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Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations

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Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations

Bruce A. Markell*

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I. INTRODUCTION

Bankruptcy reorganizations¹ proceed upon a simple premise: creditors' rights take priority over equity interests.² If a business is insolvent, then its owners take nothing. If the business can pay its creditors in full, then its owners take what remains. This simple dichotomy dissolves, however, if the business's value can vary with its ownership, or if its present owners dispute insolvency. In either case, the owners may seek to exploit any uncertainty in, or dispute over, the value of the business by bargaining for a continued stake in the reorganized entity.³

Owners may also seek to continue their participation in another way: they can offer to contribute something new to the business. In this case, bargaining of a different sort occurs. The parties do not dicker over uncertainties in value; rather, they bargain over the share of the reorganized entity that the proposed contribution will buy. In this context, owners are similar to third-party purchasers of the business.

Bankruptcy law, however, makes no clear distinction between the opportunistic owner who seeks to exploit uncertainty and the legitimate owner who seeks to buy. Both owners must formulate a plan of reorganization⁴ that meets the confirmation requirements of the Bankruptcy Code (the "Code"). These requirements are numerous,⁵ but not complex.⁶ They serve

1. Such reorganizations are carried out under Chapter 11 of the Bankruptcy Code (the "Code"). 11 U.S.C. §§ 1101-1330 (1988). Chapter 11 of Title 11, *id.* §§ 1101-1174, pertains to the reorganization of debtors, as opposed to their liquidation.

A Chapter 11 case may be supervised either by a trustee or by the debtor. The Code defaults to debtor control: it states that "'debtor in possession' means debtor." *Id.* § 1101(1). Debtors in possession, in turn, "have all the rights . . . and shall perform all the functions and duties . . . of a trustee serving in a case under this chapter." *Id.* § 1107(a). The debtor in possession's powers include the ability to continue to operate the debtor's business. *Id.* § 1108.

2. I use the term "owners" to refer to those entities that, under applicable nonbankruptcy law, are entitled to any surplus in value from the debtor, once all claims are provided for or paid. In corporations, the owners are the shareholders; in partnerships, they are the partners. The Code labels each ownership interest an "equity security." 11 U.S.C. § 101(15) (1988 & Supp. 1989). *But cf.* Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738, 740 n.8 (1988) (defining "owners" to cover any group that has some claim to the income stream or assets of the debtor).

3. For a discussion of the distortions this kind of bargaining introduces to the reorganization process, see Baird & Jackson, *supra* note 2.

4. Plans of reorganization are the vehicle for the adjustment of creditors' and equity holders' rights and interests. Subchapter II of Chapter 11 provides for plans of reorganization. 11 U.S.C. §§ 1121-1129 (1988). The debtor in possession or trustee is obligated to file a plan "as soon as practicable." *Id.* § 1106(a)(5).

5. The thirteen requirements for confirmation of a plan are contained in *id.* § 1129(a)(1)(13).

6. Some requirements specify what a reorganization plan must include. *See, e.g., id.* § 1129(a)(1) (requiring compliance with Title 11, including the mandatory form requirements listed in

to ensure that the plan adjusts creditors' rights in a manner consistent with a financially healthy⁷ reorganized debtor.⁸ In turn, the adjustments are subject to creditor approval.⁹

Any adjustments made in a proposed plan are subject to a vote by each affected creditor class; however, all is not lost if creditors do not approve the plan. The Code allows a proponent of a plan to confirm it notwithstanding creditor dissent.¹⁰ Nonconsensual confirmation, also known as "cramdown,"¹¹ first requires that the plan satisfy all other confirmation requirements.¹² Then, in lieu of creditor approval, the plan must provide for "fair and equitable" treatment of any dissenting class of creditors.¹³ In addition, the plan must not discriminate unfairly with respect to a dissenting class.¹⁴

The Code does not define "fair and equitable." Congress intended that the contours of this requirement be shaped by pre-Code history and the individualized review of particular cases.¹⁵ In charting these perimeters, courts have looked to many factors, including the principle that no plan may pay

§ 1123(a)). Others control certain creditor priorities. *See, e.g., id.* § 1129(a)(9) (specifying cash payment of administrative claims, and special treatment for certain tax claims).

7. *Id.* § 1129(a)(11). The reorganized debtor's management must also be consistent with creditors' interests, *id.* § 1129(a)(5)(A)(ii), and the plan must at least pay impaired creditors what they would have received if the debtor were liquidated instead of reorganized, *id.* § 1129(a)(7).

8. The Code uses the term "debtor" instead of "bankrupt" to refer to the entity that is the subject of the bankruptcy proceeding. *Id.* § 101(12). I use the term "reorganized debtor" to refer to the entity that survives confirmation of the plan. This entity is sometimes referred to as the "revested debtor," since confirmation revests all property of the bankruptcy estate in the debtor or other entity specified by the plan. *Id.* § 1141(b).

9. *Id.* § 1129(a)(8). Classes of creditors, not individual creditors, approve a plan. All unsecured creditors could, for example, comprise one class for approval purposes. *Id.* § 1122(a) (plan may include a claim within a class only if it is substantially similar to other claims included in that class). A class of claims "accepts" a plan if over one-half of the creditors voting approve it, and those creditors hold at least two-thirds of the amount of claims voting. *Id.* § 1126(c). A class of interests accepts whenever holders of at least two-thirds of such interests vote in favor of the plan. *Id.* § 1126(d).

10. The power to impose nonconsensual treatment is authorized by 11 U.S.C. § 1129(b) (1988).

11. This power is the subject of much learning and lore. *See, e.g.,* Richard F. Broude, *Cramdown and Chapter 11 of the Bankruptcy Code: The Settlement Imperative*, 39 BUS. LAW. 441 (1984); Kenneth N. Klee, *All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code*, 53 AM. BANKR. L.J. 133 (1979); Kenneth N. Klee, *Cram Down II*, 64 AM. BANKR. L.J. 229 (1990); Isaac M. Pachulski, *The Cram Down and Valuation Under Chapter 11 of the Bankruptcy Code*, 58 N.C. L. REV. 925 (1980).

12. 11 U.S.C. § 1129(b)(1) (1988).

13. *Id.*

14. *Id.*

15. Although 11 U.S.C. § 1129(b)(2) lists examples of "fair and equitable treatment," this list was not intended to be exclusive. As indicated at the time Congress considered the Code:

Although many of the factors interpreting "fair and equitable" are specified in paragraph (2), others, which were explicated in the description of section 1129(b) in the House report, were omitted from the House amendment to avoid statutory complexity and because they would undoubtedly be found by a court to be fundamental to 'fair and equitable' treatment of a dissenting class.

124 CONG. REC. 32,407 (1978) (statement of Rep. Edwards); *id.* at 34,006 (1978) (statement of Sen. DeConcini); *see also In re Sandy Ridge Dev. Corp.*, 881 F.2d 1346, 1352 (5th Cir. 1989); Klee, *Cram Down II*, *supra* note 11, at 230-31.

any participant more than that participant's claim.¹⁶ Another, and more famous factor is the absolute priority rule.¹⁷ This rule prevents owners, as the most junior claimants, from realizing any value of the reorganizing company unless creditors consent or are paid in full.¹⁸ The rule's alternative conditions of consent or full payment thus prevent owners from retaining control of bankruptcy debtors unfairly, cheaply, or in derogation of creditors' nonbankruptcy rights.¹⁹

History also supplies a putative exception to the fair and equitable requirement and the absolute priority rule.²⁰ Often called the new value "exception" to the absolute priority rule,²¹ this test permits owners to retain their investment on two conditions. First, they must contribute necessary new value to the reorganizing debtor. Second, the value of the contribution must be reasonably equivalent to the value of the interest they will keep. These new value principles do not require creditor consent—indeed creditor dissent is assumed—and do not require creditors to receive any minimum dividend.

This article explores the relationship between the absolute priority rule and new value principles by first examining the historical origins of the absolute priority rule. It finds that fraudulent transfer law and concepts of limited investor liability law framed early attempts to create an absolute priority rule. These doctrines focused on creditors' priority to the debtor's assets.

16. See, e.g., *In re Evans Products Co.*, 65 B.R. 870, 875 (S.D. Fla. 1986); see also 124 CONG. REC. 32,407 (1978) (statement of Rep. Edwards); *id.* at 34,006 (1978) (statement of Sen. DeConcini) ("For example, a dissenting class should be assured that no senior class receives more than 100 percent of the amount of its claims. While that requirement was explicitly included in the House bill, the deletion is intended to be one of style and not one of substance.").

17. The absolute priority rule has been the subject of much critical writing. See, e.g., John D. Ayer, *Rethinking Absolute Priority After Ahlers*, 87 MICH. L. REV. 963 (1989); Baird & Jackson, *supra* note 2; Walter J. Blum & Stanley A. Kaplan, *The Absolute Priority Doctrine in Corporate Reorganizations*, 41 U. CHI. L. REV. 651 (1974); Walter J. Blum, *The "Fair and Equitable" Standard For Confirming Reorganization Under the New Bankruptcy Code*, 54 AM. BANKR. L.J. 165 (1980); Walter J. Blum, *The Law and Language of Corporate Reorganization*, 17 U. CHI. L. REV. 565 (1950); James C. Bonbright & Milton M. Bergerman, *Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization*, 28 COLUM. L. REV. 127 (1928).

18. The subtle and far reaching implications of this formulation are discussed from a historical perspective in Section II of this article. See text accompanying notes 25-135 *infra*. The impact of the exact formulation of the rule on modern reorganizations and owner participation is the subject of Section IV. See text accompanying notes 210-315 *infra*.

19. See SECURITIES AND EXCHANGE COMM'N, REP. ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES, pt. 8, at 142-56 (1940) [hereinafter cited as SEC REPORT, with an additional indication of the part and the year published]; GARRARD GLENN, FRAUDULENT CONVEYANCES AND PREFERENCES § 224 (rev. ed. 1940); Blum & Kaplan, *supra* note 17.

20. The derivation of this formulation is set forth in Section III. See text accompanying notes 136-209 *infra*.

21. See, e.g., *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 203 (1988) (discussing continuing vitality of "'exception' or 'modification'" to absolute priority rule); Baird & Jackson, *supra* note 2, at 788 & n.104; Ralph A. Peeples, *Staying In: Chapter 11, Close Corporations and the Absolute Priority Rule*, 63 AM. BANKR. L.J. 65, 75-78 (1989); see also David M.W. Harvey, *Application of the New Money Exception in Chapter 11 Reorganizations*, 16 T. MARSHALL L. REV. 275 (1991); Derek J. Meyer, Note, *Redefining the New Value Exception to the Absolute Priority Rule in Light of the Creditors' Bargain Model*, 24 IND. L. REV. 417 (1991).

Building upon this historical base, the article traces the absolute priority doctrine through two codifications.

The article next examines new value principles. Although many recent cases²² and commentaries²³ question the wisdom of a new value exception to absolute priority, this article contends that much of this fuss is misguided. Examination of the evolution of the absolute priority rule and an analysis of new value principles demonstrate that these principles are nothing more than a rough reformulation of the absolute priority rule—albeit a reformulation that is inexplicably *tougher* on owners. To speak of the new value principles as an exception to absolute priority is thus misleading.

Yet, the absence of a true exception to absolute priority does not necessarily exclude owners from the reorganization process when creditors dissent. However one may wish to inveigh against manipulative or exploitative owners, those who contribute new value should stand on better footing.²⁴ These owners risk additional personal capital, which is a strong index of good faith.

Both practice and theory give substance to this insight, and support at least partial inclusion of owners in the process of reorganization. Reorganization practice illustrates that the presence of competing bidders for a debtor, whether they are owners or not, tends to increase creditor dividends. Recent theoretical work on the nature, design, and conduct of auctions supports this practical insight. This theoretical work asserts that the provision of maximum information to potential bidders promotes higher revenues to the seller, which, in the reorganization context, translates into higher creditor dividends. Owners' bids are a significant source of such information. It not only evidences the owners' belief that the debtor has a positive value, but also signals the potential amount of this value. In turn, this information allows nonowners to formulate their own best bids. Moreover, the presence of an owner sponsored plan and the information it represents tend to stimulate competitive bidding. Auction theory suggests that competitive bidding leads to higher seller revenue, and thus, in the reorganization context, higher creditor dividends.

The article concludes with an application of fairly simple insights from auction theory to reorganization practices so as to permit legitimate owner participation while guarding against owner exploitation. In particular, it

22. See note 154 *infra* and accompanying text.

23. See, e.g., Ayer, *supra* note 17; Baird & Jackson, *supra* note 2; Raymond T. Nimmer, *Negotiated Bankruptcy Reorganization Plans: Absolute Priority and New Value Contributions*, 36 EMORY L.J. 1009 (1987); David S. Skeel, *The Uncertain State of An Unstated Rule: Bankruptcy Contribution Rule Doctrine After Ahlers*, 63 AM. BANKR. L.J. 221 (1989); see also note 21 *supra*.

24. Indeed, entities that supply new value through purchase money loans or other means receive preferential treatment in other contexts. See, e.g., 11 U.S.C. § 547(c)(3) (1988) (providing an exception for otherwise preferential transfers if transferee provides new value to enable debtor to acquire property); *id.* § 1110 (providing exception from automatic stay for purchase money equipment lenders to certain utilities); 26 U.S.C. §§ 6323(h)(1), (6) (1988) (providing that lenders or purchasers who part with "money or money's worth" may prevail to the extent of such value, over a prior tax lien); U.C.C. § 9-312(3) (1990) (granting priority to purchase money lenders); *id.* § 9-312(4) (1988) (granting priority to noninventory purchase money lenders).

seeks to show that promotion of competing plans—from third parties or the creditors themselves—can create the necessary restraints on owner exploitation. Plans from third parties would provide direct competition to owners, and would thus check any attempt by owners to exploit. Creditor-sponsored plans can have a similar effect. Such plans, for example, could allow creditors to exchange their claims against the debtor as consideration for their competing bid for the firm. Consequently, if creditors do not share the owners' valuation, they may set their own valuation and pay for it through a credit-bid. The possibility of these competing plans will counterbalance the owners' ability to capitalize on their position, and ensure that any price paid in reorganization is a price tested by all interested parties.

II. THE ORIGINS AND CURRENT STATUS OF THE ABSOLUTE PRIORITY RULE

A. *The Crucible: Fraudulent Transfer Law*

The absolute priority rule's origins lie in the intersection between fraudulent transfer law and the rise of the railroad during the nineteenth century. Rail systems constructed during that period represented huge investments of capital,²⁵ including large amounts of secured debt.²⁶ They also represented a precarious investment: by 1915, almost one-half of American railroads had defaulted on obligations to their creditors, thus requiring some sort of financial reorganization.²⁷ Foreclosure was the traditional enforcement mechanism for defaults on such secured debt.²⁸ Yet the vast amounts involved, coupled with the pervasiveness of the default problem, rendered foreclosure virtually ineffective; no one could afford to buy the property at foreclosure.²⁹ As a consequence, syndicates of debt holders often faced the

25. As of 1906, over \$18 billion of railroad securities were outstanding. WILLIAM Z. RIPLEY, *RAILROADS: FINANCE & ORGANIZATION* 62-63 (1915). Over \$12 billion of these securities were held by the public. *Id.* at 63. Most of the proceeds from the sale of these securities went into the construction of the railroad system. *Id.*; see also Albro Martin, *Railroads and the Equity Receivership: An Essay in Institutional Changes*, 34 J. ECON. HIST. 685 (1974); Jeffrey Stern, Note, *Failed Markets and Failed Solutions: The Unwitting Formulation of the Corporate Reorganization Technique*, 90 COLUM. L. REV. 783, 784 (1990).

26. As of 1906, railroads had issued over \$9 billion of secured debt, of which almost \$8 billion was publicly held. W. RIPLEY, *supra* note 25, at 63, 105-20.

27. *Id.* at 374. In 1896, 151 railroads, representing approximately 16% of all railroad mileage, were in receivership, John Franklin Crowell, *Railway Receiverships in the United States*, 7 YALE REV. 319, 319 (Nov. 1898), which was the primary means of debt relief. See note 33 *infra* and accompanying text. Estimates of the percentage of mileage under receivership changed little in the next 20 years. Paul D. Cravath, *Reorganization of Corporations*, in 1 SOME LEGAL PHASES OF CORPORATE FINANCING, REORGANIZATION AND REGULATION 153, 154 (1917).

