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# Bank of America v. 203 North LaSalle Street Partnership: Cram Down without Debtor Exclusivity--Good or Bad for the Creditor?

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# NOTES

## *Bank of America v. 203 North LaSalle Street Partnership:* Cram Down without Debtor Exclusivity— Good or Bad for the Creditor?

BY ANN E. NOLAN\*

“Unfortunately, the approach taken today only thickens the fog.”<sup>1</sup>

### INTRODUCTION

**A**fter the Supreme Court handed down *Bank of America National Trust & Savings Ass’n v. 203 North LaSalle Street Partnership*<sup>2</sup> on May 3, 1999, one might ask if there will ever be an answer to the long-debated issue of whether there is a “new value exception”<sup>3</sup> or “new value corollary”<sup>4</sup> to the absolute priority rule<sup>5</sup> in

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\* J.D. expected 2001, University of Kentucky. The author would like to thank Professor Christopher Frost for his guidance throughout the process of writing this Note and her husband for his support and encouragement.

<sup>1</sup> *Bank of Am. Nat’l Trust & Sav. Ass’n v. 203 N. LaSalle St. P’ship*, 526 U.S. 434, 463 (1999) (Thomas, J., concurring) (describing the effect that the majority opinion will have on Chapter 11 cram down reorganizations).

<sup>2</sup> *Id.* at 434.

<sup>3</sup> The “new value exception” to the absolute priority rule is derived from pre-Code case law that permitted continued participation by pre-petition equity holders if their contribution was in money or money’s worth, reasonably equivalent to their continued participation. See 7 COLLIER ON BANKRUPTCY ¶ 1129.04[4][c][i][A] (15th ed. rev. 1996).

<sup>4</sup> The “new value corollary” is derived from the argument that new value is not logically distinct from absolute priority. See *id.* ¶ 1129.04[4][c][i][B].

<sup>5</sup> The “absolute priority rule” is the general rule that in a distribution of the assets of a corporation, senior claims or interests have priority over junior claims

Chapter 11 cram downs.<sup>6</sup> *LaSalle* is the second time that the Supreme Court has addressed the new value controversy,<sup>7</sup> and again the Court has failed to provide a definitive answer as to whether or not this doctrine survived the enactment of the current Bankruptcy Code (“the Code”).<sup>8</sup>

Section 1129(b)(2)(B)(ii)<sup>9</sup> of the Code sets forth what has come to be called the absolute priority rule.<sup>10</sup> This section permits the cram down of a plan in Chapter 11 reorganizations over a dissenting class of impaired unsecured creditors only if their claims are paid in full, or the pre-petition equity holders will not receive or retain any property on account of their prior interest in the debtor.<sup>11</sup> Creditors often oppose cram down actions by asserting that the absolute priority rule is violated if the proposed plan allows pre-petition equity owners to retain ownership of the debtor. Pre-petition equity holders respond with the argument that there is a “new value exception” or “new value corollary” to the absolute priority rule that permits them to retain ownership by contributing new capital.<sup>12</sup>

This was exactly the posture of the debate in *LaSalle*. Bank of America National Trust and Savings Association (“Bank”) made a loan of \$93 million to the 203 North LaSalle Street Partnership (“Partnership”), secured by a nonrecourse first mortgage on fifteen floors of an office building in

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or interests. *See* 11 U.S.C. § 1129(b)(2)(B)(ii) (1994).

<sup>6</sup>“Cram Down” permits confirmation of a plan notwithstanding non-acceptance by an impaired class of creditors or equity security holders under Chapter 11. *See id.* § 1129(b)(1).

<sup>7</sup> *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 203 n.3 (1988) (assuming without deciding that the new value doctrine survived enactment of the Bankruptcy Code).

<sup>8</sup> *Bank of Am. Nat’l Trust & Sav. Ass’n v. 203 N. LaSalle St. P’ship*, 526 U.S. 434, 454 (1999) (assuming that even if the new value doctrine still exists, the plan at issue would have to be rejected).

<sup>9</sup> 11 U.S.C. § 1129(b)(2)(B)(ii).

<sup>10</sup> *See* Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 STAN. L. REV. 69, 88-90 (1991) (describing the process of the codification of the absolute priority rule); *supra* note 5 (defining the absolute priority rule).

<sup>11</sup> 11 U.S.C. § 1129(b)(2)(B)(ii) (providing that a plan is fair and equitable and will be confirmed with respect to a class of unsecured claims if “the holder of any claim or interest that is junior to the claims of such [impaired] class will not receive or retain under the plan on account of such junior claim or interest any property”).

<sup>12</sup> *See infra* Part I.A (discussing the origins of the “new value exception” and “new value corollary”).

Chicago.<sup>13</sup> After defaulting on the loan, the Debtor filed for relief under Chapter 11 to protect itself from a foreclosure action that the Bank brought in state court.<sup>14</sup>

Since the value of the Bank's security was less than the outstanding balance on the mortgage, the bank chose to divide its claim into a secured claim based on the value of the property and an unsecured claim for the remaining deficiency.<sup>15</sup> During the exclusivity period,<sup>16</sup> the debtor proposed a plan with the following features:

(1) The Bank's \$54.5 million secured claim would be paid in full between 7 and 10 years after the original 1995 repayment date.

(2) The Bank's \$38.5 million unsecured deficiency claim would be discharged for an estimated 16% of its present value.

(3) The remaining unsecured claims of \$90,000, held by the outside trade creditors, would be paid in full, without interest, on the effective date of the plan.

(4) Certain former partners of the Debtor would contribute \$6.125 million in new capital over the course of five years (the contribution being worth some \$4.1 million in present value), in exchange for the Partnership's entire ownership of the reorganized debtor.<sup>17</sup>

In response to this new value plan, the Bank attempted to block confirmation by objecting.<sup>18</sup> The Court imposed the plan on the Bank using the judicial cram down.<sup>19</sup> The Bank took the position that the plan could not be confirmed as a cram down because it violated the absolute priority rule

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<sup>13</sup> *In re* 203 N. LaSalle St. P'ship, 126 F.3d 955, 958 (7th Cir. 1997), *rev'd sub nom.* Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle P'ship, 526 U.S. 434 (1999).

<sup>14</sup> *Id.*

<sup>15</sup> *Id.* The Bank was able to divide these claims based on § 506(a) and § 1111(b) of the Code. *See* 11 U.S.C. §§ 506(a), 1111(b).

<sup>16</sup> 11 U.S.C. § 1121(b) (allowing debtor exclusive opportunity to propose a plan during a period of 120 days).

<sup>17</sup> Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 440 (1999) (footnotes omitted).

<sup>18</sup> *Id.* at 440-41. The Bank was able to block consensual confirmation of the proposed plan as sole member of an impaired class of creditors. *See* 11 U.S.C. § 1129(a)(8).

<sup>19</sup> *LaSalle*, 526 U.S. at 441. The debtor used the process as set out in § 1129(b) to impose a cram down. *Id.*; *see* 11 U.S.C. § 1129(b); *supra* note 6 (defining judicial cram down).

by allowing pre-petition equity holders to retain ownership of the partnership without paying the Bank's unsecured deficiency interest in full.<sup>20</sup> The bankruptcy court approved the plan over the Bank's objection and dismissed the Bank's motion to convert to a Chapter 7 or, alternatively, to dismiss the case.<sup>21</sup> Both the district court and the court of appeals affirmed this decision, and the Bank appealed to the Supreme Court.<sup>22</sup>

Both the Petitioner's Brief<sup>23</sup> and the Respondent's Brief<sup>24</sup> to the Supreme Court focused on whether or not pre-petition equity holders could contribute new capital to the reorganization of the Debtor and retain an equity interest in light of the absolute priority rule. The Petitioner argued:

Section 1129(b)(2)(B)(ii) provides, in no uncertain terms, that the absolute priority rule is, in fact, to be absolute: junior classes (such as existing stockholders) are not to receive "any property" under a plan of reorganization "on account of" their pre-bankruptcy interests until senior classes of unsecured creditors are provided for in full. An option to become an owner of a business enterprise is undoubtedly "property," a term that is defined broadly in the Code. And that property is received "on account of" a prior interest when, as in this case, a plan gives pre-bankruptcy equity holders an exclusive opportunity to obtain a stake in the reorganized debtor—everyone except the prior equity owners is disqualified from having an opportunity to invest in the post-bankruptcy enterprise.

