditors' priority can be reconciled with the retention of an interest by old equity under a new value plan, discussed above at footnote 56 and accompanying text. The predicate is that absolute priority looks to the value of the enterprise at confirmation, not the value post−confirmation (which includes the new value contribution). If that predicate were to be applied in single asset cases, then old equity's bid could be seen as representing the value of the property

post−confirmation and not *at* confirmation. Thus, if the predicate is defeated, it would follow that either (i) there never was a viable new value concept because the Douglas standard cannot be met (the *impossibility* theory); (ii) Congress' attempt to protect the secured creditor in single asset cases failed; or (iii) the situation in single asset real estate is distinguishable. Practically speaking, the distinction seems clear. The earlier discussion dealt with a going business enterprise where the new value contribution enhanced the value of the enterprise and the interests retained in the enterprise by unpaid unsecured creditors. Here, we are talking about a single asset that old equity is attempting to acquire by its offer of new value, subject to the lien held by the secured creditor. Essentially, we are dealing with a sale of property and the bid is old equity's estimate of the value of the property to it. The amount of the secured creditors' lien should equal this value. On the other hand, if the distinction does not hold conceptually, perhaps the problem lies in the drafter's attempt to accommodate single asset cases in a one size fits all chapter 11. Back To Text

[111] Under section 1129(b)(2) the secured claim must be increased to this value. For example, if the mortgage is $10 million and the property value is determined under section 506(a) to equal $7 million, the mortgagee's claim will be bifurcated into a secured claim of $7 million and an unsecured claim of $3 million. If the debtor offers to purchase the property through a plan offering new value of $300,000, the debtor is paying $7.3 million for the property ($300,000 in cash and $7 million by taking subject to the mortgage). If the property is worth $7.3 million and the secured claim under the proposed plan is $7 million, the plan is not "fair and equitable" as to the secured class and cannot be confirmed. Back To Text

[112] New Value advocates argue that old equity's bid does not represent the "intrinsic" value of the property, but is made only because old equity wants the property to avoid adverse tax consequences. This theory seems to insinuate itself into the *LaSalle* case where the bankruptcy court states: "The debtor's partners thus seek to retain their interests not because of the intrinsic value of these interests, but because of the tax consequences that flow from their loss." In re 203 N. LaSalle St. Ltd. Partnership, 190 B.R. 567, 588 (Bankr. N.D. Ill. 1995). Interestingly the same court, in referring to the payments that would go to the unsecured deficiency creditor states that they will receive "50% of the net value of the property, either as realized in a sale, or as appraised at the time of any refinancing," Id. at 576, thus agreeing that any sale price would represent the value of the property without inquiring into the prospective purchaser's motivation.

With respect to real property the purchase price normally represents the value. As a child of real estate and a teacher of property law, it is anathema to this writer that one should look into the motivation of a buyer to determine if the price paid represents property value. If one buys a brick house, should we discount the price in computing value because the purchaser has a special fondness for brick houses? If an insurance company has an excess of funds from long term lines of business to invest in real estate equity investments and thus will pay somewhat more than it would have if most of its available funds were from short term lines of business designated for short term investments, should we discount the amount paid? Consider the manipulative possibilities if values can be changed based on a presumed motivation of the buyer. It should be remembered that while commercial properties are valued through income capitalization methods, those methods are employed to *predict* what someone would be willing to pay for the property. Since appraisers are not clairvoyant, the one thing we know about such a prediction is that it is at best an informed guess that will not be exactly accurate. Appraisal has been defined as "a guess compounded by an estimate." Peter F. Coogan, *Confirmation of a Plan under Bankruptcy Code*, 32 Case West. Res. L. Rev. 301, 313 n.62. The price actually paid for the property is the best indication of its value. *See* 5 Collier supra note 4, ¶ 506.03[4][a] at n.58 ("[I]f the collateral is actually sold during the course of the bankruptcy proceedings or pursuant to a confirmed plan, the consideration received from the sale will almost always resolve the question of value."). Back To Text

[113] Ayer, supra note 50, at 1011.Back To Text

[114] Commission Report, supra note 3, at 676.Back To Text

[115] The two most significant parts of the pay down proposal are: "(1) The new value contribution must pay down the secured portion of the claim on the effective date of the plan so that, giving effect to the confirmation of the plan, sufficient cash payments on the secured portion of the claim shall have been made so that the principal amount of the debt secured by the property is no more than 80 percent of the court−determined fair market value of the property as of the confirmation date; (2) the payment terms for the secured portion of the claim must both (i) satisfy all applicable

requirements of section 1129 of the Code, and (ii) satisfy then−prevailing market terms in the same locality regarding maturity date, amortization, interest rate, fixed−charge coverage and loan documentation . . ." Commission Report, supra note 3, at 674−75.Back To Text