28. See Stern, *supra* note 25, at 785-87.

29. See James Byrne, *The Foreclosure of Railroad Mortgages in the United States Courts*, in 1 SOME LEGAL PHASES OF CORPORATE FINANCING, REORGANIZATION AND REGULATION, *supra* note 27, at 141 (commenting that "the court and everyone else know that [a] railroad company cannot possibly get the money to pay what it owes [from a foreclosure sale]; and they know in ninety-nine cases out of a hundred that there will only be one bidder[, the secured party, at the foreclosure sale]"); see also *Guaranty Trust Co. v. Missouri Pac. Ry.*, 238 F. 812, 814-15 (E.D. Mo. 1916); *Macon & W.R.R. v. Parker*, 9 Ga. 377, 389 (1851); GARRARD GLENN, *THE LAW GOVERNING LIQUIDATION* § 172 (1935); W. RIPLEY, *supra* note 25, at 127; Stern, *supra* note 25, at 787.

daunting prospect of running a railroad.³⁰

The inadequacy of foreclosure and sale as a practical remedy to default gave rise to a new form of debt relief: reorganization.³¹ Under reorganization, railroads continued to operate while their owners and secured creditors created a new capital structure.³² The primary vehicle for reorganization was the equity receivership.³³ Once initiated, the receivership kept the railroad running, and also became the forum in which debts were satisfied. Receiverships typically satisfied old debt through a plan of reorganization and a carefully orchestrated foreclosure of the railroad's assets.³⁴ Plans usually transferred the foreclosed property to a newly created entity, and then provided for the new entity to issue debt and equity securities to satisfy the old debt.³⁵

Besides the considerable creativity needed to adopt this remedy, certain practical problems existed. First, the railroads needed managers to operate their lines.³⁶ Second, the railroads, almost by definition, needed additional

30. See, e.g., 2 ARTHUR STONE DEWING, *THE FINANCIAL POLICY OF CORPORATIONS* 1238-54 (5th ed. 1953). In *Louisville Trust Co. v. Louisville, N.A. & C. Ry.*, 174 U.S. 674, 678 (1899), the equity court appointed as its receiver "a gentleman who was the vice president of the company and its general manager."

31. 2 A.S. DEWING, *supra* note 30, at 1233-37; Cravath, *supra* note 27, at 154-56.

Until 1938, the federal bankruptcy scheme was relatively limited in scope, primarily concerned with the efficient liquidation of debtors' estates. *SEC v. United States Realty & Improvement Co.*, 310 U.S. 434, 448 (1940); see also CHARLES WARREN, *BANKRUPTCY IN UNITED STATES HISTORY* (1935). Indeed, from 1789 to 1800, 1802 to 1840, 1843 to 1867, and 1879 to 1898, there was no federal bankruptcy statute. Notable exceptions to the goal of efficient liquidation were the reorganization provisions added to the Bankruptcy Act in 1874, Act of June 22, 1874, ch. 390, 18 Stat. 178, 182-86 (1874) (repealed 1878), as well as the composition provisions found in § 12 of the 1898 Act, 11 U.S.C. § 30 (repealed 1938). The deficiencies of the 1874 amendments are noted in C. WARREN, *supra*, at 122-28. The practical problems with the § 12 compositions were set forth in SEC REPORT, *supra* note 19, pt. 8, at 72-82 (1940).

32. SEC REPORT, *supra* note 19, pt. 8, at 37-47 (1940); Byrne, *supra* note 29, at 93-96.

33. See CHARLES FISK BEACH, JR., *COMMENTARIES ON THE LAW OF RECEIVERS* at v (New York, L.K. Strouse 1891) (stating that railway receiverships were "essentially American," and dating their rise to the 25-year period preceding 1887). English practice resisted imposing receiverships upon bankrupt railways due to the absence of authorizing legislation. *Id.* § 325; see also WILLIAM WILLIAMSON KERR, *A TREATISE ON THE LAW AND PRACTICE AS TO RECEIVERS APPOINTED BY THE COURT OF CHANCERY* 66 (Geo. Tucker Bispham ed., 2d ed., Philadelphia, Kay & Brother, 1877) (finding receivership an inappropriate remedy when debtor operated under public charter or some other legislative grant).

34. 2 A.S. DEWING, *supra* note 30, at 1288-90; Byrne, *supra* note 29, at 93-96; Stern, *supra* note 25, at 791-94.

35. Reorganization managers accomplished many goals through their plan. A plan created a new company which would be controlled by the old bondholders. It also transferred the mortgaged assets to that company and established the remainder of the new company's capital structure. The new capital structure, however, took as its starting point the structure of the company in receivership. The bonds issued carried a reduced debt service through debt forgiveness and below-market terms. In addition, old shareholders often subscribed for new equity shares at prices pegged as additional "assessments" on their original shares. The funds raised from these assessments served several purposes. First, the funds paid administrative expenses, including lawyers' fees. The next payments were made to satisfy dissenting bondholders. Finally, the new railroad company used any remaining funds as its initial working capital. For more elaboration, see 2 A.S. DEWING, *supra* note 30, at 1288-97; Cravath, *supra* note 27, at 175-81; Robert T. Swaine, *Reorganization of Corporations: Certain Developments of the Last Decade*, 27 COLUM. L. REV. 901 (1927).

36. SEC REPORT, *supra* note 19, pt. 8, at 33 (1940); Cravath, *supra* note 27, at 157-61 (underscoring need for competent and sympathetic receivers).

cash to continue providing services.³⁷ Notwithstanding the scarcity of these essentials, at least one identifiable group—the stockholders—possessed both resources. Stockholders were often willing to contribute new cash to save their investment.³⁸ In addition, these same shareholders or their agents were often in a better position to manage operations.³⁹

Thus arose an alliance between bondholders and stockholders. Bondholders would initiate equity receiverships with the goal of a judicial sale of the road pursuant to the bondholders' mortgage; shareholders, or their proxies, would run the railroad.⁴⁰ This alliance did not end with foreclosure, and the reorganization plan would often provide for the new entity to issue securities to the old equity holders upon contribution of a stated price.⁴¹ In practice, the new money not only saved an old investment, but the contributions were structured so that the securities received were often worth more than the amount contributed to the reorganization.⁴²

Foreclosure not only discharged the old secured debt, but drastically affected existing unsecured debt. Since the old line's assets typically were subject to the creditors' mortgage, foreclosure removed from the reach of the unsecured creditors all property that could have been used to satisfy their claims. Unsecured creditors were squeezed out and given nothing.⁴³

Not surprisingly, unsecured creditors resisted the elimination of their claims during foreclosure. Using fraudulent conveyance law,⁴⁴ they attacked the validity of foreclosure transactions.⁴⁵ Several aspects of fraudulent conveyance law made using it attractive. At common law, a fraudulent conveyance occurred whenever a transfer was made with the intent to hinder, delay, or defraud creditors.⁴⁶ The alliance between bondholders and

37. Swaine, *supra* note 35, at 918-19. Courts often required "the railroad receiverships to pay [certain] pre-receivership claims prior to reorganization." Russell A. Eisenberg & Frances F. Gecker, *The Doctrine of Necessity and Its Parameters*, 73 MARQ. L. REV. 1, 3 (1989).

38. Swaine, *supra* note 35, at 915.

39. As noted in the SEC REPORT, *supra* note 19, pt. 8, at 33 (1940), 59% of all railroad receivers were affiliated with the debtor either as owners or as officers.

40. W. RIPLEY, *supra* note 25, at 127.

41. Cravath, *supra* note 27, at 181-98; *see also* note 11 *supra*.

42. *See, e.g.*, Swaine, *supra* note 35, at 914-17.

43. *See, e.g.*, *Chicago Rock Island & Pac. R.R. v. Howard*, 74 U.S. (7 Wall.) 392 (1868) (existing bondholders, who would not have been fully satisfied by foreclosure, agreed to give shareholders 16% of the bonds of new operating company as consideration for shareholders' approval of sale of old railroad to an interested purchaser, whereby unsecured creditors were not considered or compensated).

44. Courts and commentators have recently renamed this body of law. Originally known as fraudulent conveyance law, *see* G. GLENN, *supra* note 19, § 195, the area is now referred to as fraudulent transfer law, because it covers obligations as well as conveyances. *See* 11 U.S.C. § 548 (1988) (referring to fraudulent transfers). Compare Uniform Fraudulent Conveyance Act (1918) (emphasis added) with Uniform Fraudulent Transfer Act (1984) (emphasis added).

45. *See, e.g.*, *Howard*, 74 U.S. at 405. In *Howard*, before the distribution of the bonds, unsecured creditors used a fraudulent conveyance theory to lay claim to undistributed shareholders' bonds in the new company. These creditors alleged that the foreclosure was collusive, *id.*, and that the bonds, as proceeds of the assets of the old railroad, belonged to creditors, not shareholders, *id.* at 409.

46. Transfers made with the intent to hinder, delay, or defraud creditors had been illegal since at least 1571. 13 Eliz., ch. 5 (1571) (Eng.), *repealed by* The Law of Property Act, 15 Geo. 5, ch. 20,

shareholders during railroad reorganizations could thus be characterized as a scheme to unfairly eliminate unsecured claims, which hindered, delayed, and defrauded those creditors.⁴⁷ The alliance produced a new company with the same shareholders, the same bondholders, and the same property. The only aspect missing was unsecured and other junior debt. Moreover, then-existing common law recognized that judicial procedures such as levy and execution could be unfairly and intentionally manipulated to eliminate unsecured debt. The abuse of these procedures could also be characterized as a fraudulent conveyance.⁴⁸ Finally, the remedies afforded under fraudulent conveyance law fit; creditors could ignore a court-approved foreclosure and levy upon the railroad's assets held by the new owners.⁴⁹ The combination of these factors allowed unsecured creditors to challenge the procedure used by reference to the result it achieved; their argument, plainly stated, was this: "why should shareholders take anything when we receive nothing?"⁵⁰

§ 172 sched. 6 (1925) (Eng.). For a short background, see Bruce A. Markell, *Toward True and Plain Dealing: A Theory of Fraudulent Transfers Involving Unreasonably Small Capital*, 21 IND. L. REV. 469, 473-75 (1988). A more extensive account is set forth in 1 G. GLENN, *supra* note 19, §§ 58-62b.

47. Again, the *Howard* analysis provides an example: Since the debtor had sold the property, the Court felt that any proceeds not used to discharge the lien constituted "a fund in trust for the benefit of [the debtor's] creditors." *Howard*, 74 U.S. at 414. Moreover, diversion of the proceeds of this fund to stockholders before all debts had been paid was a form of fraudulent transfer. As stated by the Court without citation, "the rule is well settled that stockholders are not entitled to any share of the capital stock nor to any dividend of the profits until all debts of the corporation are paid." *Id.* at 409-10. See also *Louisville Trust Co. v. Louisville, N.A. & C. Ry.*, 174 U.S. 674, 689 (1899) (directing lower court, on remand, not to approve foreclosure sale "until the interests of the unsecured creditors have been preserved").

48. See, e.g., *Crary v. Sprague & Craw*, 12 Wend. 41 (N.Y. Sup. Ct. 1834) (fraudulently obtained execution and sale of goods cannot defeat rights of purchaser who bought after levy); *United States v. Conyngham*, 25 F. Cas. 599 (C.C.D. Pa. 1801) (No. 14,850) (debtor's continued possession of household goods for 13 months after levy held fraudulent, leaving the goods available for subsequent execution); *West v. Skip*, 27 Eng. Rep. 1006, 1010 (Ch. 1749) (debtor's retention of assets after levy constituted a species of fraud notwithstanding the regularity of the procedure involved; consequently, execution creditor who allowed the debtor to maintain possession lost priority to later levying creditor); see also ORLANDO BUMP, *FRAUDULENT CONVEYANCES* 507-08 (2d ed. 1876); 1 G. GLENN, *supra* note 19, § 214b; *Wood v. Dummer*, 30 F. Cas. 435 (C.C.D. Me. 1824) (No. 17,944) (creating the trust fund theory of liability to creditors). *Dewing* cites *Wood* as "the first important legal precedent" in equity receivership theory. 2 A.S. DEWING, *supra* note 30, at 1237 n.p.

Other authorities have analyzed the early origins of the absolute priority rule. See William O. Douglas & Jerome Frank, *Landlords' Claims in Reorganizations*, 42 YALE L.J. 1003, 1009-41 (1933); Jerome N. Frank, *Some Realistic Reflections on Some Aspects of Corporate Reorganization*, 19 VA. L. REV. 541, 547-60 (1933); see also SEC REPORT, *supra* note 19, pt. 8, at 52-60 (1940). Legal scholars also noted this problem long before courts had developed rules on the matter. See, e.g., C.F. BEACH, *supra* note 33, § 327, at 265-66.

49. See, e.g., *Bethel v. Stanhope*, 78 Eng. Rep. 1037, 1038 (Q.B. 1599); *Mannocke's Case*, 73 Eng. Rep. 661 (Q.B. 1571).

50. Bondholders and shareholders responded with an argument based upon procedural standing and contractual freedom. Since the encumbered assets were insufficient to satisfy the bondholders, unsecured creditors who lacked standing to challenge the foreclosure, even if they prevailed, would get nothing. Further, bondholders had the right to give their assets to the old shareholders after they had foreclosed. A modern form of this argument appears in *Baird & Jackson*, *supra* note 2, at 742-44.

The Supreme Court responded directly to these arguments in *Louisville Trust Co.*, 174 U.S. 674 (1899). Against the background of a fraudulent conveyance challenge, *id.* at 679, the court rejected

B. *From Fraudulent Transfer Law to "Fixed Principles" and Fair Offers*

Although the Supreme Court recognized the primacy of creditors' rights and the legitimacy of fraudulent conveyance attacks as early as 1868,⁵¹ bondholders and stockholders continued to ignore the rights of unsecured creditors by adopting reorganization plans that excluded these creditors.⁵² In 1913, the Court reemphasized its concerns regarding priority in *Northern Pacific Railway Co. v. Boyd*.⁵³ After *Boyd*, reorganizations would never be the same.

Boyd considered the validity of receivership of the Northern Pacific Railroad Company, which had earlier defaulted on its secured bonds during the railroad panic of 1893.⁵⁴ After a consensual receivership for the Railroad was initiated in 1893,⁵⁵ holders of the bonded indebtedness foreclosed⁵⁶ using the procedure already described above.⁵⁷ The approved plan of reorganization transferred the Railroad's assets to the newly organized Northern Pacific Railway Company.⁵⁸ As part of this reorganization plan, common shareholders of the Railroad could subscribe to common stock of the Railway upon payment of assessments equal to \$15 for every \$100 of original par value stock in the Railroad held. Preferred shareholders of the Railroad received \$50 each of new preferred and common stock for an assessment of \$10 on every \$100 of original value.⁵⁹

the standing and contractual freedom arguments, stating that "a court . . . can never rightfully become the mere silent register of the agreements of mortgagee and mortgagor," *id.* at 688-89.

The division of consideration was probably one of the factors which led the Court to refuse to validate the foreclosure. As set forth in the case on remand, former preferred shareholders received a priority right to subscribe to \$100 worth of new common stock and \$7.50 of new preferred upon surrender of \$100 old preferred and payment of \$7.50. *Farmers' Loan & Trust Co. v. Louisville, N.A. & C. Ry.*, 103 F. 110, 127 (C.C.D. Ind. 1900). Holders of old common received a similar right to subscribe; they could receive \$100 of new common and \$7.50 of new preferred upon surrender of \$300 of old common stock and payment of \$7.50. *Id.* Since the old equity securities were practically worthless—five months after the initiation of the receivership the common was trading for "a fraction of a cent" per share, and the preferred was trading at 1 to 2 cents per share, *id.* at 128—the exchange was quite a bargain for the equity holders.

The Supreme Court instructed the lower court to examine the transaction more closely for the fraud hinted at by this disparity. On remand, the trial judge seemingly took umbrage at the Supreme Court's intimations that he had not properly discharged his duties. *See id.* at 118-20. At any rate, the judge adopted the master's report, *id.* at 128, which explicitly found that there "was no fraud or fraudulent intent or fraudulent conspiracy on the part of the [bondholders'] trustees, the bondholders, the bondholders' committee, the stockholders or [the debtor]." *Id.* at 112.

51. *Howard*, 74 U.S. at 392. Note, however, that receiverships as vehicles for railroad reorganization appeared as early as the 1850s. Stern, *supra* note 25, at 792-94 (discussing Macon & W.R.R. v. Parker, 9 Ga. 377 (1851)). *See also* 2 A.S. DEWING, *supra* note 30, at 1239-42.

52. SEC REPORT, *supra* note 19, pt. 8, at 48-49 (1940).

53. 228 U.S. 482 (1913). As already noted, by that time almost a majority of railroads had undergone some form of financial reorganization. *See* text accompanying note 27 *supra*.

54. 228 U.S. at 487; STUART DAGGETT, RAILROAD REORGANIZATION 289 (1908).

55. *Boyd*, 228 U.S. at 487.

56. *Id.* at 487-90. Although the Court authorized the sale of the Railroad's unencumbered property in its decree of foreclosure entered in 1896, the property was not sold and the securities of the Railway Company were not issued until 1899. *Id.* at 491.

57. *See* text accompanying notes 31-35 *supra*.

58. *Boyd*, 228 U.S. at 488.

59. *Boyd*, 228 U.S. at 488-89; S. DAGGETT, *supra* note 54, at 303, 305, 353.