The broad language that Section 1129(b) uses in stating the absolute priority rule is not limited or qualified anywhere in the Code. Most importantly for purposes of this case, the Code does not contain a single reference to a new value exception. Congress listed the ways in which a plan can be crammed down on unconsenting creditors, but a new value exception is not among them.<sup>25</sup>

The Respondent countered with the following argument:

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<sup>20</sup> *LaSalle*, 526 U.S. at 441-42.

<sup>21</sup> *Id.* at 442.

<sup>22</sup> *Id.*

<sup>23</sup> Brief for the Petitioner, *Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434 (1999) (No. 97-1418).

<sup>24</sup> Brief for Respondent, *LaSalle* (No. 97-1418).

<sup>25</sup> Brief for the Petitioner at 12, *LaSalle* (No. 97-1418).

The Plan in this case satisfied the plain language of Section 1129(b)(2)(B)(ii). That section provides that the holder of a junior claim or interest may not, over the dissent of a class of senior interests, "receive or retain under the plan on account of such junior claim or interest any property." This is the so-called absolute priority rule and its new value corollary. By its very terms, Section 1129(b)(2)(B)(ii) does not prohibit a reorganization plan from providing that the holders of junior interests—such as the Investors here—purchase an interest in the reorganized entity. The absolute priority rule states only that if a senior class dissents, the owners may not receive this interest "on account of" their junior interests.

Here, the Investors did not receive any property under the plan "on account of" their junior interest in the debtor. They received their interest in Reorganized LaSalle "on account of"—that is, in exchange for—their payment of \$6.125 million in cash.<sup>26</sup>

The Supreme Court held that the determination of the new value doctrine was "not to be decided here"<sup>27</sup> but went on to find that "assuming a new value corollary, . . . plans providing junior interest holders with exclusive opportunities free from competition and without benefit of market valuation fall within the prohibition of § 1129(b)(2)(B)(ii)."<sup>28</sup> The Court then identified an unresolved issue, stating that "[w]hether a market test would require an opportunity to offer competing plans or would be satisfied by a right to bid for the same interest sought by old equity is a question we do not decide here."<sup>29</sup>

At first blush, it would appear that the Supreme Court's decision in *LaSalle* bolsters the rights of creditors by both eliminating exclusivity when new value plans are proposed and requiring some type of market test to ensure that full value is paid for the right to participate in the reorganization of the debtor.<sup>30</sup> It is important to remember, however, that the Supreme Court did not specifically prohibit pre-petition equity holders from participating in new value plans.<sup>31</sup> Rather, the court implied that under

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<sup>26</sup> Brief for Respondent at 8, *LaSalle* (No. 97-1418).

<sup>27</sup> *LaSalle*, 526 U.S. at 454.

<sup>28</sup> *Id.* at 458.

<sup>29</sup> *Id.*

<sup>30</sup> See, e.g., Robert S. Greenberger, *Creditor Rights in Realty Reorganizations Aided*, WALL ST. J., May 4, 1999, at B14 (concluding that creditors are in a better bargaining position after this decision).

<sup>31</sup> See, e.g., George H. Singer, *Supreme Court Clarifies "New Value Exception" to Absolute Priority Rule—or Does It?*, AM. BANKR. INST. J., July/Aug. 1999, at

certain situations when a market test is employed, a new value plan might be approved and crammed down on dissenting unsecured creditors.<sup>32</sup> It is difficult to predict how bankruptcy courts will apply the *LaSalle* decision without resolution of the new value problem.<sup>33</sup> Therefore, in order to determine how this decision affects creditors, it is necessary to look more closely at how courts might handle Chapter 11 cram downs after *LaSalle*.

This Note examines whether the *LaSalle* decision ultimately benefits the creditor in a Chapter 11 cram down. Part I details the history of the new value debate and the resulting circuit split, which the Supreme Court has failed to resolve.<sup>34</sup> Part II examines the recent Supreme Court decision, *LaSalle*, and its influence on the current new value debate and future Chapter 11 reorganizations.<sup>35</sup> Part III looks closely at the effect of removing exclusivity from the cram down process for new value plans and how this benefits or hinders the dissenting unsecured creditor.<sup>36</sup>

## I. A BRIEF HISTORY OF THE NEW VALUE DEBATE AND RECENT JURISPRUDENCE<sup>37</sup>

### A. *The Historical Background of the Absolute Priority Rule and the New Value Doctrine*

The absolute priority rule currently codified in § 1129(b)(2)(B)(ii)<sup>38</sup> has a long history. The rule can be traced from the general “fair and equitable” requirement in Chapter X of the Bankruptcy Act<sup>39</sup> to Chapter X’s predecessor, section 77B.<sup>40</sup> In turn, the origins of both provisions can be traced to

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<sup>32</sup> See, e.g., *id.*

<sup>33</sup> See *id.* at 47.

<sup>34</sup> See *infra* notes 37-72 and accompanying text.

<sup>35</sup> See *infra* notes 73-103 and accompanying text.

<sup>36</sup> See *infra* notes 104-90 and accompanying text.

<sup>37</sup> This section concerning the historical roots of the new value debate and its impact on judicial decisions is by no means intended to be dispositive. This brief discussion is merely intended to review for the reader the events leading up to the *LaSalle* decision.

<sup>38</sup> 11 U.S.C. § 1129(b)(2)(B)(ii) (1994); see *supra* notes 5, 11 (defining absolute priority).

<sup>39</sup> Bankruptcy Act of 1898, 11 U.S.C. § 621(2), 52 Stat. 883, 897 (1938) (repealed 1979).

<sup>40</sup> Bankruptcy Act of 1898, 11 U.S.C. § 205, 49 Stat. 911, 919 (1935) (repealed 1938).

the “fair and equitable” standard set out by the Supreme Court to deal with railroad insolvencies<sup>41</sup> in cases such as *Northern Pacific Railroad Co. v. Boyd*.<sup>42</sup>

This common law standard was developed to address abuses that emerged in the railroad reorganizations handled by federal equity receiverships.<sup>43</sup> Alliances would often be formed between stockholders and bondholders to wipe out junior and unsecured claims.<sup>44</sup> The stockholder would agree to seek an equity receivership while permitting the bondholders to foreclose.<sup>45</sup> The end result was an elimination of all junior and unsecured claims.<sup>46</sup> A new company would then be formed with the same stockholders, bondholders and property, less only the junior and unsecured debt.<sup>47</sup> By requiring that senior claims be paid before any junior claims or interests, the absolute priority rule was designed to preserve the legal priorities between senior and junior claims throughout the reorganization process.<sup>48</sup>

As construed under the Bankruptcy Act, the absolute priority rule was never intended to be an absolute prohibition to pre-petition equity holders’ participation in the reorganized debtor. In *Case v. Los Angeles Lumber Products Co.*,<sup>49</sup> the Supreme Court stated that “[i]t is, of course, clear that

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<sup>41</sup> See Markell, *supra* note 10, at 74-83 (discussing the early origins of the absolute priority rule and the impact of *N. Pac. R.R. Co. v. Boyd*, 228 U.S. 482 (1913)).

<sup>42</sup> *Boyd*, 228 U.S. at 482.

If the value of the [reorganization] 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 whatsoever.

*Id.* at 508.

<sup>43</sup> See Jeffrey Stern, Note, *Failed Markets and Failed Solutions: The Unwitting Formulation of the Corporate Reorganization Technique*, 90 COLUM. L. REV. 783, 786-91 (1990) (explaining the equity receivership process in railroad reorganizations).

<sup>44</sup> Markell, *supra* note 10, at 76.

<sup>45</sup> *Id.*

<sup>46</sup> *Id.*

<sup>47</sup> *Id.*

<sup>48</sup> G. Eric Brunstad, Jr. & Mike Sigal, *Competitive Choice Theory and the Broader Implications of the Supreme Court’s Analysis in Bank of America v. 203 North LaSalle Street Partnership*, 54 BUS. LAW. 1475, 1497-98 & n.75 (1999).