[116] Section 1129(b)(2)(A) provides that the stripped down lien have a value as of the effective date of the plan equal to the value of the collateral. This, however, is fiction, perhaps designed to preserve the constitutionality of the provision. *See* 11 U.S.C. § 1129 (b)(2)(A) (1994). In Wright v. Union Cent. Ins. Co., 311 U.S. 273, 278 (1940), Justice Douglas recognized that the mortgagee had constitutional protection for the value of the collateral. The constitutionality of the present Bankruptcy Code provisions dealing with the secured claim, however, is a subject for a different article (I have been given strict page limitations which I have already egregiously exceeded). Suffice it to say that it would be difficult to conceive of a mortgage with a 100% loan to value ratio (the security just coming out of bankruptcy) being sold in the secondary market for its face amount. An 80% loan to value ratio might fare somewhat better. Back To Text

[117] Rube Goldberg has been described as "an inventor whose specialty was making simple tasks complicated." *See Physics Class Pays Tribute to Goldberg*, Fla. Today, Dec. 12, 1997, at O3B.Back To Text

[118] *See* 11 U.S.C. § 101(51B). At this writing the House of Representatives has passed H.R. 764, a bill that would increase the $4 million cap to $15 million, *see* H.R. Rep. No. 105−324, at 2 (1997), and the Senate has passed S. 1559, a bill to eliminate the cap altogether. It is not clear what will eventually be agreed upon but it is clear that $15 million will not cover major real estate single asset transactions. Most of the well known new value cases do not fit within this limit.Back To Text

[119] *See* Case v. Los Angeles Lumber Prod. Co., Ltd., 308 U.S. 106, 121 (1939). Back To Text

[120] *See, e.g.,* Commission Report, supra note 3, at 551 and 555.Back To Text

[121] *See* Jones Dissent, supra note 13, at 23−24.Back To Text

[122] The meaning of the "money or money's worth" prerequisite seems to have been firmly established as a result of the Supreme Court decisions in *Case* and *Ahlers*, which clearly rejected expertise or other so−called sweat equity as meeting this requirement. Eternal vigilance, however, is still in order. Note that in In re Snyder, 967 F.2d 1126, 1130 (7th Cir. 1992) the Court of Appeals finds as a strong policy argument for retention of the new value exception that "[o]wners often have valuable information about the enterprise that outsiders lack, and owner participation allows this information to be put to use." In Greystone, 102 B.R. 560, 575 (Bankr. W.D. Tex. 1989), one of the reasons that lead the bankruptcy court to determine that creditors received "full compensation" was that "current management is deemed by all to be superior."Back To Text

[123] "The substantiality requirement is derived not from *Los Angeles Lumber's* third criterion [reasonable equivalence], but from its first—that an infusion of new capital must be necessary to the success of the undertaking." In re Snyder, 967 F.2d 1126, 1131 (7th Cir. 1992). Back To Text

[124] *See* In re 203 North LaSalle Street Ltd. Partnership, 190 B.R. 567, 586 (Bankr. N.D. Ill. 1995), where the court sees an implication in In re Woodbrook Associates, 19 F.3d 312, 320 (7th Cir. 1994), that "substantiality serves as something of a summary of the other factors . . . ." The *Woodbrook* court lists all the *Case* factors as prerequisites, but in analyzing whether the factors have been met discusses only substantiality. 19 F.3d at 319−20. Also, in *U.S. Truck*, although the Sixth Circuit upholds the finding of the District Court that "the contribution was substantial and 'essential'," the district court actually did not purport to consider whether the contribution was essential, concentrating only on substantiality. In re U.S. Truck Co., Inc., 800 F.2d 581 (6th Cir. 1986), aff'g 47 B.R. 932 (E.D. Mich. 1985). Said the court: "The basic issue, then, is whether the $100,000 amount provided in the plan is 'substantial' enough to satisfy
§ 1129(b)(2)(B)(ii)." 47 B.R. 932, 941 (E.D. Mich. 1985). In Snyder, 967 F.2d at 1131, the court points out that "[t]he requirement that a contribution be substantial is independent of the rule that a contribution must be at least equal to the value of the interest retained." 967 F.2d at 1131. However the only prerequisite issue in the case was whether the

contribution was substantial.Back To Text

[125] "Whether the infusion of new capital is 'substantial' is more a common sense determination than a mathematical calculation when the debtor comprises only a single real estate asset which is fully encumbered." In re 203 LaSalle St. Partnership, 126 F.3d 955, 967 (7th Cir. 1997) (quoting *In re* Woodbrook Assocs. 19 F.3d 312, 320 (7th Cir. 1994)).Back To Text