The reorganization plan did not provide for Boyd or any other unsecured creditor: The court-approved upset price was less than the total amount of secured indebtedness. Indeed, the Court noted that the reorganization court, in a prior suit brought by other unsecured creditors, had found that "there was no equity in the property out of which unsecured creditors could be paid."⁶⁰

Boyd sued both the *Railroad* and the *Railway* for debts owed to him by a company acquired by the *Railroad* in 1888 in what today would be called a leveraged buyout. The *Railroad* purchased a majority of the stock of Boyd's debtor, then immediately caused its new subsidiary to borrow funds against the subsidiary's assets. The proceeds of this transaction were, in one way or another, used to satisfy the acquisition debt.⁶¹

Relying on fraudulent conveyance law,⁶² Boyd alleged that the *Railway* was liable in equity for the unpaid debts of the *Railroad's* subsidiary.⁶³ The Supreme Court agreed, holding that equity would not allow an alliance of secured creditors and shareholders to eliminate unsecured debts such as Boyd's.⁶⁴ In this respect, the Court continued to apply fraudulent conveyance law.⁶⁵ Indeed, much of the Court's description of the effect of the reorganization is crafted in traditional fraudulent conveyance language.⁶⁶ If issued today, the opinion would probably be analyzed as another unexceptional "successor liability" case applying the "mere continuation" theory of fraudulent transfer or bulk transfer liability.⁶⁷ In short, the Court did not

60. *Boyd*, 228 U.S. at 490. The suit was *Paton v. Northern Pac. R.R.*, 85 F. 838 (C.C.E.D. Wisc. 1896).

61. *Boyd*, 228 U.S. at 499-500.

62. *Id.* at 501. The arguments of counsel for the *Railway* make clear that Boyd alleged that the sale of the *Railroad's* assets to the *Railway* was fraudulent as to his claim against the *Railroad*. See *id.* at 493-97.

63. *Id.* at 501.

64. *Id.* at 503-08.

65. See note 48 *supra*. The Court also cited *Howard* and *Louisville Trust* as relevant authorities. *Boyd*, 228 U.S. at 504-05. Similar fact patterns still arise. See, e.g., *Voest-Alpine Trading USA Corp. v. Vantage Steel Corp.*, 919 F.2d 206 (3d Cir. 1990).

66. The Court stated that:

[a]s between the parties and the public generally, the [foreclosure] sale was valid. As against creditors, it was a mere form. . . . The property in the hands of the former owners, under a new charter, was as much subject to any existing liability as that of a defendant who buys his own property at a tax sale.

Boyd, 228 U.S. at 506-07; see also 1 G. GLENN, *supra* note 19, § 224.

67. As with many strands of fraudulent conveyance law, this particular type of fraud has spawned its own jurisprudence. According to the modern "mere continuation" theory of fraudulent conveyances, shareholders cannot cause corporations to sell assets to a new entity that they own, and use the fiction of a new corporation to defeat creditor claims. In short, liability follows the assets. See, e.g., *Ray v. Alad Corp.*, 19 Cal. 3d 22, 29, 560 P.2d 3, 136 Cal. Rptr. 594 (1977); *Stanford Hotel Co. v. M. Schwind Co.*, 180 Cal. 348, 354, 181 P. 780 (1919); see also *Weaver v. Nash Int'l, Inc.*, 562 F. Supp. 860 (S.D. Iowa 1983) (summary judgment granting finding of no successor liability where new company did not have same shareholders of old company, but in which 3 of 7 directors remained, and all 7 officers continued in identical offices, with only 4 new offices created); cf. *Pringle v. Hunsicker*, 154 Cal. App. 2d 789, 793, 316 P.2d 742 (1957) (stating that "infusion of new blood into the business through investments by outsiders precludes the application of the ['mere continuation' theory]"). In some states, such as Michigan and New Hampshire, the "mere continuation" theory has been expanded to relax the requirement of a substantial identity of shareholders, officers, and

focus upon the amount of unpaid claims, but upon the amount of the assets diverted to junior interests.

The Court also had to deal with the contention that even a "fair plan" would not have distributed anything to unsecured creditors.⁶⁸ After all, the court-approved upset price of \$61,000,000 was less than one-half of the secured indebtedness of \$157,000,000.⁶⁹ The Court rejected the argument that the stated evidence of value established that Boyd, as an unsatisfied unsecured creditor, had no standing because of the Railroad's insolvency. As it saw the issue: "The invalidity of the sale flowed from the character of the reorganization agreement regardless of the value of the property. . . ."⁷⁰ The Court found this proposition to be a "fixed principle,"⁷¹ not affected in any way by the allegation of a lack of value for unsecured creditors.

By forcing shareholders to pay creditors in full, even if there were insufficient corporate assets, the Court attempted to allay concerns that its holding would violate the principle of limited liability. It stated that its holding did not "require the impossible, and make it necessary to pay an unsecured creditor in cash."⁷² Rather, reorganization plans could extend payment by issuing income bonds (debt instruments with contingent interest provisions) or equity securities as long as the value of the securities issued was set on "equitable terms."⁷³

What were "equitable terms"? The Court gave little guidance. As noted above, the Court did say that full payment in cash was not required.⁷⁴ The Court, however, was aware of the converse to limited liability. Upon insolvency and liquidation, shareholders forfeit their capital; all value flowing from the initial capital belongs to creditors of an insolvent company. Shareholders could not, in equity at least, derive any benefit from their risk capital so long as creditors were left unpaid.

[Thus, i]f 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.⁷⁵

In short, the right to be paid first, from shareholders' capital contributions or their proceeds, was a "right of property" inuring to the benefit of the creditors.

directors. *Turner v. Bituminous Casualty Co.*, 397 Mich. 406, 244 N.W.2d 873 (1976); see *Cyr v. B. Offen & Co., Inc.*, 501 F.2d 1145 (1st Cir. 1974) (applying New Hampshire law).

68. *Boyd*, 228 U.S. at 507-08. A prior lawsuit which had raised this point also sounded in fraudulent conveyance theories, and had been dismissed. See note 60 *supra*.

69. *Boyd*, 228 U.S. at 507.

70. *Id.*

71. *Id.*

72. *Id.* at 508.

73. *Id.*

74. *Id.* This decision was necessary to preserve shareholders' limited liability.

75. *Id.*

In *Boyd* the Court looked to the value the parties placed on the Railroad, not that determined by the trial court, to decide whether "the value of the road justified the issuance of stock."⁷⁶ Because the Railway immediately issued \$190,000,000 in bonds and \$155,000,000 in stock upon receipt of the \$61,000,000 the Court did not believe that the upset price was a fair price.⁷⁷ The reorganization diverted value to shareholders through the option to continue to participate at a favorable price. Not extending this option in some form to unsecured creditors violated those creditors' "property" right to receive priority in any distribution of corporate assets.

But if reorganization extended the "value of the road" to creditors on "equitable terms," could plan proponents exclude dissenting creditors? Equity provided no firm answer.⁷⁸ The Court's solution sounded in waiver and estoppel: "If [the creditor] declines a fair offer he is left to protect himself as any other creditor of a judgment debtor, and, having refused to come into a just reorganization, could not thereafter be heard in a court of equity to attack it."⁷⁹ In other words, upon declining a fair offer, the creditor was estopped from challenging the reorganization. Thereafter, the only recourse would be to sue to collect from the execution-proof former shell.

Boyd thus stands for two closely aligned principles. First, continued shareholder participation in the reorganized debtor creates a presumption of collusion sufficient to permit successor liability. The Court called this presumption a "fixed principle" that operates regardless of the estimated value of the debtor's property.⁸⁰ Second, reorganization managers could dispel this presumption by promulgating a fair offer to all creditors.⁸¹ So long as a fair offer made any existing value available to all participants, courts would respect the reorganization and its effect on unsecured creditors. *Boyd* thus created a procedural device to avoid judicial entanglement in substantive evaluations of value.

Boyd notwithstanding, reorganizations of all stripes continued with the participation of equity owners.⁸² Many attempted to avoid *Boyd* by offering

76. *Id.* This may be the classic example of plan proponents using liquidation value to eliminate a class, and then using going concern value to allocate the remaining interests among themselves.

77. *Id.* at 507.

78. Until the widespread acceptance of *American Steel Foundries v. Chicago, R.I. & Pac. Ry.*, 231 F. 1003 (S.D.N.Y. 1915), receiverships typically ended with foreclosure. Foreclosure preserved the fiction that the sale extinguished the unsecured creditors' debts. In *American Steel*, the judge dispensed with this fiction, and allowed the reorganized debtor to operate under its old charter. *Id.* at 1003-04; 2 ARTHUR STONE DEWING, *THE FINANCIAL POLICY OF CORPORATIONS* 1346 n.s (4th ed. 1941). The *American Steel* opinion became the subject of much discussion, *see, e.g., id.* at 1347 n.n.s & 41, until the discharge provisions of Sections 77 and 77B effectively mooted the issue.

79. *Boyd*, 228 U.S. at 508 (1913).

80. *Id.* at 507.

81. *Id.* at 508.

82. One of the first, and the most lasting, responses to *Boyd* arose in the reorganization of the St. Louis & San Francisco Railroad. There, Judge Sanborn initially understood *Boyd* to require all-cash payments to unsecured creditors, but after "three days of friendly debate in his chambers," he relented and allowed old equity holders to purchase new shares in the reorganized company. 2 ROBERT T. SWAINE, *THE CRAVATH FIRM AND ITS PREDECESSORS, 1819-1948*, at 172 (1948). Their participation, however, was conditioned on the plan's provision of a "fair and timely offer of participation" in the reorganized company to unsecured creditors. *Id.* at 173 (quoting Judge

holders of unsecured debt the ability to subscribe, along with holders of equity securities, to the securities issued by the new company. Necessity played a role in this trend: reorganizing companies needed operating capital, and equity holders were perceived as the most likely source. In 1926, the Supreme Court, recognizing this need for capital, appeared to endorse such efforts, while at least facially reaffirming *Boyd*'s two key principles.⁸³

Although the *Boyd* court tried to avoid making substantive determinations of value, it failed to offer much guidance on just what constituted a "fair offer." After weak attempts by the Court to give meaning to the term,⁸⁴ two different conceptions of fair offers eventually arose.⁸⁵ The first theory, known generically as "relative priority," did not require allocating participation rights according to the full amount of prereceivership claims. Instead, it adjusted capital structure on the basis of entitlement to future income, assuming no acceleration of senior debt. Equity holders could participate only if the projected earnings of the reorganized company exceeded pre-receivership debt service. Under the relative priority theory, therefore, shareholders who contributed new value through paid assessments could salvage at least some of their original investment.⁸⁶

Unsecured and other junior creditors pressed for a different interpretation of the "fair offer" principle announced in *Boyd*. Their alternative, known as "absolute priority," rejected allocations of participation rights based on income entitlement. Instead, it set priority according to the full amount of a creditor's state law entitlement upon liquidation.⁸⁷ Thus, junior classes could participate only when the reorganization plan allocated values in accordance with their state law entitlement. In contrast to a relative priority system, absolute priority granted the excess of market value over any assessments paid to the creditors, not to the shareholders.

The stakes were high. Reorganization managers believed that the securities issued in a reorganization had to have an initial market value greater than the associated assessment to induce shareholders to pay the assess-

Sanborn's decree). The plan's provisions were later upheld against collateral attack. *St. Louis-San Francisco Ry. v. McElvain*, 253 F. 123 (E.D. Mo. 1918).

83. *Kansas City Terminal Ry. v. Central Union Trust Co.*, 271 U.S. 445 (1926). In *Kansas City Terminal*, the Court noted that "additional funds will be essential to the success of the [reorganization], and it may be impossible to obtain them unless stockholders are permitted to contribute." *Id.* at 455 (dicta). The Court, however, also made statements which parroted *Boyd*. In particular, it stated that creditors possessed an "equitable right to be preferred to stockholders against the full value of all property belonging to the debtor corporation," and that if a fair offer was made and refused, "[creditors could not] attack the reorganization in a court of equity." *Kansas City Terminal*, 271 U.S. at 454-55.

That *Kansas City Terminal* is unsatisfactory on many counts is set forth in Ayer, *supra* note 17, at 1001-07.

84. See *Kansas City Terminal*, 271 U.S. at 456.

85. The article fixing the terminology "relative priority" and "absolute priority" is Bonbright & Bergerman, *supra* note 17, at 127.

86. Often the value of such securities when issued exceeded the amount of the assessment. 2 A.S. DEWING, *supra* note 30, at 1395; Swaine, *supra* note 35, at 914-15. Proponents of this view justified it on the basis that the new value created the excess value. See, e.g., *id.* at 916.

87. See Bonbright & Bergerman, *supra* note 17, at 127.

ments.⁸⁸ Eliminating liability for unsecured creditors was one means of ensuring higher value. Owners thus contributed hundreds of millions of dollars on the assumption that the receivership vehicle extinguished unsecured creditors' debts.

The debate continued as the Depression pushed increasing numbers of companies into receivership.⁸⁹ Given the *ad hoc* development of reorganization powers, administration was not uniform. Thus, in 1933 and 1934, Congress responded to the problems by adding Sections 77 and 77B⁹⁰ to the Bankruptcy Act of 1898 (the "Act")⁹¹ as reorganization devices. Both statutes incorporated most of the features of equity receiverships. But both went further: they explicitly allowed courts to bind dissenting minorities to the terms of a confirmed plan.⁹²

In addition, Sections 77 and 77B each required judicial findings that proposed plans be "fair and equitable" before a plan could be confirmed.⁹³ Moreover, this requirement applied to *each* creditor.⁹⁴ Contrary to what one might think, the statute's requirement did not deter reorganization practice. Proponents of relative priority believed the language of the statute allowed business as usual: continued equity participation through assessments, which preserved some value at the expense of senior creditors.⁹⁵ As seen below, other creditors did not share this view.

88. As stated by Robert T. Swaine, if such excess values could not be assured, "successful corporate reorganizations [would be] impossible." Swaine, *supra* note 35, at 915; see also 2 A.S. DEWING, *supra* note 30, at 1395; note 86 *supra*.

89. 2 A.S. DEWING, *supra* note 30, at 1234 & n.i.

90. Section 77 provided for relief for railroad corporations. Act of March 3, 1933, ch. 204, § 77, 47 Stat. 1467, 1474 (1933). Section 77B, enacted a year later, applied to other corporations. Act of June 7, 1934, ch. 424, § 77B, 48 Stat. 911, 912 (1934).

91. Act of July 1, 1898, Pub. L. 55-171, 30 Stat. 544 (1898) (repealed 1979) [hereinafter Act].

92. Under Section 77, unsecured debts were discharged to the extent that "two-thirds in amount of such creditors shall have accepted the plan in writing." Act of March 3, 1933 § 77(h)(6). If a majority of creditors voted for a plan, then their motives, however selfish, controlled. Under Section 77B, the confirmation of a plan discharged "all creditors, secured or unsecured," *id.* § 77B(g)(3) (repealed 1938), but confirmation required the vote of two-thirds of each creditor class affected. Act of June 7, 1934, § 77B(e)(1) (repealed 1938).

93. Section 77, as originally enacted, did not state that the plan had to be "fair and equitable." Rather, it stated that the plan had to be "equitable." Act of March 3, 1933 ch. 204, § 77(g), 47 Stat. 1467, 1479 (1933). It was not until 1935, after the adoption of Section 77B, that the words "fair and" were inserted before "equitable." Act of Aug. 27, 1935, ch. 774, § 77(e)(1), 49 Stat. 911, 918 (1935).

94. Section 77B explicitly allowed courts to override the creditors' vote. This seemed at odds with the explicit deference to majoritarian rule in § 77, see note 92 *supra*, and effectively shifted the focus from a fair offer, as judged by the collective self interest of creditors as a class, to a "fair" distribution, as judged by state law priorities.

95. In *Downtown Inv. Co. v. Boston Metro. Bldgs., Inc.*, 81 F.2d 314 (1st Cir. 1936), the court held that Section 77B did not incorporate the absolute priority rule and affirmed a plan based upon relative priorities. Other early cases seemed to discard absolute priority, but are of limited value due to the lack of objections raised or the brevity of discussion by the courts. See, e.g., *In re A.C. Hotel Co.*, 93 F.2d 841 (7th Cir. 1937); *In re Peyton Realty Co.*, 18 F. Supp. 822 (E.D. Pa. 1936); *In re Burns Bros.*, 14 F. Supp. 910 (S.D.N.Y. 1936).

C. *From Fair Offers to "Fair and Equitable" Plans: The First Codification*

The issue of which standard, relative or absolute priority, should govern was squarely presented to the Supreme Court in 1939 by *Thomas K. Case*.⁹⁶ The debtor company had filed under Section 77B of the Act, proposing a plan of reorganization according to which existing shareholders would retain 23 percent of the common equity for no additional monetary consideration. Under the terms of the plan, bondholders such as *Case* would receive the remainder of the common shares, plus certain preferred shares.