<sup>49</sup> *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106 (1939).



there are circumstances under which stockholders may participate in a plan of reorganization of an insolvent debtor."<sup>50</sup> The Court provided further guidance as to when pre-petition equity holders should be permitted to participate, stating that "[w]here . . . necessity exists and the old stockholders make a fresh contribution and receive in return a participation reasonably equivalent to their contribution, no objection can be made."<sup>51</sup> The Court further required that "the stockholder's participation must be based on a contribution in money or in money's worth, reasonably equivalent in view of all the circumstances to the participation of the stockholder."<sup>52</sup>

Subsequent courts have distilled the limitations of the new value doctrine into a five part test: in order for pre-petition equity holders to participate in the new ownership structure over the objection of creditors not paid in full, the equity holders must provide capital contributions that are (1) new, (2) substantial, (3) in the form of money or money's worth, (4) necessary for a successful reorganization, and (5) reasonably equivalent to the interest obtained.<sup>53</sup>

The question now is whether the new value doctrine survived enactment of the Bankruptcy Code by Congress in 1978.<sup>54</sup> Although the absolute priority rule was incorporated into the Code, there was no explicit reference to the judicially created new value exception. Some scholars argue that the new value doctrine is nothing more than a restatement of the absolute priority rule.<sup>55</sup> Others note that pre-Code cases may have created a new value exception that did not survive enactment of the Code because it was not specifically codified.<sup>56</sup>

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<sup>50</sup> *Id.* at 121.

<sup>51</sup> *Id.*

<sup>52</sup> *Id.* at 122.

<sup>53</sup> See *Bonner Mall P'ship v. U.S. Bancorp Mortgage Co. (In re Bonner Mall P'ship)*, 2 F.3d 899, 908-09 (9th Cir. 1993), *vacatur denied and appeal dismissed as moot*, 513 U.S. 18 (1994).

<sup>54</sup> It is outside the scope of this Note to detail the raging debate concerning whether or not the new value doctrine is an exception or a corollary to the absolute priority rule. Many scholarly commentaries provide in-depth analysis on each side of the issue. See sources cited *infra* notes 55-56.

<sup>55</sup> See, e.g., Markell, *supra* note 10, at 96-102 (explaining the equivalence between the absolute priority rule and the new value corollary, therefore, justifying the corollary's existence after codification of the absolute priority rule in the Code).

<sup>56</sup> See, e.g., Harvey R. Miller & John J. Rapisardi, *Separate and Unequal: The Seventh Circuit Isolates and Neutralizes the Undersecured Creditor in In re 203 N. LaSalle Street Partnership*, 28 U. MEM. L. REV. 667, 681-82 (1998).

These two basic theories created the subsequent circuit split after enactment of the Code. The next section briefly describes how the circuits have addressed the issue of the new value doctrine and the Supreme Court's unsuccessful attempts to resolve the issue prior to *LaSalle*.

*B. The Supreme Court's Unsuccessful Attempts to Resolve the Circuit Split*

The Supreme Court specifically granted certiorari in *LaSalle* to resolve a circuit split on the new value issue.<sup>57</sup> Unfortunately, the Court did not carry out its intended purpose.<sup>58</sup> Therefore, it is important to briefly examine how each circuit has resolved this issue.

Much of the current debate surrounding the new value doctrine originated from the Supreme Court's decision in *Norwest Bank Worthington v. Ahlers*.<sup>59</sup> The issue that the Court faced in this case was whether a farmer could retain his farm by contributing "labor, experience, and expertise" in satisfaction of the new value doctrine without paying the full amount of the bank debt.<sup>60</sup> The Court chose not to accept the Solicitor General's argument that the new value doctrine had not survived enactment of the Code.<sup>61</sup> Rather, the Court assumed without deciding that the doctrine had survived and that the plan in question did not satisfy the doctrine's requirements.<sup>62</sup> It appears that "the Court rendered judgment with an opinion which purports to add nothing to the law as it has been understood for fifty years."<sup>63</sup> Therefore, this decision left it for the courts to continue the debate as to whether there is a new value doctrine still in force.

The U.S. Court of Appeals for the Seventh Circuit in *In re 203 North LaSalle Street Partnership*<sup>64</sup> joined the Ninth Circuit in *Bonner Mall*

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<sup>57</sup> *Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 443 (1999).

<sup>58</sup> *Id.*

<sup>59</sup> *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988).

<sup>60</sup> *Id.* at 199.

<sup>61</sup> *See id.* at 203 n.3.

<sup>62</sup> *Id.*

<sup>63</sup> John D. Ayer, *Rethinking Absolute Priority After Ahlers*, 87 MICH. L. REV. 963, 964 (1989).

<sup>64</sup> *In re 203 N. LaSalle St. P'ship*, 126 F.3d 955 (7th Cir. 1997), *rev'd sub nom.* *Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle P'ship*, 526 U.S. 434 (1999).

*Partnership v. U.S. Bancorp Mortgage Co. (In re Bonner Mall Partnership)*<sup>65</sup> in finding that the new value exception had survived enactment of the 1978 Code. Both courts held that a proposed plan would not violate the absolute priority rule if the former equity owners were required to offer value that was new, substantial, money or money's worth, necessary for successful reorganization, and reasonably equivalent to value or interest received.<sup>66</sup>

In contrast, both the Fourth and Second Circuits have failed to explicitly address the existence of the new value doctrine. In *Travelers Insurance Co. v. Bryson Properties, XVIII (In re Bryson Properties, XVIII)*,<sup>67</sup> the Court of Appeals for the Fourth Circuit denied cram down of a plan which permitted limited partners the exclusive right to contribute and recover new capital.<sup>68</sup> The court assumed, but did not decide, that a new value doctrine existed.<sup>69</sup> The Court of Appeals for the Second Circuit in *Coltex Loop Central Three Partners v. BT/SAP Pool C Associates (In re Coltex Loop Central Three Partners)*<sup>70</sup> proceeded without providing any answer as to the new value issue.<sup>71</sup> The court concluded that even if the traditional new value doctrine had survived, the plan could not be confirmed because the partners avoided any type of market test, and thus received a bargain by virtue of their previous position.<sup>72</sup>

It is clear from these examples that the bankruptcy community is in desperate need of some type of resolution to this new value debate. Although *LaSalle* did not explicitly answer this question, perhaps the Court's decision said enough to institute an entirely new process in Chapter 11 reorganizations that will no longer focus on the new value doctrine. Part II of this Note looks at the Court's decision in *LaSalle* and attempts to determine how this will affect the future of Chapter 11 cram down proceedings.

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<sup>65</sup> *Bonner Mall P'ship v. U.S. Bancorp Mortgage Co. (In re Bonner Mall Partnership)*, 2 F.3d 899 (9th Cir. 1993), *vacatur denied and appeal dismissed as moot*, 513 U.S. 18 (1994).

<sup>66</sup> *In re N. LaSalle St. P'ship*, 126 F.3d at 963-65; *Bonner Mall P'ship*, 2 F.3d at 908-09.

<sup>67</sup> *Travelers Ins. Co. v. Bryson Prop., XVIII (In re Bryson Properties, XVIII)*, 961 F.2d 496 (4th Cir. 1992).

<sup>68</sup> *Id.* at 505.

<sup>69</sup> *Id.*

<sup>70</sup> *Coltex Loop Cent. Three Partners v. BT/SAP Pool C Assocs. (In re Coltex Loop Cent. Three Partners)*, 138 F.3d 39 (2d Cir. 1998).

<sup>71</sup> *Id.* at 44-45.

<sup>72</sup> *Id.*

## II. THE *LASALLE* DECISION

It is not surprising that the *LaSalle* decision, anticipated to provide a final resolution as to whether there is a new value exception or corollary to the absolute priority rule, has generated substantial criticism.<sup>73</sup> The following three sections examine the three opinions within the *LaSalle* decision. Justice Souter wrote for the majority of six Justices,<sup>74</sup> Justice Thomas concurred in an opinion joined by Justice Scalia,<sup>75</sup> and Justice Stevens dissented.<sup>76</sup>

### A. *The Majority Opinion*

The majority opinion began with an in-depth analysis of the pre-Code origins of the absolute priority rule and new value corollary or exception.<sup>77</sup> The majority then attempted to plow through the drafting history of the Code, searching for legislative intent concerning codification of the new value doctrine.<sup>78</sup> This would lead one to believe that the Court was preparing to make a determination as to whether the new value doctrine remained a viable part of the Code. At the conclusion of this discussion, however, the Court merely made an observation:

The upshot is that this history does nothing to disparage the possibility apparent in the statutory text, that the absolute priority rule now on the books as subsection (b)(2)(B)(ii) may carry a new value corollary.