[126] For example, in *LaSalle*, the court found that the contribution was equal to approximately 10.7% of the deficiency claim but agreed with other courts that substantiality "'may not always hinge on a comparison of the proposed contribution to the total amount of unsecured debt.'" 190 B.R. at 587 (quoting *Woodbrook*, 19 F.3d at 320 and *Snyder*, 967 F.2d at 1131). This also serves as an interesting admission that Justice Douglas' requirement that creditors receive their *full* right of priority may no longer be an issue.Back To Text

[127] LaSalle, 190 B.R. at 588 (finding contributions of $4.1 million in this case far greater than contributions of $30,000 and $100,00 in *Snyder* and *Woodbrook*, respectively).Back To Text

[128] Id. (quoting Snyder, 967 F.2d at 1131−32).*Back To Text*

[129] Id. Back To Text

[130] *See* id.Back To Text

[131] 271 U.S. 445 (1926).Back To Text

[132] Id. at 455 (emphasis added).Back To Text

[133] Case v. Los Angeles Lumber Co. 308 U.S. 106, 117 (1939).Back To Text

[134] 126 F.3d 955, 967 (7th Cir. 1997).Back To Text

[135] Case, 308 U.S. at 117.Back To Text

[136] 800 F.2d 581 (6th Cir. 1986), aff'g 47 B.R. 932 (E.D. Mich. 1985).Back To Text

[137] The requirement of necessity was not really a factor in the lower court decision since the only prerequisite that court was referring to was that of substantiality. The Court of Appeals seemed to be saying that the District Court had dealt implicitly with the necessity requirement when it upheld the District Court’s conclusion that the contribution was "substantial and 'essential'." *See* U.S. Truck, 800 F.2d at 588.

In a situation similar to *U.S. Truck*, the Bankruptcy Court in *Greystone*, in finding that the necessity predicate had been met, acknowledged that the mortgagee had agreed to advance the necessary funds (to pay off the unsecured creditors and complete tenant finish obligations) but pointed out that the lender was not willing to fund future operations unless it were given ownership of the property (i.e. unless absolute priority were observed), "a condition precedent inimical to the reorganization." In re Greystone III Joint Venture, 102 B.R. 560, 577 (Bankr. W.D. Tex. 1989). The "reorganization" had to mean the debtor's plan because the reorganization was necessary only for the debtor to keep the property. No plan would be necessary if absolute priority had been observed since the property would continue to be operated by the mortgagee without old equity's contribution. Back To Text

[138] Teamsters Nat'l Freight Indus. Negotiating Comm. v. U.S. Truck Co. (In re U.S. Truck Co.), 800 F.2d 581 (6th Cir. 1986), aff'g In re U. S. Truck Company Inc., 47 B.R. 932 (E.D. Mich. 1985).Back To Text

[139] *See generally*, Commission Report, supra note 3, at 545−67Back To Text

[140] Northern Pacific Ry. v. Boyd, 228 U.S. 482 (1913).Back To Text

[141] *See* id. at 508 (stating creditors were entitled to benefit of value derived from control).Back To Text

[142] 485 U.S. 197 (1988).Back To Text

[143] Id. at 207−08 (citing Boyd, 228 U.S. at 508).Back To Text

[144] *Cf.* Dylan Thomas, Do Not Go Gentle Into That Good Night, *reprinted in* The Norton Anthology of Modern Poetry 911 (Richard Ellmann & Robert O'Clair eds., 1973).Back To Text

[145] LaSalle, 190 B.R. at 588.Back To Text

[146] *See, e.g.,* Travelers Ins. Co. v. Bryson Properties, XVIII (In re Bryson Properties, XVIII), 961 F.2d 496, 504 (4th Cir. 1992) (stating exclusive right to propose new value plan constitutes property); In re Outlook/Century Ltd., 127 B.R. 650, 654 (Bankr. N.D. Cal. 1991) (finding exclusivity constitutes property old equity retains on account of existing interests).Back To Text

[147] *See Dissent*, *supra* note 13, at 24−29.Back To Text

[148] *Id.* at 25−26.Back To Text

[149] *Id.* at 25.Back To Text

[150] *Id.* at 25−26.Back To Text

[151] *Id.* at 26−27.Back To Text

[152] *See* Commission Report, *supra* note 3, at 545.Back To Text

[153] In re 203 N. LaSalle Street Partnership, 126 F.3d at 955, 969 (7th Cir. 1997).Back To Text

[154] *See* Commission Report, supra note 3, at 563−65 (discussing perceived problems with use of credit bidding).Back To Text

[155] *See* id. at 563.Back To Text

[156] *See* id.Back To Text

[157] This analogy was originally made in another context by an old associate and friend, Frank E. Roegge. Back To Text

[158] *See generally*, Karen Gross, Failure and Forgiveness, Chapter 12 (1997).Back To Text

[159] *See* supra notes 56, 110 and accompanying text.Back To Text