The case directly challenged the Court to choose between the relative and absolute priority principles. The stock issuance, together with certain dividend restrictions on the stock issued, preserved relative priorities.⁹⁷ Under the absolute priority standard, however, the plan failed miserably. The debtor's principal assets were worth approximately \$830,000, and a first mortgage was outstanding of more than \$3,800,000.⁹⁸

The Court, speaking through its newest Justice, William O. Douglas,⁹⁹ construed the statute's use of "fair and equitable" to incorporate the absolute priority standard. Justice Douglas did not even see much of an issue. He stated the "words 'fair and equitable' . . . are words of art which prior to the advent of § 77B had acquired a fixed meaning through judicial interpretations in the field of equity receivership reorganizations."¹⁰⁰ Absolute priority and *Case* prevailed.¹⁰¹

This pronouncement completed the transformation from fair offers to fair distributions. *Case* supplanted *Boyd*'s procedural test with a substantive requirement: all plans must honor state law entitlements. Moreover, aggregate creditor preferences were no longer a sufficient basis for reorganization.

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

97. *Id.* at 119-20.

98. *Id.*

99. Justice Douglas was appointed in the spring of 1939; *Case* was argued on October 18, 1939. The decision was handed down on November 6, 1939.

100. *Case*, 308 U.S. at 115. To illustrate that meaning, Justice Douglas quoted extensively from *Howard, Louisville Trust Co., Boyd, and Kansas City Terminal*. See *id.* at 116-20.

101. *Id.* at 118-19. *Case*'s victory was initially hollow. Before the Court's decision, *Case* demanded to be paid in cash, including all accrued interest and expenses. 2 A.S. DEWING, *supra* note 30, at 1304 n.h. So irritating was *Case* that the debtor's employees scraped together a fund of \$28,000 to buy peace and continue the debtor's operations; since this was less than the \$36,000 he thought he was owed, *Case* refused to accept it. *Id.* at 1305 n.h.

On remand, the debtor proposed a new plan, which canceled all bond debt, and issued new equity in the debtor *pro rata* with the amount of outstanding debt. Under the debtor's plan, *Case* received 5,238 shares, or .61%, of the 859,628 shares of common stock issued. Since *Case* held only \$13,500 in bonds, he was transformed from a creditor holding \$13,500 in bonds into a minority shareholder. See *id.* at 1309 n.o.

Case may have had the last laugh, however. The debtor's main asset was a dockyard in Los Angeles. *Case*, 308 U.S. at 109. With the advent of World War II, the debtor acquired a backlog of defense contracts. The debtor's value thus rose sharply to \$4 per share. 2 A.S. DEWING, *supra* note 30 at 1309 n.o. *Case* thus could have sold his stock in the early 1940s for almost \$21,000, more than the principal amount of his original bonds. In any event, the debtor was acquired in 1946, and liquidated soon thereafter. *Id.* at 1309.

The application of the fair and equitable standard had to occur on a creditor by creditor basis.

The Court, in a series of cases in the early 1940s,¹⁰² quickly confirmed that *Case's* interpretation of "fair and equitable" governed Section 77 railroad reorganization cases¹⁰³ and Chapter X¹⁰⁴ reorganizations. In these cases, the Court also illuminated the nature of the creditors' entitlement under the absolute priority rule.

As stated above, *Case* required reorganization plans to respect state law entitlements. But the decision failed to clarify which state law entitlements were critical. One possibility was that only liquidation priorities were to be respected. According to this view, creditors maintained priority only over what they would have received if there were a quick liquidation sale. An alternative theory accorded priority equal to the full amount of the creditors' claims; creditors previously extended capital to the entity, and thus were entitled to receive at least that much.

The answer to this problem lay between these two polar extremes. Liquidation values as a basis for priority were inapposite as they defeated one of reorganization's basic goals, that of preserving the debtor as a going concern.¹⁰⁵ Priority equal to the full value of creditors' claims ran into trouble as well. The origins of the absolute priority rule lay in fraudulent conveyance law, and that body of decisions focused on the value of the debtor's assets.¹⁰⁶ Reorganizations ultimately adopted this historical view, allocating to creditors a priority equal to all of the value that existed, rather than the amount of all claims, or a value which could be obtained quickly but with sacrifice.¹⁰⁷ Under this view, once the debtor's value was allocated to creditors, reorganization extinguished all unsatisfied claims.¹⁰⁸ Consistent with

102. *Group of Institutional Investors v. Chicago, M., St.P. & Pac. R.R.*, 318 U.S. 523 (1943); *Marine Harbor Properties, Inc. v. Manufacturers Trust Co.*, 317 U.S. 78 (1942); *Consolidated Rock Prods. Co. v. Du Bois*, 312 U.S. 510 (1941).

103. *Group of Institutional Investors*, 318 U.S. at 542.

104. *Marine Harbor Props.*, 317 U.S. at 85.

105. See, e.g., HOUSE COMMITTEE ON THE JUDICIARY, BANKRUPTCY LAW REVISION, H.R. REP. NO. 595, 95th Cong., 1st Sess. 223 (1977) [hereinafter H.R. REP. NO. 595].

106. See generally G. GLENN, *supra* note 19, at §§ 56-57.

107. See also *Group of Institutional Investors*, 318 U.S. at 541-42 ("The issue involved in such a determination [that the stock had no value] is whether *there is a reasonable probability that the earning power of the road will be sufficient to pay prior claims of interest and principal and leave some surplus for the service of the stock.*") (emphasis added); *Consolidated Rock Prods. Co. v. Du Bois*, 312 U.S. 510, 529 (1941) ("As indicated in the *Boyd* case, the *creditors are entitled to have the full value of the property*, whether 'present or prospective, for dividends or only for purposes of control,' first appropriated to payment of their claims.") (citations omitted) (emphasis added); *Kansas City Terminal Ry. v. Central Union Trust Co.*, 271 U.S. 445, 454 (1926) ("Unsecured creditors of insolvent corporations are entitled to the benefit of the values which remain after lienholders are satisfied, whether this is present or prospective, for dividends or only for purposes of control."); *Northern Pacific Ry. v. Boyd*, 228 U.S. 482, 508 (1913) ("[T]he creditors [are] entitled to the benefit of that value, whether it was present or prospective, for dividends or only for purposes of control.")

108. *In re 620 Church St. Bldg. Corp.*, 299 U.S. 24, 27 (1936) (under Section 77B, reorganization plan which allocated all value to first lienholders extinguished "whatever interest petitioners may have [had] as junior lienors under the Illinois law").

concepts of limited liability, owners' separate assets were never at risk to augment the funds available to creditors.

Although the principle of allocation was set, the mechanics for its implementation were not. *Boyd* hinted at a partial answer by implicating that income bonds or preferred stock could be used as vehicles to distribute value.¹⁰⁹ Other methods existed, most notably regular debt instruments. It was not until *Group of Institutional Investors v. Chicago, Milwaukee, St. Paul & Pacific Railroad*,¹¹⁰ however, that the scope of this principle became somewhat clearer. There, the Court reviewed allocations of value among creditors (the owners were already excluded through a lack of reorganization value) and was forced to come to grips with state law entitlements. It determined that absolute priority is satisfied if "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."¹¹¹ The Court focused on the exchange of old debt for new securities. It further implied that creditors must receive rights reasonably equivalent in value to the rights they surrender.¹¹² Thus, a reorganization lawyer's task lies in adroit drafting of the terms of the securities issued by the debtor.

The Court's decision also imposed a limitation on a creditor's right to receive property equal in value to the debt surrendered. Creditors participate to the lesser of their aggregate claims or the debtor's reorganization value. Viewed another way, solvent debtors satisfy the absolute priority rule when they distribute securities that are reasonably equivalent to the creditors' pre-petition claims. Insolvent debtors, by contrast, need only distribute securities that have an aggregate value equal to the debtor's reorganization value. In a non-trivial sense, this value is all the value the debtor has.¹¹³

109. 228 U.S. at 508. The Court affirmed this principle in *Case*, 308 U.S. at 117; *see also Kansas City Terminal*, 271 U.S. at 454-55.

110. 318 U.S. 523 (1943).

111. *Id.* at 565 (emphasis added).

112. *Cf. Kansas City Terminal*, 271 U.S. at 455 ("Unsecured creditors of insolvent corporations are entitled to the benefit of the values which remain after lienholders are satisfied, whether this is present or prospective, for dividends or only for purposes of control.") (emphasis added).

113. Against this background, the Court recently committed at least four errors in its attempt to construe the absolute priority rule in *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988). First, the Court misstated the rule's origins, noting that "[t]he rule had its genesis in judicial construction of the undefined requirement of the early bankruptcy statute that reorganization plans be 'fair and equitable.'" *Id.* at 202. As shown above, the "genesis" was in equity receiverships and fraudulent transfer law. In fact, the rule's origins predate the 1899 Act, to which the Court referred.

The second error occurred in the statement of the absolute priority rule itself. The Court said that "the absolute priority rule 'provides that a dissenting class of unsecured creditors must be provided for in full before any junior class can receive or retain any property [under a reorganization] plan.'" *Id.* (alteration in the original). As shown in the text, this statement may apply to solvent debtors, but it is too restrictive for insolvent ones. Creditors' participation rights end when they receive their aliquot share of reorganization value. As the Court interpreted the rule, absolute priority would eliminate the ability to solicit owners or junior creditors for assessments or additional contributions.

Third, the Court mistakenly asserted that the rule "gained express statutory force, and was incorporated into Chapter 11 of the Bankruptcy Code adopted in 1978. *See* 11 U.S.C. § 1129(b)(2)(B)(ii) (1982 ed., Supp IV)." *Id.* The problem here lies in the restricted citation: the cited subsection applies only to unsecured creditors, yet a different subsection refers to secured credi-

Although Congress deleted the "fair and equitable" requirement from Chapter XI in 1952,¹¹⁴ no real challenge to *Case* was made until Congress commissioned a review of the bankruptcy laws in the early 1970s.¹¹⁵ The contours of the absolute priority rule were then due for re-examination.

D. *The Second Codification: Absolute Priority and the Code*

By 1973, the Act was due for overhaul.¹¹⁶ Part of the revision effort centered on tempering the effects of the absolute priority rule.¹¹⁷ Strong disagreement among interested groups from business,¹¹⁸ academic,¹¹⁹ and

tors and equity interests. See 11 U.S.C. § 1129(b)(2)(A) (1988); *id.* § 1129(b)(2)(C). The Court, furthermore, fails to provide for any of the uncodified components of the rule. See Klee, *Cram Down II*, *supra* note 11.

Finally, the Court stated that "it is clear that Congress had no intention to expand [the new value] exception" beyond that in place prior to codification. 485 U.S. at 205. This observation overlooks the fact that Congress explicitly and consciously relaxed the conditions under which the absolute priority rule could be waived. Prior to the Code's adoption, a single creditor had the right to invoke the absolute priority rule. After the Code's adoption, however, class vote could override a single creditor's interests, thereby waiving the application of the rule. 11 U.S.C. §§ 1126(c), 1129(a)(8), 1129(b)(1) (1988). This change was far more significant to creditors' rights than any which could be wrought by tinkering with purported exceptions. See text accompanying note 283 *infra*.

114. Pub. L. No. 82-456, § 35, 66 Stat. 420, 433 (1953); see note 152 *infra*.

115. Act of July 24, 1970, Pub. L. No. 91-354, 84 Stat. 468 (1970).

116. The report of the Commission established in 1970 suggested extensive changes. BANKRUPTCY COMMISSION OF THE UNITED STATES, REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. 137, 93d Cong., 1st Sess. (1973) [hereinafter COMMISSION REPORT]. Bills based upon the Commission's suggestions were introduced in 1973. S. 2565, 93d Cong., 1st Sess. (1973); H.R. 10792, 93d Cong., 1st Sess. (1973). Although Congress held preliminary hearings on these bills, it took no further action. With some revisions, the Commission's bill was reintroduced during the next session. S. 235, 93d Cong., 2d Sess. (1975); H.R. 31, 93d Cong., 2d Sess. (1975).

117. The Commission found that "the rigidity of the [absolute priority] rule has frequently resulted in the destruction rather than the protection of interests of public investors. . . . [These investors] are frequently eliminated from participation in a reorganization by reason of the strict application of a statute designed primarily for their protection." COMMISSION REPORT, *supra* note 116, pt. 1, at 256.

According to the Commission's proposal, equity owners could participate "if their future contributions, e.g., continued management, [were] essential to the business." *Id.*, pt. 2, § 7-303(4), at 258. This section was designed to "adopt[] the District Court's opinion which was reversed in *Case*." *Id.*, pt. 2, § 7-303(4), Commission's note at 254. The Commission also suggested allowing delayed participation for equity holders when future increased performance so justified. *Id.*, pt. 2, § 7-303(3), at 241. Finally, it sought to streamline the type and amount of valuation evidence necessary to establish compliance with the absolute priority rule. *Id.*, pt. 2, § 7-310(2)(B), at 252.

118. *The Bankruptcy Reform Act: Hearings on S. 235 and S. 236, Before the Subcomm. on Improvements in Judicial Machinery of the Senate Judiciary Comm.*, 94th Cong., 1st Sess. 459 (1975) [hereinafter *S. 235 and S. 236 Hearings*] (statement of Robert J. Grimmig, on behalf of the American Bankers Association); *id.* at 654-55 (statement of John J. Creedon, on behalf of American Life Insurance Association).

119. *Id.* at 1043-44 (subsequent statement of Vernon Countryman, December 19, 1975) (stating that the Commission proposal discusses the absolute priority concept with "weasel words" on valuation, and urging "the subcommittee to return to the original 'fair and equitable' test without the leeway-providing verbiage"); Victor Brudney, *The Bankruptcy Commission's Proposed "Modifications" of the Absolute Priority Rule*, 48 AM. BANKR. L.J. 305 (1974); Note, *The Proposed Bankruptcy Act: Changes in the Absolute Priority Rule for Corporate Reorganizations*, 87 HARV. L. REV. 1786 (1974).

governmental¹²⁰ quarters, over the need for, and the proper scope of, any reform created an impasse.

This deadlock broke in early 1976 through compromise.¹²¹ The compromise called for two changes to the absolute priority rule. First, it proposed that only *classes* of creditors could invoke the rule. In this respect the compromise sought to overrule the procedural protections afforded by *Case*: under the compromise, an individual creditor who had been outvoted could not challenge a plan on absolute priority grounds.¹²² Second, under the compromise, individual creditors, in lieu of the absolute priority rule, would receive the "best interest of creditors" test. As a consequence, each creditor would receive an amount at least equal to the liquidation value of its claim. From the debtor's perspective, any allocation of the value in excess of liquidation value should be distributed by majority vote. An individual creditor could no longer bargain for every last dollar of going concern value. Once the creditor received its liquidation value, the Code allocated the surplus of going concern value over liquidation value by democratic vote within and among *classes* of creditors.¹²³ With the compromise in hand, the legislative process restarted.

The first bill introduced after the compromise, H.R. 6,¹²⁴ contained a

120. *S. 235 and S. 236 Hearings*, *supra* note 118, at 709-10, 716 (statement of Philip A. Loomis, Jr., Commissioner, Securities and Exchange Commission) ("We oppose the . . . modifications of the absolute priority rule.").

121. The terms of this compromise were set forth in a letter to Congress from the respective heads of the National Bankruptcy Conference and the National Conference of Bankruptcy Judges. Letter from John Copenhaver, President, National Conference of Bankruptcy Judges, & Charles A. Horsky, Chairman, National Bankruptcy Conference, to Congress (June 12, 1976), *reprinted in Bankruptcy Act Revision: Hearings on H.R. 31 and H.R. 32 Before the Subcomm. on Civil and Constitutional Rights of the House Judiciary Comm.*, 94th Cong., 1st & 2d Sess. 1938 (1976) [hereinafter *Hearings on H.R. 31 and H.R. 32*].

122. According to the compromise:

[A] junior class may receive reorganization values even if a superior class receives less than its full priority interest (valued on a going concern basis) so long as the superior class consents and receives its liquidation value, *i.e.*, best interest test. Under these circumstances the absolute priority rule does not apply.

Id. at 1941. This letter, together with the Commission's work, formed the basis for the Code's sections involving the absolute priority rule. SUBCOMMITTEE [sic] ON CIVIL AND CONSTITUTIONAL RIGHTS OF THE COMMITTEE ON THE JUDICIARY, TABLE OF DERIVATION OF H.R. 8200, 95th Cong., 1st & 2d Sess. 23 (Comm. Print 1977).

123. J. Ronald Trost, *Corporate Bankruptcy Reorganizations: For The Benefit of Creditors or Shareholders?*, 21 UCLA L. REV. 540, 550-51 (1973). These changes obviated the need to debate the Commission's proposed relaxation of the rule: "Because of the changes in the confirmation rules, the provisions of the pending bills which 'relax' the absolute priority rule standards, *i.e.*, § 7-303(3) and (4) . . . are no longer necessary." Letter from John Copenhaver, President, National Conference of Bankruptcy Judges, & Charles A. Horsky, Chairman, National Bankruptcy Conference, to Congress, *supra* note 121, at 1941.