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<sup>73</sup> With power comes responsibility, and the Supreme Court shirked its own when it issued an opinion (a) that had no predicate in the facts before it, (b) that no one understands and (c) that left the world—or at least the bankruptcy world—to wonder what a statute means, what it says and, if it seems to mean what it says, how anyone can satisfy its requirements.

Jonathan Backman, *In LaSalle, The Supreme Court Does It Again—Nothing*, BANKR. STRATEGIST, June 1999, at 1, 4; see also Mark A. McDermott, *Bankruptcy Reorganizations: Before and After the Supreme Court's Stillborn Decision in 203 North LaSalle*, FED. LAW., Aug. 1999, at 22, 23 (“Unfortunately for practitioners, the Court’s refusal to decide this issue, along with the Court’s cryptic reasoning, result in a ruling that may be difficult and costly to implement in future cases.”).

<sup>74</sup> *Bank of Am. Nat’l Trust & Sav. Ass’n v. 203 N. LaSalle St. P’ship*, 526 U.S. 434, 437-58 (1999).

<sup>75</sup> *Id.* at 458-63.

<sup>76</sup> *Id.* at 463-71.

<sup>77</sup> *Id.* at 444-46.

<sup>78</sup> *Id.* at 446-49.

Although there is no literal reference to “new value” in the phrase “on account of such junior claim,” the phrase could arguably carry such an implication in modifying the prohibition against receipt by junior claimants of any interest under a plan while a senior class of unconsenting creditors goes less than fully paid.<sup>79</sup>

Having determined that the history was “equivocal,”<sup>80</sup> the Court then moved on to consider various interpretations of the “on account of”<sup>81</sup> modifier.<sup>82</sup> First, the Court rejected the Debtor’s proposed interpretation of the phrase as meaning something like “in exchange for” or “in satisfaction of.”<sup>83</sup> The Court found this interpretation to be too expansive and manipulable.<sup>84</sup> The Court then rejected the Government’s “starchy position”<sup>85</sup> that Congress had intended to categorically exclude pre-petition equity holders from retaining property under a plan if creditors are not paid in full.<sup>86</sup>

The Court then discussed a more middle of the road interpretation:

A less absolute statutory prohibition would follow from reading the “on account of” language as intended to reconcile the two recognized policies underlying Chapter 11, of preserving going concerns and maximizing property available to satisfy creditors. Causation between the old equity’s holdings and subsequent property substantial enough to disqualify a plan would presumably occur on this view of things whenever old equity’s later property would come at a price that failed to provide the greatest possible addition to the bankruptcy estate, and it would always come at a price too low when the equity holders obtained or preserved an ownership interest for less than someone else would have paid.<sup>87</sup>

After pages of theoretical analysis concerning the viability of each interpretation, the Court simply shrugged off the issue, stating:

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<sup>79</sup> *Id.* at 449.

<sup>80</sup> *Id.* at 448.

<sup>81</sup> 11 U.S.C. § 1129(b)(2)(B)(ii) (1994) (providing that “the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan *on account of* such junior claim or interest any property” (emphasis added)).

<sup>82</sup> *LaSalle*, 526 U.S. at 449-54.

<sup>83</sup> *Id.* at 449.

<sup>84</sup> *Id.* at 450.

<sup>85</sup> *Id.* at 451.

<sup>86</sup> *Id.* at 452-53.

<sup>87</sup> *Id.* at 453 (citations omitted).

Which of these positions is ultimately entitled to prevail is not to be decided here . . . . [The proposed plan] is doomed, we can say without necessarily exhausting its flaws, by its provision for vesting equity in the reorganized business in the Debtor's partners without extending an opportunity to anyone else either to compete for that equity or to propose a competing reorganization plan.<sup>88</sup>

The Court then found that the exclusive opportunity to propose a reorganization plan without extending the opportunity to anyone else to compete for that equity or propose an alternative plan should be treated as an item of property.

It is that the exclusiveness of the opportunity, with its protection against the market's scrutiny of the purchase price by means of competing bids or even competing plan proposals, renders the partners' right a property interest extended "on account of" the old equity position and therefore subject to an unpaid senior creditor class's objection.<sup>89</sup>

The remaining portion of the majority's opinion focused on the need to allow market influences to be the primary indicators as to the value in the reorganization process.<sup>90</sup> The Court noted that, by allowing pre-petition equity holders to have exclusive control over the process of proposing new value plans, the market is never really tested, and parties cannot determine the value of the debtor.<sup>91</sup> The Court observed that, "[i]f the price to be paid for the equity interest is the best obtainable, old equity does not need the protection of exclusiveness (unless to trump an equal offer from someone else); if it is not the best, there is no apparent reason for giving old equity a bargain."<sup>92</sup>

The Supreme Court did little to resolve the conflict surrounding the new value doctrine. It did not take the opportunity to hold that pre-petition equity holders could never receive an interest in the reorganized debtor, nor did it expressly find that a new value doctrine exists. It is clear from the opinion, however, that all new value plans must now be subjected to some type of market test to avoid the exclusivity problem.<sup>93</sup> Unfortunately, the

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<sup>88</sup> *Id.* at 454.

<sup>89</sup> *Id.* at 456.

<sup>90</sup> *Id.* at 456-58.

<sup>91</sup> *Id.* at 456.

<sup>92</sup> *Id.*

<sup>93</sup> Howard Seife & Lois Dix, *Bankruptcy New-Value Exception*, NAT'L L.J., June 21, 1999, at B6.

specific market test to be employed and the exact process to be followed were left open by the Court.<sup>94</sup> Therefore, until it is clear as to how the courts will employ this decision, the economic expectations of borrowers and creditors will remain in doubt. Part III looks specifically at the impact of removing exclusivity and employing a market test and how this will affect the creditor in Chapter 11 reorganization proceedings.

### B. *The Concurring Opinion*

Although the concurring opinion agreed with the majority's conclusion that the reorganization plan cannot be confirmed, it did not agree with the majority's approach to interpreting the Bankruptcy Code. The concurring opinion called for a straightforward, plain-meaning approach and specifically warned against the inherent danger "in excessive reliance on pre-Code practice."<sup>95</sup>

With the use of two common dictionaries only, the two concurring justices found that the "on account of" phrase was not ambiguous and refers to some type of causal relationship between junior interest and property received or retained.<sup>96</sup> Therefore:

Regardless [of] how direct the causal nexus must be, the prepetition equity holders here undoubtedly received at least one form of property—the exclusive opportunity—"on account of" their prepetition equity interest. Since § 1129(b)(2)(B)(ii) prohibits the prepetition equity holders from receiving "any" property under the plan on account of their junior interest, this plan was not "fair and equitable" and could not be confirmed.<sup>97</sup>

It is also important to note that the concurring opinion referred to the majority's "speculations about the desirability of a 'market test'" as "dicta binding neither this Court nor the lower federal courts."<sup>98</sup> These speculations, however, are clearly not dicta because they are incorporated into the majority's holding.<sup>99</sup>

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<sup>94</sup> *Lasalle*, 526 U.S. at 458 ("Whether a market test would require an opportunity to offer competing plans or would be satisfied by a right to bid for the same interest sought by the old equity is a question we do not decide here.").

<sup>95</sup> *Id.* at 462 (Thomas, J., concurring).

<sup>96</sup> *Id.* at 460 (Thomas, J., concurring).

<sup>97</sup> *Id.* (Thomas, J., concurring) (citation omitted).

<sup>98</sup> *Id.* (Thomas, J., concurring) (citation omitted).

<sup>99</sup> Brunstad & Sigal, *supra* note 48, at 1479 & n.17.

### C. *The Dissenting Opinion*

Justice Stevens rejected the majority's conclusion that the pre-petition equity holders retained ownership "on account of" their interests in the debtor, but rather urged an interpretation of § 1129(b)(2)(B)(ii) that would permit a junior claimant to receive or retain interest as long as it was not at a "bargain price."<sup>100</sup>

The dissenting opinion argued that the approval of the plan by the bankruptcy court was a valuation determination and the court clearly found that the infusion of capital was at a sufficiently fair price to allow interest to be retained by the old equity.<sup>101</sup> Justice Stevens concluded that the Code does not impose a requirement for a "market test;" particularly where, as in this case, the unsecured creditor does not challenge the valuation or request an auction.<sup>102</sup>

In conclusion, Justice Stevens found that the "exclusive opportunity" to propose a plan was not a property right, but was only a function of the Code's creation of an exclusive period during which the debtor may propose a plan of reorganization.<sup>103</sup>

Although these three opinions take differing views on the correct Chapter 11 reorganization process, Part III focuses only on the majority's introduction of the "market test" into the Chapter 11 cram down process.

### III. CRAM DOWN WITHOUT EXCLUSIVITY WHEN A NEW VALUE PLAN IS PROPOSED—WHAT DOES THIS MEAN FOR THE CREDITOR?

As creditors now enter the Chapter 11 reorganization stage, it will be difficult to bargain without knowing how the bankruptcy courts will deal with new value plans. This hinders the process, for the parties will not be able to adequately gauge their leverage, which in turn will cause a strain on negotiations and compromise.<sup>104</sup> It is clear that the *LaSalle* decision has left many questions unanswered.<sup>105</sup> The uncertainty will inevitably gener-

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<sup>100</sup> *LaSalle*, 526 U.S. at 465 (Stevens, J., dissenting).

<sup>101</sup> *Id.* at 466 (Stevens, J., dissenting).

<sup>102</sup> *Id.* at 467-68 (Stevens, J., dissenting).

<sup>103</sup> *Id.* at 470-72 (Stevens, J., dissenting).

<sup>104</sup> *See, e.g.,* McDermott, *supra* note 73, at 26 (stating that "the economic expectations of borrowers and lenders remain in doubt").

<sup>105</sup> William L. Medford & Patton Boggs, *Conducting Equity Auctions Under LaSalle—The Fog Thickens*, AM. BANKR. INST. J., Oct. 1999, at 20, 20.



ate higher costs and additional litigation within the reorganization process.<sup>106</sup>

The *LaSalle* decision has significantly changed the way in which creditors will now have to approach the reorganization process. Upon entering negotiations, creditors will want to try to project how the bankruptcy court might answer the questions left open by the Supreme Court. How will exclusivity be handled? Will the debtor still be able to exclusively produce a plan during the 120-day period as set out in the Code,<sup>107</sup> or can the creditor seek to terminate exclusivity for cause?<sup>108</sup> In addition, what market test will the court employ—competing plans, competing bids, or an auction process? Finally, what will the courts do with the lingering question whether there is a new value doctrine?

There are really no concrete answers to these questions. The processes created to deal with the requirements set out by the Supreme Court will vary from court to court, depending on how each bankruptcy judge reads and incorporates the *LaSalle* decision. The remaining portion of this Note attempts to provide some insight into how bankruptcy courts might approach these difficult questions and how this will affect creditors.

The first portion of this section focuses briefly on pre-*LaSalle* cases<sup>109</sup> that have addressed exclusivity, market testing and the new value debate.<sup>110</sup> The second portion focuses on various proposals that have been suggested to reform the Code and the effect these proposals might have on the bargaining position of the creditor.<sup>111</sup> The final section focuses on the

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[T]he court did not address whether: (1) an offer to bid suffices, as opposed to an actual auction; (2) third parties may bid, or only existing creditors; (3) an auction must occur if the equity involved is publicly traded; (4) an auction must occur if the debtor proposes its plan after exclusivity terminates; and (5) whether the termination of exclusivity suffices if no creditor files a competing plan.

*Id.*

<sup>106</sup> Backman, *supra* note 73, at 1 (“The Supreme Court’s absurd ruling . . . turns an easy issue into a difficult one and ensures not only years of additional litigation, but millions of dollars of additional attorney fees with respect to an issue that is not really an issue at all.”).

<sup>107</sup> 11 U.S.C. § 1121(b) (1994) (allowing debtors an exclusive opportunity to propose a plan during a 120-day period).

<sup>108</sup> *Id.* § 1121(d) (exclusivity shall be terminated only upon a showing of “cause”).

<sup>109</sup> See *infra* text accompanying notes 114-39.

<sup>110</sup> Medford & Boggs, *supra* note 105, at 20.

<sup>111</sup> See *infra* text accompanying notes 140-62.

policies underlying Chapter 11 and economic theories in bankruptcy.<sup>112</sup> The section then proposes a process, consistent with the examined theories, for which creditors should argue when faced with a new value plan proposed in a cram down.<sup>113</sup>

#### A. *Pre-LaSalle Case Law*

The cases discussed in this section are intended to provide a few examples of judicial treatment of exclusivity, market testing, and new value prior to *LaSalle*. It is evident upon close examination of these cases that the process of reorganization cram down is significantly different depending on the court. Therefore, it is important for each creditor to become familiar with the court and the judge who presides over a given Chapter 11 reorganization. This gives the creditor some indication of what to expect if the debtor introduces the issue of cram down.

Similar facts to those in *LaSalle* were present in *In re BMW Group I, Ltd.*<sup>114</sup> Like the *LaSalle* Court, The *BMW Group* court also found the exclusive purchase right held by the pre-petition equity holders to be in violation of the absolute priority rule.<sup>115</sup> The *BMW Group* decision, however, provided a definitive answer to the question whether the new value doctrine still exists. This court looked only at the plain language in § 1129(b)(2)(B)(ii) and found that there was no “new value exception” to the “fair and equitable” requirement,<sup>116</sup> but rather that there was a new value corollary that had to be satisfied.<sup>117</sup> The court explained that this corollary required only that the price offered by the pre-petition equity holder be fair.<sup>118</sup> The court concluded that “there is no valid reason why old equity should be prohibited per se from purchasing the reorganized debtor’s equity” as long as the market has been tested to ensure that the highest price is paid.<sup>119</sup> Unfortunately, this court did not discuss any particular type of market test or how the exclusivity problem should be resolved.

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<sup>112</sup> See *infra* text accompanying notes 164-81.

<sup>113</sup> See *infra* text accompanying notes 182-90.

<sup>114</sup> *In re BMW Group I, Ltd.*, 168 B.R. 731 (Bankr. W.D. Okla. 1994).

<sup>115</sup> *Id.* at 733, 735.

<sup>116</sup> *Id.* at 734.

<sup>117</sup> See *id.*

<sup>118</sup> *Id.*

<sup>119</sup> *Id.*

*In re Homestead Partners, Ltd.*<sup>120</sup> incorporated an auction of stock into the reorganization cram down process to ensure that the entire process was competitive.<sup>121</sup> The court looked specifically at the plain meaning of § 1129(b)(2)(B)(ii) and found that there was not a “new value exception,” but rather an invaluable pre-Code corollary that was intended to guide the application of the absolute priority rule by uncovering the true impetus behind the old equity group’s involvement.<sup>122</sup> The court found that this “new value corollary” required that the pre-petition equity holders satisfy the evidentiary burden of proving “necessity” and the reasonable value of their new capital infusion.<sup>123</sup>

The court further explained that without any type of market test, these requirements would pose an insurmountable evidentiary burden for the pre-petition equity holders.<sup>124</sup> Following this explanation, there was a long discussion by the court attempting to determine what form of market test is the most desirable.<sup>125</sup> The court ultimately concluded that the debtor was entitled to the 120-day exclusivity period, but upon confirmation of a new value plan, the new equity interest must be held out for auction, giving each creditor the opportunity to compete for control.<sup>126</sup> Although this court answered all questions surrounding new value, exclusivity, and the appropriate market test, at least one other court found it to be unsatisfactory and provided other alternatives.<sup>127</sup>

Bankruptcy Judge Robert E. Brizendine began his opinion in *Condor One, Inc. v. Moonraker Assocs. (In re Moonraker Assocs.)*,<sup>128</sup> by agreeing with the reasoning and conclusions set forth by Bankruptcy Judge W. Homer Drake, Jr. in *Homestead*<sup>129</sup> concerning the viability of new value in

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<sup>120</sup> *In re Homestead Partners, Ltd.*, 197 B.R. 706 (Bankr. N.D. Ga. 1996) (following the auction process set out in *In re Bjolmes Realty Trust*, 134 B.R. 1000 (Bankr. D. Mass. 1991)).

<sup>121</sup> *Id.* at 720.

<sup>122</sup> *Id.* at 713 & n.7.

<sup>123</sup> *Id.* at 714-15.

<sup>124</sup> *Id.* at 715-16.

<sup>125</sup> *Id.* at 717-19.

<sup>126</sup> *Id.* at 719. It is important to note that there are some concerns that this auction process may violate the registration requirements for sales of stock under the Securities Act of 1933. *Id.* at 717-18; Medford & Boggs, *supra* note 105, at 20, 31.