124. As initially introduced on January 4, 1977, § 1129(b) of H.R. 6 read as follows:

(b) If all of the requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court, on request of the proponent of such plan, shall confirm such plan notwithstanding such paragraph if such plan is fair and equitable with respect to all classes except any class that has accepted the plan and that is comprised of claims or interests on account of which the holders of such claims or interests will receive or retain under the plan not more than would be so received or retained under a plan that is fair and equitable with respect to all classes.

simple statement of the compromise position: a court would confirm a plan "if such plan [were] fair and equitable with respect to all classes except any class that has accepted the plan."¹²⁵ This bill was amended two and one-half months later to eliminate the simple injunction that the plan be "fair and equitable." In its stead, the amended bill attempted to define fair and equitable treatment, but without using the words "fair and equitable."¹²⁶ Successive bills added to the statement of the rule.¹²⁷ The House Report reflected these changes, but categorized them as a "partial codification" of the absolute priority rule.¹²⁸

After some procedural wrangling with the Senate, the House's version of the bankruptcy bill prevailed.¹²⁹ But it contained a drastically different treatment of nonconsensual reorganizations which implicated the absolute priority rule. Whereas the original House bill contained only one subsection on nonconsensual confirmation that did not use the words "fair and equitable,"¹³⁰ the bill that emerged for final consideration included two subsections on the topic, and explicitly incorporated the phrase "fair and equitable."¹³¹ The first subsection harkened back to H.R. 6 by providing that a court could cramdown a non-consensual plan over the dissent of any class only if the plan were, among other things, "fair and equitable."¹³² Although the bill did not attempt to define this concept explicitly, Congress's prior efforts to define it were not lost. The second subsection on cramdown retained the various treatments developed in earlier bills as *examples* of fair and equitable treatment.¹³³ As the floor remarks made clear, the list of illustrations was not exhaustive; courts were not to exclude other components and interpretations.¹³⁴

H.R. 6, 95th Cong., 1st Sess. § 1129(b) (Jan. 4, 1977).

125. *Id.*

126. H.R. 6, 95th Cong., 1st Sess. § 1129(b) (Mar. 21, 1977). This bill was the first to create different categories of fair and equitable treatment for different types of claims.

127. See H.R. 7330, 95th Cong., 1st Sess. § 1129(b) (May 23, 1977); H.R. 8200, 95th Cong., 1st Sess. § 1129(b) (July 11, 1977); and H.R. 8200, 95th Cong., 1st Sess. § 1129(b) (Sept. 8, 1977).

128. H.R. Rep. No. 595, *supra* note 105, at 414. The report also confirmed the rule's focus on returning only the reorganization value to creditors. It stated that "creditors are entitled to be paid according to the going concern value of the business." *Id.* at 223.

129. The Senate attempted to substitute a bill sponsored by the Securities and Exchange Commission in place of the House bill. See S. 2266, 95th Cong., 2d Sess. (1978). This bill proposed preserving a two-track reorganization system, and required a mandatory trustee for debtors whose equity interests were publicly held. *Id.* § 1130. Under this substitute bill, private companies would be exempt from the fair and equitable rule. *Id.*

130. H.R. 8200, 95th Cong., 1st Sess. § 1129(b) (Sept. 8, 1977).

131. H.R. 8200, 95th Cong., 2d Sess. § 1129(b), *reprinted in* 124 CONG. REC. 32,350 (1978). Due to these changes, the statements on absolute priority contained in H.R. REP. NO. 595, *supra* note 105, are not as authoritative as they might otherwise be. Congress recognized this, and in lieu of a Conference Report, read virtually identical statements into both the House and Senate records on the bill. 124 CONG. REC. at 32,391 (statement of Rep. Rousselot). As noted at the time, Congress believed that this procedure imbued such remarks with "the effect of being a conference report." *Id.*

132. *Id.* at 32,376 (statement of Rep. Rousselot).

133. Technically, the bill stated that the fair and equitable treatment "included" the examples. *Id.*

134. *Id.* at 32,407 (statement of Rep. Edwards); *id.* at 34,006 (1978) (statement of Sen. DeCon-

The scope of these unmentioned yet nonexcluded items was broad. Among the concepts that did not receive explicit statutory expansion, for example, was the fundamental idea that no participant should receive more than its nonbankruptcy entitlement. That other uncodified concepts remained underscores the open texture of the statute.¹³⁵

III. THE EPHEMERAL EXCEPTION: NECESSARY NEW VALUE

A. *The Second Strand: New Value and Owner Participation*

As already indicated, Congress's treatment of absolute priority left courts with many loose ends to untangle.¹³⁶ Some of these lay in the so-called uncodified aspects of the fair and equitable requirement.¹³⁷ But Congress left the courts another, more fundamental uncertainty to resolve: the new value "exception" to the absolute priority rule. A distinct line of cases tracing back to *Case* focuses specifically upon the role of the owner in reorganization, and purportedly states the conditions on which owners can preserve their ownership in the reorganized debtor. Many believe that these cases create an exception to the absolute priority rule.¹³⁸ These cases, however, do not establish any exception; they simply restate the absolute priority rule itself.

Recall first that *Case* could have been decided solely on absolute priority grounds. The value of the debtor's property did not permit continued participation by its shareholders.¹³⁹ Nevertheless, the debtor attempted to show that the absolute priority rule permitted continued shareholder participation. It argued that its shareholders were contributing sufficient value to retain their interests through their "continuity of management" and their "financial standing and influence in the community."¹⁴⁰

This claim came at a critical time in reorganization history. Section 77B

cini) (noting that "many of the factors interpreting 'fair and equitable' . . . , which were explicated in the description of section 1129(b) in the House report, were omitted from the House amendment [T]he deletion is intended to be one of style and not one of substance.").

135. See Klee, *Cram Down II*, *supra* note 11, at 234-37 (suggesting that it is unclear whether senior creditors must receive post-petition interest before junior creditors receive anything); *id.* at 237-38 (suggesting that it is unclear whether senior creditors may be paid in securities inferior in priority or quality to those issued to junior creditors).

136. For example, the proper treatment of smaller debtors such as proprietors and one-person corporations remained unanswered. Debtors who might otherwise have filed for Chapter XI under the Act now had to be concerned with the absolute priority rule. These debtors presented new problems in applying Chapter XI principles to individuals. See H. Gray Burks IV, *Application of the Absolute Priority Rule to Exemptible and Abandonable Property—Is Cramdown Eliminated in Individual Chapter 11's?*, NORTON BANKR. L. ADVIS. 1, 1 (Jan. 1991); Peeples, *supra* note 21. Under the strict rules of Chapter 11 voting, these debtors still had to meet the voting requirements of § 1129(a)(8) if they were to allocate value to themselves. Thus, a hunt for an exception began. See, e.g., *In re Yasparro*, 100 B.R. 91, 99 (Bankr. M.D. Fla. 1989); *In re Witt*, 60 B.R. 556 (Bankr. N.D. Iowa 1986); *In re East*, 57 B.R. 14 (Bankr. M.D. La. 1985).

137. See Klee, *Cram Down II*, *supra* note 11.

138. See note 21 *supra*.

139. See note 97 *supra*.

140. *Case v. Los Angeles Lumber Co.*, 308 U.S. 106, 122 (1939). In addition, the debtor attempted to place a value on the relinquishment of its right to postpone foreclosure for almost ten years. *Id.* at 127. The Court rejected this proffer, stating: "The right to remain in unmolested

had ended its short life of four years, and Congress had already replaced it with Chapters X and XI of the Act.¹⁴¹ These acts were not entirely new legislation; they contained much of the same language as Section 77B, including the fair and equitable requirement.¹⁴² Given the new statute and the perceived evils of Section 77B, however, it is not surprising that the Solicitor General appeared *amicus curiae* on behalf of Case. He argued strongly that the proffered contributions were inadequate under the fair and equitable rule as applicable in equity reorganizations, Section 77B, and Chapter X. He also addressed the general standard for owner participation in reorganizations under *Boyd's* "fixed principle," stating that it was limited to those situations in which "the contribution is either in money or in money's worth [and is] reasonably equivalent to the participation afforded."¹⁴³

Justice Douglas adopted and adapted the Solicitor General's view and language. In writing *Case*, he stated that "[t]he stockholder's participation must be based on a contribution in money or money's worth, reasonably equivalent in view of all the circumstances to the participation of the stockholder."¹⁴⁴

Justice Douglas nonetheless applied only half of this test. He looked first at the proposed contributions of continuity and reputation, which were surely different from the cash assessments common in equity reorganizations. He categorized the claimed contributions as "intangible" and "ephemeral,"¹⁴⁵ and further stated that allowing such "vague hopes or possibilities" to count as contributions would be to permit "easy evasions of the principle of full or absolute priority."¹⁴⁶ Such intangibles had no place on the debtor's balance sheet and thus could not be of any conceivable benefit to

dominion and control over the property was necessarily waived or abandoned on invoking the jurisdiction of the federal courts in these proceedings." *Id.*

141. Chandler Act of 1938, ch. 575, § 1, 52 Stat. 840 (1938). The succession was something of a victory for Justice Douglas. While a member of the Yale Law School faculty, he had written articles condemning certain receivership reorganization practices. Douglas & Frank, *supra* note 48; William O. Douglas, *Protective Committees in Railroad Reorganizations*, 47 HARV. L. REV. 565 (1934). Later, as a member of the Securities and Exchange Commission, he chaired and bore primary responsibility for a Commission study on the effectiveness and fairness of Section 77B. SEC REPORT, *supra* note 19. Chapter X contained most of the Commission's suggested reforms.

142. Chandler Act of 1938, ch. 575, § 221(2), 52 Stat. 840; 11 U.S.C. § 621(2) (repealed 1979).

143. Brief for the United States as Amicus Curiae at 40-41, *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106 (1939) (Nos. 39-23 & 39-24) [hereinafter Brief].

144. 308 U.S. at 122. As noted in *Ayer*, *supra* note 17, at 975 n.57, the Solicitor General's brief relied heavily upon Carl B. Spaeth & Gordon M. Winks, *The Boyd Case and Section 77*, 32 ILL. L. REV. 769 (1938). Justice Douglas also incorporated the necessity requirement suggested in the Solicitor General's brief. The Solicitor General stated that as a condition to continued shareholder participation, the Court had to find that the owners' contribution was essential to the success of the reorganization, and that the "new funds [could not] be obtained unless stockholders are permitted to contribute and retain an interest." Brief, *supra* note 143, at 42. Following this lead, Justice Douglas wrote: "Especially in the latter case [*Kansas City Terminal*] did this Court stress the necessity, at times, of seeking new money 'essential to the success of the undertaking' from the old stockholders. Where that 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." *Case*, 308 U.S. at 121 (footnote omitted).

145. *Case*, 308 U.S. at 122-23.

146. *Id.*

the creditors of the reorganized debtor.¹⁴⁷

Having rejected the substance of the proffered consideration, Justice Douglas never reached the second half of the test—the relation between the quantity of the proposed contribution and the level of continued participation. He thus never directly addressed the scope and meaning of “reasonable equivalen[ce].” Had Section 77B remained in the Act, shareholders may have had the incentive to test the limits of “reasonable equivalen[ce].”

But, as already noted, Section 77B was shortlived. Although Chapter X retained the fair and equitable requirement,¹⁴⁸ it mandated the appointment of a disinterested trustee.¹⁴⁹ This factor at least partially explains the preference, from 1938 to the Code’s adoption in 1978, for filing under Chapter XI rather than under Chapter X. Although Chapter XI purported to affect only unsecured debt,¹⁵⁰ owners perceived that it had at least two key advantages over Chapter X. First, it did not require a trustee to be appointed and thus left insiders in control.¹⁵¹ Second, it was free from the absolute priority rule.¹⁵²

As a result of this filing preference, the number of likely candidates for application of new value principles declined. Because the absolute priority rule did not apply in Chapter XI proceedings, the issue never arose in those cases. In 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.¹⁵³ Rather, the reported cases

147. *Id.*

148. Act § 221(2); 11 U.S.C. § 621(2) (repealed 1979). The Supreme Court stated that the new statute left “unaltered” its construction of fair and equitable. *Case*, 308 U.S. at 119 n.14. It later held that the absolute priority rule had been incorporated wholesale into Chapter X. *Marine Harbor Properties, Inc. v. Manufacturer’s Trust Co.*, 317 U.S. 78, 85 (1942).

149. Act § 156; 11 U.S.C. § 556 (repealed 1979). This was one of the points supported by the Securities and Exchange Commission in its testimony before Congress. *See Revision of the Bankruptcy Act: Hearings on H.R. 6439 and H.R. 8046 Before the Subcomm. on Bankruptcy and Reorganization of the House Comm. on the Judiciary, 75th Cong., 1st Sess. 162-200 (1937)* (testimony of William O. Douglas), reprinted in H. REP. NO. 1409, 75th Cong. 1st Sess. 37-38. No trustee was necessary under Chapter X if the debtor had less than \$250,000 of non-contingent debt. Act § 156, 11 U.S.C. § 556 (repealed 1979).

150. COMMISSION REPORT, *supra* note 116, pt. 1, at 240.

151. *Id.*, pt. 1, at 244.

152. Congress deleted the “fair and equitable” requirement from Chapter XI in 1952. Pub. L. No. 82-456, § 35, 66 Stat. 420, 433 (1952). As the accompanying House Report stated, “the fair and equitable rule, as interpreted in [*Boyd and Case*] cannot be realistically applied in a Chapter XI [action]. . . . Were it so applied, . . . no corporate debtor where the stock ownership is substantially identical with management could effectuate an arrangement except by payment of the claims of all creditors in full.” H.R. REP. NO. 2320, 82d Cong., 2d Sess. 21 (1952); *see also* S. REP. NO. 1395, 82d Cong., 2d Sess. 11-12 (1952). Currently, Chapter 12 and Chapter 13 debt adjustment plans do not need to be “fair and equitable” with respect to dissenting creditors. 11 U.S.C. §§ 1225(b)(1), 1325(b)(1) (1988).

153. Two cases deserve special attention for what they do not hold. *Horowitz v. Kaplan (In re Waltham Watch)*, 193 F.2d 64 (1st Cir. 1951), *cert. denied*, 342 U.S. 946 (1952) is often mentioned as support for allowing interests in a reorganized debtor to be awarded to owners based on the provision of labor. In *Waltham Watch*, however, after the Chapter X case was filed, and although he “received no compensation, and had no stock interest, [Sachs, the manager of the debtor company] devoted practically all of his time in an effort to effect a reorganization and a reopening of the plant.”

during that period focused on whether the reorganization value of the company was sufficient to permit junior interests to participate without further contribution.

But the precedent did not die. It languished, seemingly moribund, until the Code's adoption in 1978. Since then, there has been an explosion of cases which discuss the new value "exception" to the absolute priority rule.¹⁵⁴ Some courts have stated that new value principles apply only when

Id. at 68. In addition, Sachs lent substantial sums to the debtor in order to process inventory and pay down the one creditor blocking reorganization. *Id.* at 69.

The trustee's plan allowed Sachs to buy stock and granted stock options to him. Due to the combined efforts of the manager and the trustee, the value of the stock and the option increased between the time the bargain was struck and the time of the Chapter X confirmation hearing. Sachs's price was \$.25 per share, which was the quoted price as of the filing; by the time of the confirmation hearing, the quoted price reached \$2 per share. *Id.* at 71. The option's strike price was approximately pegged at 95% of market value. *Id.* at 70.

The court approved the plan over the objection of shareholders, who had the opportunity to subscribe for additional shares. It distinguished *Case* on what seemed to be a proper basis: Sachs had no equity interest at all which the plan protected. *Id.* at 74. All that Sachs protected, at best, was his future employment. *Id.* at 75. Moreover, the court stressed, he did not receive the benefit of below market prices for a promise of *future* labor; the reward was for risks taken *during* the pendency of the proceeding. *Id.* at 74-75. In short, at least a portion of the compensation to Sachs satisfied an administrative claim for value given, which would have been senior to general creditors' claims in any event.

A similar case, *In re Polycast Corp.*, 289 F. Supp. 707 (D. Conn. 1968), involved a former president of an acrylic sheet and photographic filters manufacturer who lent equipment to the Chapter X trustee. He and his investor group also agreed, pursuant to the Chapter X trustee's plan, to contribute property worth over \$312,000 in exchange for 81% of the equity interests in the reorganized debtor. The debtor had a reorganization value of \$784,000. *Id.* at 710. The court found that the amount of interest received was "commensurate with and does not exceed the contributions which [the contributors] have made and will make." *Id.* at 712. The court, however, need not have reached this conclusion as it chose not to implicate the absolute priority rule for the same reason that *Waltham Watch* did not. Those who funded the plan of reorganization lacked any equity interest in the corporation. *Id.* at 710-11. Furthermore, finding possible candidates to acquire the debtor, and then sponsoring a plan which incorporated the best proposal, were among the precise functions of a Chapter X trustee.