<sup>127</sup> *Condor One, Inc. v. Moonraker Assocs. (In re Moonraker Assocs.)*, 200 B.R. 950, 954 (Bankr. N.D. Ga. 1996).

<sup>128</sup> *Id.* at 950.

<sup>129</sup> *In re Homestead*, 197 B.R. at 706.

relation to the absolute priority rule.<sup>130</sup> Judge Brizendine held that it was “consistent with congressional intent, that a ‘new value’ plan is neither an exception to nor prohibited by Section 1129(b)(2)(B)(ii), but merely raises the questions of when and under what circumstances such a plan satisfies the requirements of that provision.”<sup>131</sup> It is Judge Drake’s answers to the questions “when and under what circumstances” with which Judge Brizendine did not agree.<sup>132</sup>

Judge Brizendine chose not to accept Judge Drake’s ruling that required an auction or some form of competitive bidding in every instance in which the debtor in a Chapter 11 proposes a new value plan.<sup>133</sup> Judge Brizendine justified his decision by explaining that such a market test analysis does not always ensure that the new value plan being presented is actually offering the maximum value to the estate.<sup>134</sup> Although Judge Brizendine acknowledged the benefits of a competitive bidding environment to the enforcement of absolute priority, he explained that often this will not further the goals of obtaining maximum value for the estate,<sup>135</sup> but rather will upset the “bargaining leverage created by Congress.”<sup>136</sup> The opinion then further explained how creditor bids can often actually distort the true value of the estate by overestimating its value.<sup>137</sup>

Judge Brizendine ultimately proposed that competitive bidding not be used as a “cure-all” but rather “as a tool that may be used by a court in reaching its judgment concerning value.”<sup>138</sup> In conclusion, the court found that a debtor should be allowed to make an attempt to propose a plan that satisfies all material requirements of the Code and should not be further burdened with the requirement of having to out-bid all creditors.<sup>139</sup>

The opinions in *Homestead* and *Moonraker* illustrate how differently each judge approaches the questions of new value, exclusivity, and market testing—even when they are from the same circuit. These opinions follow

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<sup>130</sup> *In re Moonraker*, 200 B.R. at 952.

<sup>131</sup> *Id.*

<sup>132</sup> *Id.* at 952, 954 (“To conclude that a purchase option restricted to old equity is always fatal, in this Court’s opinion, is too strict a reading of the requirements of Section 1129(b)(2)(B)(ii).”).

<sup>133</sup> *Id.* at 954.

<sup>134</sup> *Id.* at 954-55.

<sup>135</sup> *Id.*

<sup>136</sup> *Id.* at 955.

<sup>137</sup> *Id.*

<sup>138</sup> *Id.*

<sup>139</sup> *Id.* at 955-56.

two completely different processes when determining how to handle a Chapter 11 cram down. These illustrative cases also demonstrate the difficulty creditors will have in determining how each individual court will handle post-*LaSalle* cram downs.

### *B. Proposals to Reform the Code*

As the cases in the previous section suggest, Chapter 11 cram downs are riddled with unanswered questions. Bankruptcy judges now face the difficult task of answering three questions in every Chapter 11 cram down proceeding. First, is there any need to answer the question whether there is a new value exception or corollary to the absolute priority rule after the ruling in *LaSalle*? Second, when is it necessary to lift exclusivity? Finally, what is the appropriate market test to use when valuing a reorganizing debtor?

The National Bankruptcy Review Commission ("the Commission") was established by Congress through Title VI of the Bankruptcy Reform Act of 1994<sup>140</sup> to study and evaluate current bankruptcy law. The most recent Commission report was issued on October 20, 1997<sup>141</sup> and contains concrete proposals to answer the lingering questions of new value, exclusivity, and market testing. Of course, there are varying opinions as to whether these proposals provide the best answers to these lingering questions,<sup>142</sup> but they will be used in this section as an alternative framework to generate discussion.

Although this report was issued prior to *LaSalle*, it may provide some guidelines that courts can look to when formulating the correct process to incorporate in order to satisfy the broad requirements of the *LaSalle* decision. This section looks at the Commission's proposed answers and how each will affect the decisions creditors make in bargaining within the cram down process.

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<sup>140</sup> National Bankruptcy Review Commission Act, 11 U.S.C. prec. § 101 n. (1994).

<sup>141</sup> NAT'L BANKR. REVIEW COMM'N, BANKRUPTCY: THE NEXT TWENTY YEARS, NATIONAL BANKRUPTCY REVIEW COMMISSION FINAL REPORT (1997), available at <http://www.nbrc.gov/report/12chapt1.html> (last visited Jan. 4, 2001) [hereinafter COMMISSION REPORT].

<sup>142</sup> See, e.g., G. Eric Brunstad, Jr. et al., *Review of the Proposals of the National Bankruptcy Review Commission Pertaining to Business Bankruptcies: Part One*, 53 BUS. LAW. 1381 (1998).

### 1. *New Value Exception or Corollary to the Absolute Priority Rule*

The Commission recommends that a new value corollary to the absolute priority rule be explicitly incorporated into the Code.<sup>143</sup> This recommendation is based on the belief that it is “economically irrational to foreclose beneficial equity participation that often can provide a valuable source of capital to help fund a business reorganization.”<sup>144</sup> The Commission discusses the importance of a resolution to this debate in fostering a cram down process that is “balanced, fair, and above all, clear.”<sup>145</sup>

Unfortunately, the *LaSalle* decision did not follow this line of thinking and, instead of providing an answer to this long debated question, focused on the idea of obtaining fair value by the use of some form of market testing.<sup>146</sup> Perhaps the Court will never resolve this debate, since the use of a market test guards against the ultimate fear that pre-petition equity holders are obtaining a bargain price for the reorganized debtor.<sup>147</sup> Without any explicit answer provided by the Supreme Court or a revision to the Code, it would appear that this debate will continue to be a topic in all new value reorganizations.

Therefore, some bankruptcy courts after the *LaSalle* decision may refuse any objection by a creditor based on the argument that there is no new value exception or corollary to the absolute priority rule if the new value plan is subject to some type of market test. In contrast, other courts may continue to entertain this debate, allowing tremendous amounts of time and money to go into resolution of this threshold question before even looking at the merits of a case.

As a creditor in this turbulent environment, the best strategy is to try and determine how the bankruptcy judge might answer this threshold question, especially in circuits that have not articulated an answer to this question. Until the Supreme Court says more on the issue, this appears to be an argument that a creditor should always raise when facing a new value plan of reorganization.

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<sup>143</sup> COMMISSION REPORT, *supra* note 141, § 2.4.15.

<sup>144</sup> *Id.*

<sup>145</sup> *Id.*

<sup>146</sup> *Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 457-58 (1999).

<sup>147</sup> *See id.* at 456 (“If the price to be paid for the equity interest is the best obtainable, old equity does not need the protection of exclusiveness (unless to trump an equal offer from someone else); if it is not the best, there is no apparent reason for giving old equity a bargain.”).

## 2. *Exclusivity and Market Testing*

Not only does the Commission offer a definitive answer to the new value debate, it also proposes additional changes to the Code to deal with the issues of exclusivity and market testing. The report recommends that an addition be made to the current Code that would lift exclusivity when a debtor seeks to cram down a plan that proposes financing contributions from pre-petition equity holders.<sup>148</sup> The Commission goes on to explain that lifting exclusivity would permit other parties to propose plans of reorganization, the best way to accomplish "marketplace validation of value."<sup>149</sup>

The Proposal is designed to maintain the balance between the need for capital to preserve the business and its going concern value and the need to increase the certainty that old equity pays a market price for whatever ownership it buys in the reorganized company.

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Practically speaking, when a debtor sought confirmation, the confirmation process would stop to give any party eligible under section 1121 an opportunity to propose its own plan. The proposing party would have sufficient time to negotiate, solicit votes, and craft a competing plan. Through this mechanism, any party in interest who believed that the value of the enterprise was higher than the equity holders' assessment would have the opportunity to challenge the valuation in the most concrete way: the party could seek outside financiers or put up its own money to buy the equity stake in the business.<sup>150</sup>

The Commission stresses the importance of only terminating exclusivity when the debtor affirmatively seeks cram down of a new value plan so that it does not curtail the opportunity or lessen the incentive for parties to first make an attempt to construct a consensual plan.<sup>151</sup> In addition, the Commission explains that because pre-petition equity holders would no longer have an exclusive right to bid on the equity in the reorganized debtor, concerns that retention of a preemptive right to bid for the equity was property impermissibly retained by the former owners of the debtor would be alleviated.<sup>152</sup>

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<sup>148</sup> COMMISSION REPORT, *supra* note 141, § 2.4.15.

<sup>149</sup> *Id.*

<sup>150</sup> *Id.*

<sup>151</sup> *Id.*

<sup>152</sup> *Id.* (responding to cases like *In re BMW Group I, Ltd.*, 168 B.R. 731 (Bankr. W.D. Okla. 1994) (holding that absolute priority was violated if pre-petition equity

The Commission also includes a brief explanation of why competing plans are more desirable than an auction process or some form of credit bidding. It observed:

The difficulty with the auction approach is that it divests the court of its own independent review of the factors required for confirmation of a new value plan and requires establishing an auction process and reorganization plan format acceptable to the debtor as well as to potential bidders. The debtor can structure the terms of the auction to advantage old equity. If no one bids at the auction except the debtor, the debtor's bid is accepted. Auctions, without more, do not eliminate the possibility of self-dealing.

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Credit bidding violates the principle of equality of distribution among all legally similar creditors. It also undercuts reorganization efforts because it provides the leverage to a secured creditor, by virtue of its unsecured portion of debt, to seize any business in which it is not paid in full.<sup>153</sup>

The Commission's proposal to limit exclusivity and to provide for competing plans would most likely satisfy the requirements outlined in the *LaSalle* decision. The proposal assures that pre-petition equity holders do not retain any exclusive "property right" to propose a competing plan and, by incorporating the use of competing bids, the plan will be subjected to the scrutiny of the market.<sup>154</sup> Unfortunately, there is no consensus that this method of market testing is the appropriate resolution in these situations.

There is some argument that there is no reason to wait to lift exclusivity, but that competing plans should also be proposed during the initial negotiation process.<sup>155</sup> This would enhance the process by permitting parties to place more realistic values on their positions which would in turn reduce the need for litigation.<sup>156</sup> In addition, there is also concern as to whether creditors will have the ability to obtain sufficient information to put together a competing plan.<sup>157</sup> One commentator suggests that creditors

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holders retained exclusive right to propose new value plan)).

<sup>153</sup> *Id.*

<sup>154</sup> *Id.*

<sup>155</sup> Brunstad et al., *supra* note 142, at 1415-16.

<sup>156</sup> *Id.* at 1415.

<sup>157</sup> *Id.* at 1418 ("[S]ome suggested that creditors need adequate access to the debtor's books, records and other information.").



should insist on full and complete access to the debtor's business through representatives, such as accountants or business consultants, who can evaluate a possible purchase.<sup>158</sup>

In contrast, there is substantial support behind the use of an auction process rather than competing plans.<sup>159</sup> In a vast majority of Chapter 11 cases there is no accessible market for the reorganized debtor.<sup>160</sup> There may not be enough information for third parties to put together a bid, or these parties may be unwilling to go about the task of assembling a bid when the only purpose is to test the sufficiency of the contribution offered by the pre-petition equity holders.<sup>161</sup> When this situation occurs, there is the possibility that the pre-petition equity holders will be the highest bidders and will acquire an interest in the reorganized debtor at a bargain price.<sup>162</sup> Obviously, this result would be a violation of the absolute priority rule and an inadequate market test to produce the results required by the *LaSalle* decision.

As a creditor facing these possible outcomes, the best strategy is to be prepared for everything. At the beginning of any Chapter 11 reorganization, it will be important for the creditor to understand that if there is a new value plan proposed, that creditor must be prepared to prove that the proposed contribution by the pre-petition equity holders is not the actual value that the market would pay. To prove this, the creditor will have to be prepared to bid or offer a competing plan that illustrates a higher value. If the creditor is not interested in acquiring an interest in the reorganized debtor, third parties should be contacted to generate other prospective purchasers for the business.

It would appear that if the creditor takes these precautionary steps, the creditor would be prepared for any process that the bankruptcy judge decides to employ. Where the creditor merely relies on an objection that pre-petition equity holders should not be entitled to contribute new value there is significant risk, as a court may find that after the *LaSalle* decision the only requirement to ensure that the absolute priority rule is not violated is to expose the plan to the market.

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<sup>158</sup> LYNN M. LOPUCKI, STRATEGIES FOR CREDITORS IN BANKRUPTCY PROCEEDINGS 559-60 (3d ed. 1997).

<sup>159</sup> See, e.g., *In re Homestead*, 197 B.R. 706, 719 & n.14 (Bankr. N.D. Ga. 1996); Markell, *supra* note 10.

<sup>160</sup> Brunstad et al., *supra* note 142, at 1416.

<sup>161</sup> *Id.* at 1416-17.

<sup>162</sup> See LOPUCKI, *supra* note 158, at 557-58.

### C. Arguments Creditors Should Make When Facing a New Value Plan

The previous two sections describe the unsettled landscape in Chapter 11 cram downs after the Court's *LaSalle* decision.<sup>163</sup> Once a creditor understands this reality, that creditor must then prepare to articulate to the bankruptcy judge a process to be followed which not only meets the requirements of *LaSalle*, but also satisfies the policies underlying Chapter 11.

This section begins with a brief survey of the academic debate concerning Chapter 11 bankruptcy policy. The discussion will then turn to the *LaSalle* decision and the bankruptcy policies articulated in that opinion. The section concludes with a strategy for creditors to follow when crafting arguments that will satisfy the policies and procedures mandated by the Supreme Court in *LaSalle*.

#### 1. Chapter 11 Bankruptcy Policy

There are generally two themes that run through the Chapter 11 policy debate.<sup>164</sup> One view derives from an economic perspective of the creditor's bargain,<sup>165</sup> and the other originates from a theory of default distribution based on varying policy goals.<sup>166</sup>

The commentators who follow an economic perspective of the creditor's bargain are often focused on contractual relationships and

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<sup>163</sup> See *supra* notes 140-62 and accompanying text.

<sup>164</sup> Although this Note focuses on these two themes only, it is important for the reader to understand that there are other policy theories scholars have used to explain and justify the Chapter 11 process. See, e.g., Lucian A. Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775 (1988) (advocating a new method for division of the reorganization "pie"); Brunstad & Sigal, *supra* note 48, at 1475 (advocating the use of a competitive choice theory); John M. Czarnetzky, *Time, Uncertainty, and the Law of Corporate Reorganizations*, 67 FORDHAM L. REV. 2939 (1999) (using an Austrian economics model to approach Chapter 11); Christopher W. Frost, *Bankruptcy Redistributive Policies and the Limits of the Judicial Process*, 74 N.C. L. REV. 75 (1995) (asserting that an institutional capability argument is justification for an "investor-focused bankruptcy regime").

<sup>165</sup> See, e.g., Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815 (1987); Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857 (1982).

<sup>166</sup> See, e.g., Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775 (1987).

efficiency. One of these theorists, Professor Baird, asserts that whatever rights creditors had prior to bankruptcy should continue to be respected during the reorganization process.<sup>167</sup> The idea is to respect the rights that each creditor bargained for in the free market, essentially avoiding any incentive a party might have to seek bankruptcy only to take advantage of an alternative distribution scheme.<sup>168</sup> Baird also argues that following this theory of bankruptcy policy provides guidelines and rules for bankruptcy judges to follow, which will limit the unbridled discretion that leads to the problem of forum shopping.<sup>169</sup>

Professor Warren advocates a very different view of bankruptcy, which she describes as a “dirty, complex, elastic, interconnected view . . . from which I can neither predict outcomes nor even necessarily fully articulate all the factors relevant to a policy decision.”<sup>170</sup> Scholars who advocate this type of view are often referred to collectively as “traditionalists.”<sup>171</sup> As Warren explains, the economic analysis articulated by Baird is “clear, straightforward, and always promises to yield firm answers to hard questions.”<sup>172</sup> Warren goes on to find fault with this analysis by pointing out that it only focuses on enhancing the collective return to creditors<sup>173</sup> while ignoring other distributional issues based on competing interests and public policy.<sup>174</sup> Under the traditionalist view, the reorganization process is a forum to weigh and measure the interests and concerns of the debtor, the creditors and the public, with the bankruptcy judge sitting as an “arbiter of fairness.”<sup>175</sup>

These differing policy views inject another complexity into the Chapter 11 reorganization process. It is likely that since there is a lack of convergence as to the correct conclusion to this policy question, bankruptcy judges and practitioners will look to this academic literature when facing the reorganization of a business in the Chapter 11 process.<sup>176</sup> The reorgani-

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<sup>167</sup> See Baird, *supra* note 165, at 832.