154. See *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988), *rev'g* 794 F.2d 388 (8th Cir. 1986); *In re Stegall*, 865 F.2d 140 (7th Cir. 1989), *aff'g* 85 B.R. 510 (C.D. Ill. 1987); *In re Blankemeyer*, 861 F.2d 192 (8th Cir. 1988); *Carson Nugget, Inc. v. Green (In re Green)*, 98 B.R. 981, 982 (Bankr. 9th Cir. 1989); *In re Hendrix*, No. 90-635-BKC-3P1, 1991 WL 185112 (M.D. Fla. Sept. 19, 1991); *In re Ashton*, 107 B.R. 670 (Bankr. D.N.D. 1989); *In re Aztec Co.*, 107 B.R. 585 (Bankr. M.D. Tenn. 1989); *In re Club Assocs.*, 107 B.R. 385 (Bankr. N.D. Ga. 1989); *In re Waterways Barge Partnership*, 104 B.R. 776 (Bankr. N.D. Miss. 1989); *In re Sherwood Square Assocs.*, 107 B.R. 872 (Bankr. D. Md. 1989); *In re Johnson*, 101 B.R. 307 (Bankr. M.D. Fla. 1989); *In re Perdido Motel Group, Inc.*, 101 B.R. 289 (Bankr. N.D. Ala. 1989); *Pennbank v. Winters (In re Winters)*, 99 B.R. 658 (Bankr. W.D. Pa. 1989); *In re Kramer*, 96 B.R. 972 (Bankr. D. Neb. 1989); *In re Kendavis Indus. Int'l*, 91 B.R. 742 (Bankr. N.D. Tex. 1988); *In re UVAS Farming Corp.*, 91 B.R. 579 (Bankr. D.N.M. 1988); *In re Maropa Marine Sales Serv. & Storage, Inc.*, 90 B.R. 544 (Bankr. S.D. Fla. 1988); *Travelers Ins. v. Olson (In re Olson)*, 80 B.R. 935 (Bankr. C.D. Ill. 1987); *In re AG Consultants Grain Div., Inc.*, 77 B.R. 665 (Bankr. N.D. Ind. 1987); *In re Bohman*, 77 B.R. 639 (Bankr. S.D. Ohio 1987); *In re Eisenbarth*, 77 B.R. 228 (Bankr. D.N.D. 1987); *In re Roberts Rocky Mountain Equip. Co.*, 76 B.R. 784 (Bankr. D. Mont. 1987); *In re Baugh*, 73 B.R. 414 (Bankr. E.D. Ark. 1987); *In re Star City Rebuilders, Inc.*, 62 B.R. 983 (Bankr. W.D. Va. 1986); *In re Witt*, 60 B.R. 556 (Bankr. N.D. Iowa 1986); *In re Pecht*, 57 B.R. 137 (Bankr. E.D. Va. 1986); *In re East*, 57 B.R. 14 (Bankr. M.D. La. 1985); *In re Pecht*, 53 B.R. 768 (Bankr. E.D. Va. 1985); *In re Jartran, Inc.*, 44 B.R. 331 (Bankr. N.D. Ill. 1984); *In re Modern Glass Specialists, Inc.*, 42 B.R. 139 (Bankr. E.D. Wis. 1984); *In re Knutson*, 40 B.R. 142 (Bankr. W.D. Wis. 1984); *In re Fursman Ranch*, 38 B.R. 907 (Bankr. W.D. Mo. 1984); *In re Barr*, 38 B.R. 323 (Bankr. E.D. Mich. 1984); *In re Toy &*

creditors are paid in full.¹⁵⁵ Others assert that any contribution will suffice if the debtor is insolvent.¹⁵⁶ Still others claim that some link between the contribution and the debt discharged by the plan must exist to trigger the new value rule.¹⁵⁷ In short, interpretive chaos reigns.

The Supreme Court has addressed these critical issues but not in a very helpful manner. In *Norwest Bank Worthington v. Ahlers*,¹⁵⁸ a farmer answered a creditor's relief from stay motion by asserting that he could confirm a new value plan with the promise of future labor. Although he managed to convince the Eighth Circuit Court of Appeals that his plan was permissible, the Supreme Court disagreed.

Facing the issue directly, the Court stated that a debtor's "promise of future labor warrants no exception to [the] operation [of the absolute priority rule]."¹⁵⁹ The Court thus rejected the lower court's conclusion that the debtors' "future contributions of 'labor, experience and expertise' in running the farm—because they have 'value' and are 'measurable'—are 'money or money's worth' within the meaning of *Los Angeles Lumber*."¹⁶⁰

Had the Court stopped at that conclusion, *Ahlers* would be an unexceptional example of the Court correcting errors made by a lower court. But the Court did not stop there; it continued on, questioning whether the new value exception survived the codification of the Code in 1978.

The Solicitor General's *amicus curiae* brief prompted this discussion. The Solicitor General argued that because Section 1129(b) did not explicitly retain *any* exception to the fair and equitable rule, Congress had "dropped the infusion-of-new capital exception to the absolute priority rule."¹⁶¹ The Supreme Court responded:

Sports Warehouse, Inc., 37 B.R. 141 (Bankr. S.D.N.Y. 1984); *In re* Huckabee Auto Co., 33 B.R. 132 (Bankr. M.D. Ga. 1981); *In re* Genesee Cement, Inc., 31 B.R. 442 (Bankr. E.D. Mich. 1983); *In re* Tomlin, 22 B.R. 876 (Bankr. M.D. Ala. 1982); see also notes 163-175 *infra*.

The explosion of cases discussing absolute priority is not hard to explain. Chapter 11 allows insiders to remain in control and gives them advantages not available under the Act to retain that control. See text accompanying notes 280-284 *infra*.

155. *In re* Drimmel, 108 B.R. 284, 289 (Bankr. D. Kan. 1989); *In re* 47th & Belleview Partners, 95 B.R. 117, 120 (Bankr. W.D. Mo. 1988); *In re* Rudy Debruycker Ranch, Inc., 84 B.R. 187, 190 (Bankr. D. Mont. 1988). If followed to its logical conclusion, this position clearly eliminates any "exception."

156. See, e.g., *In re* Jartran, Inc., 44 B.R. at 368 (holding that an owner may retain an interest only if the full going concern value has first been allocated to creditors).

157. See, e.g., *In re* Kendavis Indus. Int'l, Inc., 91 B.R. at 749 (deeming proffered contribution of \$5,000,000 insubstantial in light of \$500,000,000 outstanding debt); *In re* Olson, 80 B.R. at 937 (finding contribution which was only 1.56% of the unsecured debt insubstantial).

158. 485 U.S. 197 (1988). See note 113 *supra* for a criticism of the Court's treatment of the absolute priority rule.

159. *Ahlers*, 485 U.S. at 206.

160. *Id.* at 203. Although beyond the scope of this article, it is surprising that the court did not look to 11 U.S.C. § 547(a)(2), which defines new value for purposes of preference law. It states that "new value" means money or money's worth in goods, services, or new credit." *Id.* (emphasis added). This is consistent with those cases finding, in the absolute priority context, that new value exists for services already rendered, as opposed to services to be rendered. See, e.g., *Horowitz v. Kaplan (In re Waltham Watch)*, 193 F.2d 64 (1st Cir. 1951), *cert. denied*, 342 U.S. 946 (1952).

161. Brief for the United States as *amicus curiae* at 22, *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988) (No. 86-958).

We need not reach this question to resolve the instant dispute. . . . [W]e think it clear that even if the *Los Angeles Lumber* exception to the absolute priority rule has survived enactment of the Bankruptcy Code, this exception does not encompass respondents' promise to contribute their "labor, experience, and expertise" to the reorganized enterprise.

Thus, our decision today should not be taken as any comment on the continuing vitality of the *Los Angeles Lumber* exception—a question which has divided the lower courts since passage of the Code in 1978. Rather, we simply conclude that even if an "infusion-of-'money-or-money's-worth'" exception to the absolute priority rule has survived the enactment of § 1129(b), respondents' proposed contribution to the reorganization plan is inadequate to gain the benefit of this exception.¹⁶²

This dictum caused a furor among lower courts. One court has interpreted this statement as a divine hint, suggesting that "there are no exceptions to the absolute priority rule as codified by the 1978 Code. Thus, the only way the rule is satisfied is by payment in full of the senior class."¹⁶³ Other courts have agreed,¹⁶⁴ while some have declined to find that Congress discarded new value principles.¹⁶⁵ Another group has wallowed in unconvincing attempts to apply and refine the absolute priority rule.¹⁶⁶

162. *Ahlers*, 485 U.S. at 203 n.3 (citation omitted).

163. *In re Rudy Debruycker Ranch, Inc.*, 84 B.R. 187, 190 (Bankr. D. Mont. 1988).

164. *See, e.g., In re Outlook/Century Ltd.*, 127 B.R. 650, 656 (Bankr. N.D. Cal. 1991); *In re Embassy Ent. of St. Cloud*, 125 B.R. 553, 554 (D. Minn. 1991); *In re Lumber Exch. Ltd. Partnership*, 125 B.R. 1000, 1008-09 (Bankr. D. Minn. 1991); *In re Drimmel*, 108 B.R. 284, 288-89 (Bankr. D. Kan. 1989); *In re 47th & Bellevue Partners*, 95 B.R. 117, 120 (Bankr. W.D. Mo. 1988).

165. *See, e.g., Anderson v. Farm Credit Bank (In re Anderson)*, 913 F.2d 530, 532 (8th Cir. 1990); *Piedmont Assocs. v. CIGNA Property & Casualty Ins. Co.*, CIV.A.1: 91-CV1840JOF, 1991 WL 193700 (N.D. Ga. Sept. 3, 1991); *In re Mortgage Inv. Co.*, 111 B.R. 604, 618 & n.23 (Bankr. W.D. Tex. 1990); *In re Pullman Constr. Indus. Inc.*, 107 B.R. 909, 943-48 (Bankr. N.D. Ill. 1989); *In re Greystone III Joint Venture*, 102 B.R. 560, 572-75 (Bankr. W.D. Tex. 1989), *aff'd*, 127 B.R. 138 (W.D. Tex. 1990); *In re Yasparro*, 100 B.R. 91, 96-97 (Bankr. M.D. Fla. 1989).

166. *See, e.g., In re 222 Liberty Assocs.*, 108 B.R. 971, 983 n.12 (Bankr. E.D. Pa. 1990) (interpreting *Case* to be a determination of the substantiality of the proffered contribution); *In re Henke*, 90 B.R. 451 (Bankr. D. Mont. 1988) (allowing an individual to contribute nonexempt property, income from a patent held in the name of the owner, for purposes of new value exception).

A plethora of faithless renditions of the original test partially explains this confusion. A prime example appears in Official Creditors' Comm. *ex rel.* Class 8 Unsecured Creditors v. Potter Material Serv., Inc. (*In re Potter Material Serv., Inc.*), 781 F.2d 99 (7th Cir. 1986). In that case, a shareholder agreed to fund plan payments to unsecured creditors, and discharge their claims for a cash payment equal to 3% of their claims. He also agreed to guarantee bank debt incurred pursuant to the plan and to pay certain administrative claims. *Id.* at 100.

The court implicitly found that the cash offer satisfied the requirement of "money or money's worth" by attempting to assess the sufficiency of this contribution with *Case* standards. According to the court, any contribution "must (1) represent a substantial contribution and (2) equal or exceed the value of the retained interest in the corporation." *Id.* at 100. Although the second part of the test corresponds to *Case's* dictum that the contribution be "reasonably equivalent in view of all the circumstances to the participation of the stockholder," *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106, 121 (1939), the first part of the test—substantiality—does not appear in *Case*.

The *Potter* court cited three cases in support of its "substantiality" requirement: *Case*, *In re Marston Ent., Inc.*, 13 B.R. 514 (Bankr. E.D.N.Y. 1981), and *In re Landau Boat Co.*, 13 B.R. 788 (Bankr. W.D. Mo. 1981). None of these cases support its use. *Case* does not use the word "substantial" in any context relevant here. *Marston*, in turn, used the term when discussing *Case's* requirement of "money or money's worth"; it equated "substantial" with "tangible." *In re Marston*, 13 B.R. at 518. It did not, however, use "substantial" to describe the requirement of reasonable

B. *The Ephemeral Exception*

1. *The equivalence of new value and absolute priority.*

Confusion over the absolute priority rule is deplorable, especially when the rule is fundamental to reorganization. The basic problem is that the use of the term "exception" to describe new value principles is a catachresis. The conditions required to satisfy the new value "exception" also satisfy the absolute priority rule.

Recall the requirements for the new value "exception" as set forth in *Case*: "[W]here the debtor is insolvent, the stockholder's participation must be based on a contribution in money or money's worth, reasonably equivalent in view of all the circumstances to the participation of the stockholder."¹⁶⁷ Many new value cases have turned on the issue of whether the debtor's owners have offered to contribute "money or money's worth."¹⁶⁸ In *Ahlers*, for example, the Court simply reaffirmed that a promise of future labor is not sufficiently tangible (and therefore leviable) to meet this standard.¹⁶⁹ Even after *Ahlers*, however, lower courts continue to assess the quality of proffered contributions: guaranties of postconfirmation debt,¹⁷⁰ payment of certain expenses of the debtor,¹⁷¹ release of liens,¹⁷² outright forgiveness or cancellation of debt,¹⁷³ and a host of other possible contributions¹⁷⁴ have all been reviewed for their acceptability.

The issues in these cases are rather straightforward. For whatever reason, a class of creditors declines to accept the owners' plan, and the owners then seek to confirm over the creditors' objection. The court's inquiry under *Case* is disarmingly simple. First, the court measures the owners' proffered

equivalency. Thus, *Marston* transplanted a descriptive term for the quality of a contribution to the quantity analysis, and other courts blindly followed this error. *Landau Boat* simply adopted *Marston's* formulation. *In re Landau*, 13 B.R. at 792-93.

167. 308 U.S. at 122.

168. See, e.g., *In re Drimmel*, 108 B.R. 284; *In re Lettick Typographic, Inc.*, 103 B.R. 32 (Bankr. D. Conn.); *In re Yasparro*, 100 B.R. at 91; *In re Rudy Debruycker Ranch, Inc.*, 84 B.R. 187; *In re Sawmill Hydraulics, Inc.*, 72 B.R. 454 (Bankr. C.D. Ill. 1987).

169. 485 U.S. at 197.

170. E.g., *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351 (7th Cir. 1990); *In re Potter Material Serv., Inc.*, 781 F.2d 99; *In re Pullman*, 107 B.R. 909; *In re 47th & Bellevue Partners*, 95 B.R. 117 (Bankr. W.D. Mo. 1988) (net cash deficiency guaranty by general partner); *In re Maropa Marine Sales Serv. & Storage, Inc.*, 90 B.R. 544 (Bankr. S.D. Fla. 1988); *In re Sawmill Hydraulics*, 72 B.R. 454.

171. See, e.g., *In re Drimmel*, 108 B.R. 284; *In re Future Energy Corp.*, 83 B.R. 470 (Bankr. S.D. Ohio 1988) (payment of debtor's pre-confirmation attorneys' fees).

172. E.g., *In re Snyder*, 105 B.R. 898, 900-01 (Bankr. C.D. Ill. 1989); *In re Future Energy Corp.*, 83 B.R. 470.

173. E.g., *In re C.P.M. Constr.*, 124 B.R. 335 (Bankr. D.N.M. 1991) (claim for difference between market wages and actual wages); *In re Lettick Typographic, Inc.*, 103 B.R. 32; *In re Future Energy Corp.*, 83 B.R. 470.

174. E.g., *In re Hendrix*, No. 90-635-BKC-3P1, 1991 WL 185112 (M.D. Fla. Sept. 19, 1991) (promise of debtor's wife to provide \$800 a month to fund plan); *In re Snyder*, 105 B.R. at 899 (gift from third party); *In re Henke*, 90 B.R. 451, 456 (Bankr. D. Mont. 1988) (income from patent); *In re Rudy Debruycker Ranch, Inc.*, 84 B.R. at 189 (inheritance); *Brown v. Brown's Indus. Uniforms, Inc.* (*In re Brown's Indus. Uniforms, Inc.*), 58 B.R. 139, 140-41 (Bankr. N.D. Ill. 1985) (pledge of owner's personal assets to secure payment of reorganization debt).

contribution against a quality scale. If the contribution possesses the requisite quality, that is, if it is equivalent to money or money's worth, then *Case* requires a second and more interesting inquiry. Will the "old stockholders . . . receive in return a participation reasonably equivalent to their contribution"?¹⁷⁵ This test appears to require two simple valuations: that of the proffered contribution and that of the interest received. The application of the test then consists of comparing the two to see if they are reasonably equivalent. This comparison, however, also requires the valuation of at least one more item: the debtor itself. This additional valuation is necessary due to the link between the value of the debtor and the value of all ownership interests in the debtor; a 100% equity interest in a debtor is worth no more and no less than the debtor itself. This introduction of the debtor's value, however, leads to the realization that application of *Case's* dicta yields the same result in all cases as does application of the absolute priority rule to the same facts. For all practical purposes, the two are equivalent.¹⁷⁶

This can be seen from a simple example. *Case's* dicta requires that an owner's contribution be reasonably equivalent to the interest retained. In the most common example, this means that if an owner seeks to retain a 100% interest in the debtor, then she must contribute property reasonably equivalent to the debtor's postconfirmation value.