<sup>168</sup> *Id.*

<sup>169</sup> *Id.* at 831-32.

<sup>170</sup> Warren, *supra* note 166, at 811.

<sup>171</sup> Czarnetzky, *supra* note 164, at 2942.

<sup>172</sup> Warren, *supra* note 166, at 812.

<sup>173</sup> *Id.* at 777.

<sup>174</sup> *Id.* at 799.

<sup>175</sup> Brunstad & Sigal, *supra* note 48, at 1516.

<sup>176</sup> See Richard A. Posner, *Foreword* to CORPORATE BANKRUPTCY: ECONOMIC AND LEGAL PERSPECTIVES, at xi-xii (Jagdeep S. Bhandari & Lawrence A. Weiss eds., 1996) (explaining that he thinks this literature will be helpful to bankruptcy judges and the bankruptcy bar).

zation process can change drastically depending on the policy view the bankruptcy judge decides to follow. For example, if a judge agrees with the policies asserted by Professor Baird, he or she may feel more restrained in making value decisions looking only to previously negotiated contractual relationships. On the other hand, if the judge follows Professor Warren's theories, he or she may feel less restrained in making these value decisions, taking into consideration not only the debtor-creditor relationships but also public policy arguments.

It is important to assess the *LaSalle* decision and examine the majority opinion to see if the Court gave any indication as to the appropriate policy to be followed when answering difficult distributive questions in a Chapter 11 cram down.

## 2. Bankruptcy Policy in the *LaSalle* Decision

In *LaSalle* the Supreme Court did not come out and resolve the academic debate concerning the appropriate policy justifications for Chapter 11 reorganizations, but the Court did provide some indication of how a bankruptcy judge should handle policy questions when determining which market test is appropriate in the situation of a cram down.

The Court does little more than require a market test to ensure that pre-petition equity holders are not taking advantage of their position by proposing a plan under which old equity holders are granted the exclusive opportunity to purchase equity in the reorganized entity.<sup>177</sup> The Court states that "[w]hether a market test would require an opportunity to offer competing plans or would be satisfied by a right to bid for the same interest sought by old equity, is a question we do not decide."<sup>178</sup>

This question left open by the Court will generate a substantial amount of uncertainty for the dissenting creditor. It is likely that bankruptcy judges will look to the policy arguments outlined in the previous section to determine which market test is appropriate. Although the Court did not decide on the appropriate test, it did discuss in some length the preference for allowing market valuation rather than untested court decisions on valuation.<sup>179</sup>

This statement may justify the economic perspective asserted by scholars such as Baird.<sup>180</sup> Essentially it would appear as if the Court was

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<sup>177</sup> *Bank of Am. Nat'l Trust and Sav. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 454 (1999).

<sup>178</sup> *Id.* at 458.

<sup>179</sup> *Id.* at 457-58.

<sup>180</sup> See *supra* notes 167-69 and accompanying text.

attempting to limit the distributional decisions made by bankruptcy judges and advocated by commentators such as Warren.<sup>181</sup> It is unclear if the decision can be read to support this argument, but it may provide the dissenting creditor with some supporting authority when forming arguments to present to the bankruptcy court in a cram down situation post-*LaSalle*. The next section focuses on the strategic arguments the dissenting creditor should make based on bankruptcy policy and the *LaSalle* decision.

### 3. *Strategic Arguments*

The arguments developed in this section are based on the assumption that a new value plan has been proposed by pre-petition equity holders and the court, following the *LaSalle* decision, has decided to lift exclusivity to expose the proposed new value plan to some form of market test. At this point in the cram down process, it will now be important for the dissenting creditor to articulate for the court the proper form of market testing which should be employed to satisfy not only the requirements of the *LaSalle* decision, but also sound bankruptcy policy. This will especially be important in those jurisdictions that have not yet addressed this type of question.

The creditor should begin by first directing the court to the part of the *LaSalle* decision that creates a preference for market testing over the untested valuation of the bankruptcy judge.<sup>182</sup> This seems to encourage a policy view based on economic factors rather than a theory based on distribution of losses caused by default.<sup>183</sup> Although the Supreme Court did not mandate any particular form of economic market testing, this presumption can be used to support a type of auction process over the use of competing bids.

At least one commentator finds that with competing plans, “[i]n the final analysis, the preferences of creditors and shareholders may have less to do with determining the survivor in the competing-plan arena than the *bankruptcy judge’s independent determination* of which plan is the ‘best’ choice.”<sup>184</sup> Although bankruptcy courts must look to the statutory require-

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<sup>181</sup> See *supra* notes 170, 172-74 and accompanying text.

<sup>182</sup> See *supra* notes 177-79 and accompanying text.

<sup>183</sup> The author would then encourage the creditor to use the policy arguments articulated by those scholars who follow an economic perspective based on an idea of the creditor’s bargain. For a brief discussion of this policy, see *supra* notes 165, 167-69 and accompanying text.

<sup>184</sup> Daniel J. Carragher, *A Game of Survivor: The Competing-Plan Challenge*, AM. BANKR. INST. J., Oct. 2000, at 14, 39 (emphasis added).

ments in § 1129(c),<sup>185</sup> they may still weigh the equities of the situation related to the probable success of the reorganization.<sup>186</sup> The court may have competing plans to choose from in this situation, but it does not always mean that the bankruptcy judge's decision will replicate the decision in a competitive market environment. Using this type of analysis, the dissenting creditor would argue that the use of competing plans fails to satisfy the requirements mandated in *LaSalle* by incorporating a valuation decision made by the bankruptcy judge.

An auction process that allows some form of credit bidding is the best way to satisfy a market value test in a Chapter 11 cram down.<sup>187</sup> The auction will ensure that market price dominates and will eliminate the uncertainty surrounding the proof of reorganization value.<sup>188</sup> Allowing creditors to credit-bid at the auction will preserve the creditors paramount right to choose the form of their payment.<sup>189</sup> In addition, the use of credit-bidding will equalize the bargaining positions of all parties involved.<sup>190</sup> This process will not only satisfy the market testing requirements of *LaSalle*, but will also limit the valuation determinations made by bankruptcy judges.

#### IV. CONCLUSION

In conclusion, the *LaSalle* decision would appear to leave creditors in a position of superior bargaining power. Debtors will no longer be able to propose new value plans that provide a bargain purchase to the pre-petition equity holders. Rather, the offer of new capital will now have to be tested to ensure that it is equivalent to the value that the market would pay. This would seem to ensure that creditors will always be paid the most for their claims, but there are precautionary steps that the creditor must take to ensure that this is the case.

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<sup>185</sup> 11 U.S.C. § 1129(c) (1994). The court must determine whether each of the plans are confirmable and then compare the plans based on the following factors: 1) type of plan, 2) treatment of creditors and equity holders, 3) feasibility, and 4) preferences of creditors and equity holders. *See In re Holley Garden Apartments, Ltd.*, 238 B.R. 488, 493 (Bankr. M.D. Fla. 1999).

<sup>186</sup> *See, e.g., In re Holley*, 238 B.R. at 496.

<sup>187</sup> *See In re Homestead Partners, Ltd.*, 197 B.R. 706, 719 & n.14 (Bankr. N.D. Ga. 1996).

<sup>188</sup> *See* Markell, *supra* note 10, at 120.

<sup>189</sup> *Id.* at 121.

<sup>190</sup> *See id.* at 124.

The creditor must understand that the Chapter 11 reorganization process may not be consistent from court to court. After the *LaSalle* decision, there are many questions left open concerning exclusivity, new value and market testing. Therefore, the creditor will not be able to predict the process that will be used to satisfy the requirements set out by the Supreme Court in *LaSalle*.

To address this lack of predictability, the most important thing the creditor will have to do is to prepare to challenge the value that pre-petition equity holders propose to contribute by offering a competing plan or bidding for an interest in the reorganized debtor. The creditor may also want to argue that the proposal does not satisfy the absolute priority rule, but it is unclear whether courts will even hear these objections after *LaSalle*.

Overall, the *LaSalle* case has generated more questions than answers and it seems it will be a long time before the fog lifts and the bankruptcy community receives the answers for which it is looking.