But postconfirmation value is not the price that a third party would pay for a debt-free company. Although this is the starting point,¹⁷⁷ such value must reflect reductions from that debt-free value equal to the amount of obligations incurred or continued in the reorganization plan.¹⁷⁸ For example, if a company which is otherwise worth \$200 incurs \$150 of debt in its plan of reorganization, then its postconfirmation 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 raises the post-confirmation value to \$100.¹⁷⁹ If no further value is given to creditors, the owner will have purchased the debtor for \$50 less than its post-confirmation value. The only way to balance the equation, and achieve reasonable equivalence, is to force the transfer of the \$50 contribution, directly or indirectly, to the creditors.

If creditors receive the extra \$50, then they will have received \$200, or

175. *Case*, 308 U.S. at 121 (1939).

176. Appendix A *infra* sets forth these relationships in more mathematical terms, and provides examples of their application. See text accompanying notes 316-322 *infra*.

177. Consolidated Rock Prods. Co. v. Du Bois, 312 U.S. 510, 525-26 (1941); see also note 318 *infra*.

178. See RICHARD F. BROUDE, REORGANIZATIONS UNDER CHAPTER 11 OF THE CODE, § 13.01, at 13-5 (1991). For relatively sophisticated applications of this principle, see *In re Pullman Constr. Indus. Inc.*, 107 B.R. 909 (Bankr. N.D. Ill. 1989); *In re Jartran, Inc.*, 44 Bankr. 331 (Bankr. N.D. Ill. 1984).

179. This number is derived by adding the original \$200 in reorganization value to the \$50 cash contribution, and then subtracting the \$150 of reorganization debt. The sequence assumes that the owner will contribute only if her plan is confirmed, which, given the uncertainties of confirmation, is probably reflective of actual practice.

the amount of preconfirmation reorganization value. At one level, this is only fair. Postconfirmation value in an insolvent debtor exists only to the extent that creditors' claims are discharged.¹⁸⁰ Cast a different way, creditors participate in a reorganization based upon their antecedent debt, but owners participate only on the basis of new value.

At a more important level, using *Case* to force creditors to receive an amount equal to reorganization value is trivial. The absolute priority rule itself requires that creditors participate in a reorganization in an amount equal to the lesser of their claims or the debtor's reorganization value.¹⁸¹ In an insolvent debtor, this means that creditors of an insolvent debtor are entitled to property equal to reorganization value. But as indicated above, and as shown in Appendix A,¹⁸² *Case*'s new value standard yields the identical result.

The interplay of these relationships means that any contribution of money or money's worth permits owners to retain ownership so long as creditors receive property equal to the debtor's reorganization value. This result obtains, regardless of whether the inquiry starts with the absolute priority rule or *Case*'s *dicta*. In one sense, this is all the creditors could expect. Receipt of an amount equal to reorganization value is the most creditors could expect outside of bankruptcy¹⁸³ or under fraudulent transfer law. Moreover, this value probably represents the maximum amount a third party would pay for the debt-free reorganized company. Regardless of expectations, however, creditors will receive the same amount under the absolute priority rule as under the new value principles.

2. *The consequences of equivalence.*

Recognizing the equivalence between absolute priority and new value principles has critical implications for the relative roles of owners and creditors in business reorganizations. First, owners of an insolvent debtor need not contribute anything to the reorganization if their plan allocates all reorganization value to creditors.¹⁸⁴ This means that once their plan allocates all reorganization value to creditors, owners are not at risk for anything other than their original risk capital. Their obligations as owners end. To require otherwise would violate the nonbankruptcy concept of limited liability,¹⁸⁵ and would deviate from the absolute priority rule's origins in fraudu-

180. Another way to interpret *Case* is that owners can enjoy the value created by the discharge of creditors' claims only to the extent that the owners contribute money or money's worth.

181. See text accompanying notes 112-113 *supra*.

182. See text accompanying notes 316-322 *infra*.

183. In practice, it is probably *more* than creditors would receive. See text accompanying notes 299-302 *infra* (asserting that the assumptions designed to augment reorganization value are designed to discount market distaste for companies in bankruptcy, making ascertaining true reorganization value illusory).

184. This statement assumes that the other confirmation requirements have been met. See text accompanying note 190 *infra*, (discussing adverse repercussions for owners who do not contribute cash after allocating all value to creditors). The statement also assumes that there are no state law theories under which creditors may pierce the corporate veil.

185. There are those who believe that the erosion of limited liability is not necessarily bad,

lent transfer law.¹⁸⁶ As a corollary, owners who do not wish to bid for their debtor may simply walk away, leaving the remains of the debtor to creditors.¹⁸⁷ This result is not as harsh as it sounds. Plans which cancel all equity interests and issue stock to senior creditors are theoretically desirable¹⁸⁸ and comply with the fair and equitable requirement.¹⁸⁹

Equivalence also has harsh consequences for owners. Allocation of all reorganization value to creditors in the form of reorganization debt leaves a truly valueless residual equity interest. In such circumstances if owners retain the equity interest, confirmation of the reorganization plan may be difficult, if not impossible, without some contribution of additional value. The owner, as mentioned above, must show that the postconfirmation debtor will not need "further financial reorganization."¹⁹⁰ Cash contributions may be necessary to make this showing, as well as to supply working capital for the reorganized debtor.¹⁹¹ In short, business needs, not creditor claims, dictate the need for owner contributions.

Equivalence highlights a deeper problem: defining and determining value. If absolute priority is satisfied, creditors will receive all reorganization value, leaving a valueless entity. If an owner nonetheless desires to contribute more, then the owner appears irrational. A rational owner would not invest in a worthless company. But if owners are acting rationally then there must be *some* value they hope to capture by their contribution.¹⁹² If so, *Boyd* requires that this value be allocated to the creditors, not purchased by the owners in a transaction in which the creditors do not participate.

The apparent irrationality arises only if we believe that there is one fixed

especially if it preserves creditors' rights. See Daniel William Fessler, *The Fate of Closely Held Business Associations: The Debatable Wisdom of "Incorporation,"* 13 U.C. DAVIS L. REV. 473 (1980); Henry Hansmann & Reiner Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879 (1991).

186. See text accompanying notes 51-81 *supra* (discussing the role of fraudulent conveyance law in shaping the absolute priority rule). The difference between aggregate creditors' claims and reorganization value is discharged, 11 U.S.C. § 1141 (1988), and creditors may not proceed against the debtor to collect any portion of such deficiency. 11 U.S.C. § 524 (1988).

187. This result can be accomplished in many ways. The owners could, for example, convert the debtor's case from Chapter 11 to Chapter 7, 11 U.S.C. § 1112(a) (1988), or could consent to the appointment of a Chapter 11 trustee, *id.* § 1104(a).

188. See Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527 (1983).

189. See, e.g., *Group of Institutional Investors v. Chicago, M., St.P. & Pac. R.R.*, 318 U.S. 523 (1943).

190. 11 U.S.C. § 1129(a)(11) (1988).

191. See, e.g., *In re Pullman Constr. Indus. Inc.*, 107 B.R. 909, 944-45 (Bankr. N.D. Ill. 1989).

192. See, e.g., *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351 (7th Cir. 1990). In this case, Judge Easterbrook, capturing this tension, reviewed a claim that an owner's guaranty of post-confirmation debt justified continuing the owners' equity interests. The owners contended that the value of the guaranty exceeded the value of the retained equity interest. Judge Easterbrook responded:

There is something unreal about this calculation. If the stock is worth less than the guarantees, why are [the owners] doing it? If the value of the stock is "minimal," why does [the] Bank object to letting [the owners] keep it? Is *everyone* acting inconsistently with self-interest, as the court's findings imply? And why, if the business is likely to fail, making value of the stock "minimal," could the court confirm the plan of reorganization?

Id. at 1359; see also Ayer, *supra* note 17, at 1011-16.

value upon which all parties agree. The setting of value is not so precise. Reorganizations do not have the benefit of a fluid and functioning market.¹⁹³ As a consequence, in valuing the debtor, participants—including courts—rely upon educated guesses.¹⁹⁴ In short, the numerical value placed on a debtor is not unique or determinative; it is simply the most likely number on a probability distribution of possible values.¹⁹⁵

Owners, if they are risk-taking entrepreneurs, may perceive a debtor's value differently than risk averse creditors. Nonoperational reasons, such as tax incidents of ownership¹⁹⁶ or sentimentality,¹⁹⁷ which increase the allure of continued ownership, may also shape owners' perceptions of value. In any of these situations, owners may be willing to risk additional personal capital to preserve their preferences and perceptions and thus rationally buy a debtor at a price which others believe exceeds the debtor's net worth.¹⁹⁸

Owners who have higher private values, and who act upon them, either seek to preserve values irrelevant to creditors, or simply choose a value

193. Several recent proposals attempt to finesse this lack of a market by creating market surrogates, Roe, *supra* note 188, or by pitting creditors against one another in a bidding contest, Lucian Arye Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775 (1988). This article's proposal on competing creditor plans, see text accompanying notes 309-315 *infra*, is intended to be in the spirit of these proposals.

194. Peter Coogan is credited with noting that reorganization value is "a guess compounded by an estimate." Peter F. Coogan, *Confirmation of a Plan Under the Bankruptcy Code*, 32 CASE W. RES. L. REV. 301, 313 n.62 (1982). Coogan was equivocal on whether the characterization was his. *Id.*

195. See Baird & Jackson, *supra* note 2, at 745 & n.21. The Code generally does not assume value to be a fixed amount, but rather the most likely amount. For example, if the value of a claim is uncertain, then the Code permits it to be estimated, 11 U.S.C. § 502(c) (1988), and this may involve taking into account various probabilities. See *Bittner v. Borne Chem. Co.*, 691 F.2d 134 (3d Cir. 1982); see also 11 U.S.C. § 506(a) (1988); SENATE COMM. ON THE JUDICIARY, BANKRUPTCY REFORM ACT OF 1978, S. REP. NO. 989, 95th Cong., 2d Sess. 68 (1978) (stating that, in connection with proposed Section 506, "valuation is to be determined in light of the purpose of the valuation and the proposed disposition or use of the subject property").

196. See, e.g., *In re Aztec Co.*, 107 B.R. 585, 588 (Bankr. M.D. Tenn. 1989) ("Existing joint venturers have unique tax incentives to make the new investment. The \$500,000 new investment is far in excess of the value of the interest that the venturers will retain in the debtor.").

197. E.g., *In re Eisenbarth*, 77 B.R. 228 (Bankr. D.N.D. 1987); *In re Pecht*, 57 B.R. 137 (Bankr. E.D. Va. 1986).

198. Auction theory, described briefly at text accompanying notes 231-246 *infra*, reflects this view. Models derived from auction theory center around two extreme cases: the independent private values model and the common value model. Paul Milgrom, *The Economics of Competitive Bidding: A Selective Survey*, in SOCIAL GOALS AND SOCIAL ORGANIZATION: ESSAYS IN MEMORY OF ELISHA PAZNER 261, 264-66 (Leonid Hurwiz, David Schmeidler & Hugo Sonnenschein eds., 1985) [hereinafter Milgrom, *The Economics of Competitive Bidding*]. Under variants of the independent private value model, values ascribed to an item auctioned differ with the bidders. R. Preston McAfee & John McMillan, *Auctions and Bidding*, 25 J. ECON. LITERATURE 699, 705 (1987). This difference could be due to sentimentality of the owner, or due to the different costs faced by bidders in extracting value from the item bought. *Id.* at 705-06. Under the common value model, the auctioned item has something closer to a single objective price. This characteristic may be due to an active secondary market for the item, or the fact that the item's ultimate value may be uncertain to all until more information is known. Auctions for oil leases in which a market price exists for the oil, but where the amount of oil covered by the lease is unknown, may illustrate this type of model. *Id.* at 705. In practice, valuation behavior at auctions generally tends to fall somewhere in between these extremes, making modeling a highly individual art which varies largely with the preferences and types of expected bidders. Milgrom, *The Economics of Competitive Bidding*, *supra* at 266.

higher than that acceptable to creditors for the creditors' continued participation. In neither situation is it necessarily the case that owners are arrogating to themselves value that could be transferred to creditors if creditors simply extinguished their debt in exchange for all of the equity interests in the debtor.

If owners as a group do have different perceptions of value, they may be willing to bid for the debtor when others will not. This consequence carries with it the possibility of abuse. Owners can bid low and seek to bluff creditors as to reorganization value. If creditors fail to call this bluff, then owners walk away with value that does not rightfully belong to them. Although owners may be able to set the initial reorganization value, their use of that value should be subject to inspection and overbid by creditors or others whose own valuations may be influenced by owners' initial positions.¹⁹⁹ As a result, the procedural protections developed in *Boyd* and *Case* become relevant.

3. Summary.

The combination of the two *Case* requirements—fresh value and reasonable equivalence—merely rephrases the absolute priority rule. As such, *Case*'s new value principles cannot constitute an exception to the absolute priority rule. Justice Douglas knew, or should have known, this. Railroad reorganizations relied heavily upon shareholders retaining interests worth more than their assessments,²⁰⁰ thus transferring value to junior classes at the expense of senior classes. *Boyd*, literally read, barred this result.

If the new value principles were intended as a true suspension of absolute priority, Justice Douglas could have stated that when creditors demonstrate necessity, relative rather than absolute priority governs. But he did not. *Case* purports both to preserve owners' ability to participate and to eliminate owners' ability to receive stock worth more than their contribution. It does this by permitting participation, but only at levels reasonably equivalent to the continued participation. Reasonable equivalency, however, assumes that one can fix one end of the equation: creditors' entitlements. Through an absolute priority rule that fixes creditors' entitlement at reorganization value, the Court made value comparisons of preconfirmation contributions and post-confirmation interests possible. The Court failed, however, to create a separate valuation process for debtors when owners participate. In short, the Court created no exception.

The complexities of the new value issue and its ubiquitous nature have caused some to adopt Alexander's approach to the Gordian knot: slice through history and find that the Code eliminated the new value doctrine.²⁰¹

199. See text accompanying notes 309-315 *infra* (suggesting a solution to the problem).

200. See Swaine, *supra* note 35.

201. See, e.g., *In re Rudy Debruycker Ranch, Inc.*, 84 B.R. 187, 190 (Bankr. D. Mont. 1988) ("[T]he easy answer is that inferred by the *Ahlers* case, namely, there are no exceptions to the absolute priority rule as codified by the 1978 Code. Thus, the only way the rule is satisfied is by payment in full of the senior class."); see also *In re Drimmel*, 108 B.R. 284 (Bankr. D. Kan. 1989); *In re 47th*

If this elimination is done without an appreciation of what is being discarded, or why, this approach is unsatisfactory.

C. *The Canard of Noncodification*

Elimination of the "new value" controversy would be relatively simple if the Code explicitly and completely defined the fair and equitable requirement. Courts could disregard *Case* and all associated precedent. But this avenue of attack ignores the fact that Congress neither intended nor made such a statutory statement. Inquiry along these lines thus diverts attention away from the primary task of setting rules according to which equity owners can participate. More importantly, uncritical dismissal of *Case*'s formulation of the new value principles could wreak interpretive havoc with the absolute priority rule. As shown above, the exception simply reworks the rule itself.²⁰² It would thus be an antinomy to dismiss the logic and text of *Case*'s *dicta* without also dismissing the absolute priority rule.

Finally, interpreting *Case* to require more from owners in bankruptcy than in nonbankruptcy liquidation schemes undercuts both the rule's origins in fraudulent conveyance law and nonbankruptcy concepts of limited liability. If owners in bankruptcy must pay more than required under state law, Chapter 11 loses much of its allure. Such an interpretation of *Case* would discriminate against owners with money to invest, and could deprive creditors of increased dividends. Thus, although somewhat of a deviation, it is appropriate to dismiss the argument that the Code abolished *Case*'s *dicta*.

Several arguments for abandoning the *Case dicta* have been pressed. One common argument for elimination lies in the absence of any "exception" from absolute priority in the text of the Code. Because the Supreme Court is clear that the starting place for analysis of the Code is its text,²⁰³ the argument concludes that this omission is evidence that Congress intended to eliminate the new value principles from reorganizations. One must grant the initial premise of this argument: nothing resembling *Case*'s *dicta* appears in the Code.²⁰⁴ But the Code's structure does not support the major premise that omission is exclusion.²⁰⁵

& Bellevue Partners, 95 B.R. 117 (Bankr. W.D. Mo. 1988). The Solicitor General suggested this approach in *Ahlers*. Brief for the United States as Amicus Curiae at 22, *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988) (No. 86-958).

202. See text accompanying notes 316-322 *infra*.

203. *United States v. Ron Pair Enterprises*, 489 U.S. 235, 241-42 (1989). *But cf. Grogan v. Garner*, 111 S. Ct. 654 (1991) (using prior law and inferred legislative intent to determine the appropriate quantum of evidence in dischargeability proceedings).

204. But then, nothing similar to *Case*'s *dicta* appeared in § 77B either, and Justice Douglas did not seem bothered by the lacuna.

205. The Court also seems to have retreated somewhat from *Ron Pair*'s strict view. In *Grogan*, the Court embraced the notion that a determination of plain meaning necessarily requires looking to the text of the statute and "to the design of the statute and to its object and policy." 111 S. Ct. at 659 n.13 (quoting *Crandon v. United States*, 494 U.S. 152 (1990)). See also *Johnson v. Home State Bank*, 111 S. Ct. 2150 (1991) (using context and legislative history to supply meaning to "claim"); *Toibb v. Radloff*, 111 S. Ct. 2197 (1991) (using the same method to determine the eligibility of an individual to file under Chapter 11). Moreover, neither *Grogan*, *Johnson*, nor *Toibb* cite *Ron Pair*.

As shown above, early drafts of the Code attempted to define "fair and equitable."²⁰⁶ Congress eventually discarded this approach and adopted the historical language as the standard.²⁰⁷ This standard, however, is then illuminated by nonexclusive examples of compliance with the fair and equitable rule contained in a different subsection.²⁰⁸ Thus, although it is true that no mention of an exception is found in the Code, it is also true that no inference can be made from that exclusion.

Similarly, some may argue that Congress's rejection of the Commission's proposal to relax the rule also rejected the new value exception. This argument sweeps too broadly. The Commission's proposals assumed the existence of an exception. The proposed changes were no more than rather moderate tinkering with the list of qualifying contributions and the evidentiary standard necessary to establish value.²⁰⁹ As a consequence, one cannot infer that rejection of the Commission proposal constituted wholesale disapproval of the new value rule. Rather, it only rejected the Commission's proposed relaxation of the rule's requirements.

IV. OWNER PARTICIPATION UNDER THE CODE

A. *The Owner Participation Debate*

If a new value "exception" did not and does not exist, then the natural follow-up question is what accommodation, if any, should exist for owners of a Chapter 11 business? Initially, one might look for guidance to the stated reason for an exception—owners are the bank of last resort to fund working capital needs.²¹⁰ Other justifications may also exist. As mentioned above, owners may have non-operating incentives, such as minimizing tax incidents of their ownership to preserve their equity positions.²¹¹ In addition, owners may know more about the debtor than third parties. As a result of this information, owners may invest more confidently in the business.²¹² Finally, owners as a group may be more entrepreneurial. They may take risks more than on average. Given that business valuations are at best an average of a

206. See note 124 *supra*.

207. See 11 U.S.C. § 1129 (b)(1) (1988).

208. See *id.* § 1129(b)(2) (listing examples of compliance with the fair and equitable rule and stating that "the condition that the plan be fair and equitable with respect to a class *includes* [those requirements]"). Section 102(3) reminds us that within the Code, the term "includes" is not limiting. *Id.* § 102(3).

209. As previously set forth, the compromise between the National Conference of Bankruptcy Judges and the National Bankruptcy Conference rejected this expansion. See text accompanying notes 121-123 *supra*. The two groups rejected the proposals because class waiver accomplished more for debtors than delayed participation ever could.

210. *Kansas City Terminal Ry. v. Central Union Trust Co.*, 271 U.S. 445, 455 (1926); see also SEC REPORT, *supra* note 19, pt. 8, at 55 (1940). This may still be the case. See, e.g., *In re Mortgage Inv. Co.*, 111 B.R. 604, 619 (Bankr. W.D. Tex. 1990); *In re Greystone III Joint Venture*, 102 B.R. 560, 574 (Bankr. W.D. Tex. 1989).

211. See, e.g., *In re Aztec Co.*, 107 B.R. 585, 588 (Bankr. M.D. Tenn. 1989) ("No sane outside investor would put new money in this project . . . Existing joint venturers have unique tax incentives to make this new investment."); see also text accompanying notes 196-197 *supra*.

212. See Baird & Jackson, *supra* note 2, at 745-46.

range of estimates, risk-taking owners may be more likely to believe that the upper ranges of possible estimates are more accurate than the lower or middle ranges.

Although each of these observations may have some independent validity, none address the absolute priority rule's core concern of ensuring payment to creditors of all reorganization value before any distributions to owners occur.²¹³ If an exception to this rule should be made, then there ought to be at least some showing that the exception's expected benefits to someone other than owners exceeds its harms to creditors. That no such analytical showing has yet been made is due to an irreducible fact: owners' contributions to debtors, without more, do not benefit creditors at all.

Plans which propose to cash out existing creditors for a small percentage of their allowed claims demonstrate this point. Creditors in such cases receive nothing more than cash equal to a portion of their claim;²¹⁴ they are denied the option to participate in the reorganized debtor. As a result, the benefits that accrue to continued ownership are held solely by owners.

Creditors also fail to receive any benefit under plans that issue long term debt in exchange for a discharge, or under plans that allocate less than all of the new debtor's equity interests to creditors. In these cases, it is arguable that the contribution strengthens the reorganized entity, and in turn, makes a successful reorganization more likely.²¹⁵ Reorganized debtors, however, ought not to be hobbled with debt. Contributions that merely facilitate servicing postconfirmation reorganization debt should instead be used to satisfy prepetition debt. Otherwise, owners abuse the reorganization process by leveraging their new investment and reducing, through application of limited liability principles, their postconfirmation risk.²¹⁶

213. This concern obviously recedes to nothing if creditors are paid in full or are otherwise unimpaired. *See, e.g.*, 11 U.S.C. § 1124(1) (1988). The Code conclusively presumes acceptance of a plan by any such unimpaired class. *Id.* § 1126(f). The fair and equitable requirement, in turn, only applies to dissenting classes, *id.* § 1129(b)(1), which unimpaired classes can never be.

214. The remainder of the claims will be rendered unenforceable by the discharge granted upon confirmation. *Id.* § 1141 (providing for treatment of any claim only as specified in Chapter 11 plan, and for discharge of claims to the extent that there is no provision for them).

The tactic discussed in the text is often employed by owners. *See, e.g.*, *Official Creditors' Comm. ex rel. Class 8 Unsecured Creditors v. Potter Material Serv., Inc.*, (*In re Potter Material Serv., Inc.*), 781 F.2d 99 (7th Cir. 1986); *In re Ashton*, 107 B.R. 670, 674 (Bankr. D.N.D. 1989); *In re Snyder*, 105 B.R. 898, 902-03 (Bankr. C.D. Ill. 1989); *In re Eaton Hose and Fitting Co.*, 73 B.R. 139 (Bankr. S.D. Ohio 1987).

215. *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1359 (7th Cir. 1990) (rejecting proposed contribution of a guaranty by a shareholder); *In re 222 Liberty Assocs.*, 108 B.R. 971, 984-85 (Bankr. E.D. Pa. 1990); *In re Pullman Constr. Indust. Inc.*, 107 B.R. 909, 944-45 (Bankr. N.D. Ill. 1989).

216. Such an argument makes the required showing of feasibility, 11 U.S.C. § 1129(a)(7) (1988), a nullity. *See In re Drimmel*, 108 B.R. 284, 290 (Bankr. D. Kan. 1989), in which the court recognized that:

What is actually sought by the debtor under their plans and the *Los Angeles Lumber* exception is the right to buy the business without following § 363 or § 1123(a)(5)(D) and § 1129(a)(11), while using § 1129(b)(2)(A) cram down to force secured creditors to provide 100% loan-to-value financing for their collateral and ignoring the right to full payment granted unsecured creditors under § 1129(b)(2)(B)(i).

Id.; *see also In re Snyder*, 105 B.R. 898 (treating issues separately).

Moreover, although creditors receiving less than all of the equity interests under a plan benefit from an owner's contribution, that benefit is attenuated. Any exception to absolute priority translates into less than full payment of reorganization value to creditors. If existing equity interests retain or pay for an interest, then the remaining reorganization value goes to the owners. The result is exactly what *Case* and its predecessors decried: the arrogation by owners to themselves of value properly belonging to creditors.

In short, any nexus between traditional justifications for owner contributions and any benefit to creditors from the continuation of the business is too attenuated to justify an exception. Each of the arguments above boils down to owners' attempts to capture for themselves the difference between reorganization value and the amount of plan payments to creditors.²¹⁷ The lack of an undiminished link between the contribution made and the benefit conferred dooms any attempt to base an exception in any system retaining absolute priority as axiomatic. It also creates an opportunity for adroit owners of Chapter 11 debtors to siphon value from creditors to themselves or to their business.

Furthermore, even if the "exception" is viewed benignly as a safe harbor, presumptively avoiding the appearance of the type of collusion *Boyd* condemned, it is no longer necessary. First, unsecured creditors can no longer be dealt with outside of the reorganization. The Code requires the debtor to classify, and specify the treatment of, all creditors in the plan.²¹⁸ Moreover, any confirmed plan binds all creditors with notice of the plan.²¹⁹ In contrast to the perceived need in equity receiverships, there is no legal reason to be concerned with the construction of a substantively fair offer. Statutes, furthermore, have replaced the concepts of waiver by inaction and estoppel as the basis of debt discharge. Under these statutes, creditors' votes to accept a plan, not judicial opinion as to the plan's fairness, control. Second, the Code's relaxation of the absolute priority rule to allow class waiver²²⁰ has decreased the need to create an exception to protect owners from a single, irrational creditor. With class waiver, the task is much more daunting, and presumably requires categorizing the choice of an entire class of creditors as irrational.²²¹

What role, then, for the owner? Although traditional justifications do

217. This practice is similar to the equity reorganization tactic of assessing old shareholders a price less than the worth of the new stock issued (or retained) by them. In both cases owners receive (or retain) ownership interests of a value higher than that contributed. Moreover, the aggregate amount of value in each instance is the differential noted above.

218. 11 U.S.C. § 1123(a)(1)-(3) (1988).

219. *Id.* § 1141.

220. Balloting in Chapter 11 is by classes of claims as specified in the proposed plan of reorganization. *See id.* § 1126(c). The non-consensual confirmation provisions are invoked only when the plan proponent fails to secure the affirmative vote of all impaired classes of claims. *Id.* § 1129(b)(1).

221. This argument is not valid for secured creditors, who typically comprise their own class. *See R. BROUDE supra* note 178, § 9.02[1]. In such cases, however, § 1126(e) assists the plan proponent by allowing the disqualification of those votes cast in bad faith or for an improper purpose. *Id.* § 1126(e).

not support an exception to absolute priority, it does not follow that courts should exclude owners completely. After all, basic compliance with *Case* is compliance with the absolute priority rule. But ill will against owners persists. The remainder of this section analyzes arguments that can be made in favor of owner participation.

1. *The first argument: nondiscrimination.*

The first argument for owner participation is simple. Creditors should not care about the source of their creditor dividends. A court may confirm a plan in which a third party acquires the debtor, either through a sale of all assets, through a corporate merger, or through other means of consolidation.²²² Creditor treatment will not vary if an owner promulgates the same plan.²²³ In short, owners' money should be no different than funds provided by a third party investor.

So phrased, the concern over owner participation appears trivial. Why should anyone reject the same amount of money simply because it comes from an owner instead of a stranger? The real problem, however, is that the identity of the contributors may affect how creditors perceive the desirability of the reorganization plan. Owners have the motive and opportunity to manipulate the bankruptcy process through, for example, unprincipled use of plan exclusivity. This potential for manipulation may provide a basis for creditors' perceptions that third party valuations are more trustworthy than owner valuations.²²⁴

This concern over potential abuse also implicitly assumes that owner participation is undesirable to the point of its exclusion. But other vehicles for preventing owner manipulation exist. If owners, for example, undercapitalize the prepetition debtor or act inequitably to the detriment of creditors, then creditors may subordinate payment of owners' claims to the full payment of creditors' claims.²²⁵ Furthermore, if owners' inept or dishonest management caused the debtor's financial problems, certain confirmation requirements may bar further owner participation. First, the plan proponent must appoint management for the reorganized debtor whose service does not violate the public interest.²²⁶ Second, if an owner's demonstrable lack of

222. *Id.* § 1123(a)(5)(B) (plan may call for transfer of debtor's assets to another entity, even if formed specifically for that purpose); *id.* § 1123(a)(5)(C) (plan may call for merger or consolidation of debtor with another entity); *id.* § 1123(a)(5)(D) (plan may call for sale of all of debtor's assets). The acquiring entity cannot, however, be a mere sham. See *In re Perdido Motel Group, Inc.*, 101 B.R. 289, 292 (Bankr. N.D. Ala. 1989) (denying confirmation of plan in which acquiring entity was new corporation, capitalized at \$1000, and controlled by insiders).

223. This statement assumes that both the third party plan and the owners' similar plan satisfy the absolute priority rule. This assumption seems reasonable; to eliminate equity, a third party would have to show that such class of interests has no value, and that the price paid is equivalent to the interest retained. Substitution of an owner for the third party does not change this analysis.

224. This concern traces back to *Boyd* and its rejection of hypothetical valuations in favor of the valuations upon which owners and creditors actually rely. *Northern Pacific Ry. v. Boyd*, 228 U.S. 482, 506-08 (1913).

225. 11 U.S.C. § 510(c) (1988).

226. *Id.* § 1129(a)(5).

skill in financial matters caused the debtor's downfall, it would be difficult for the debtor to show that a plan according to which the same owner retains control will not require "further financial reorganization."²²⁷ If the absolute priority rule were expanded to prohibit all participation by owners, then these rules would be meaningless.

While there is no doubt that owner participation can be undesirable, analysis of the role of the owner in the reorganization process reveals distinct benefits from owner participation.

2. *The second argument: insights from auction theory.*

Any plan sponsored by an owner signals at least two facts. First, it signals that the owners believe the reorganized debtor has positive value. Second, the plan's terms, especially the consideration offered, convey some impression of the owners' belief of the amount of that value. This information, although minimal, can be important.

Insights from auction theory can help creditors and potential investors to quantify the owners' perceived value of the debtor, and can facilitate the transfer of that value to the debtors' creditors. Auctions and reorganizations possess key structural similarities. At stake in any business reorganization is the control of the postconfirmation debtor. The process of obtaining that control, however, is unlike that which occurs in a typical business acquisition. In nonbankruptcy contexts, parties bargain over the price of control and then execute binding contracts to memorialize the deal they reach.²²⁸ The affirmative approval of the substantive terms of the transaction by a government agency or court is rarely required.

In bankruptcy, as stated above, the process differs. Plan proponents attempt to win support of creditors and other participants through their plan's allocation of plan consideration.²²⁹ With some limitations on who may submit an initial plan,²³⁰ the court may hear and consider competing bids at any time prior to confirmation. The bids may be considered in their own right, or as objections to a proposed plan.²³¹ In the end, the bankruptcy court will confirm only one plan, although the confirmed plan will not be identified until the confirmation hearings, which occur at the end of the process.²³² In short, no deal is final until confirmation. It is always subject to overbid.

227. *Id.* § 1129(a)(11).

228. There are limits to this freedom of contract, especially in the case of public companies. See Erica M. Ryland, Note, *Bracing for the "Failure Boom": Should a Revlon Auction Duty Arise in Chapter 11?*, 90 COLUM. L. REV. 2255, 2256-58 (1990).

229. Reorganizations in which the debtor's assets are sold in bulk illustrate this proposition. 11 U.S.C. § 1123(a)(5)(D) (1988).

230. This statement is subject to the effects of debtor's exclusivity. *Id.* § 1121(b); see notes 289-293 *infra* (discussing the effects of debtor's exclusivity).

231. Some courts have allowed creditors and equity interests to review competing plans. See *In re UVAS Farming Corp.*, 91 B.R. 579 (Bankr. D.N.M. 1988) (allowing two competing shareholder factions to promulgate competing plans); *In re Evans Prod. Co.*, 65 B.R. 31 (Bankr. S.D. Fla. 1986) (allowing three competing plans to be voted on by creditors).

232. 11 U.S.C. § 1129(c).

Auctions share this feature. Each bidder in an English increasing-bid auction²³³ wrests the bid from the last bidder by its own bid. Nothing is final until the hammer drops. In other words, both auctions and reorganizations share a feature not present in normal contracting: once the bidding is initiated, the seller typically cannot stop the process and bind itself to any one bidder. An auctioneer keeps the auction going until the bidding stops at the highest price; similarly, a plan of reorganization is subject to competing plans that offer different or higher consideration.

Admittedly, there are differences. The auction for control of a reorganized debtor generally operates within a longer time frame. Auctions typically are conducted in one sitting; reorganizations can take months or years.²³⁴ This extended time frame highlights another difference. Auctions are usually perceived as cash and carry.²³⁵ Reorganizations, in contrast, may yield cash substitutes such as reorganization debt or equity securities; there may be terms other than price that become relevant.²³⁶ Finally, the extended time frame and the flexibility of the form of consideration require discounting the various offers to present value, a process generally absent in auctions.²³⁷

But these differences are relatively minor. Differences in time and in the quality of securities ultimately condense into questions of value. As a consequence, the strategies adopted by bidders at auctions are likely to be similar to the strategies adopted by plan proponents in a contested reorganization.

If the analogy between auctions and reorganizations is valid, auction theory can provide a highly evolved attempt to model the underlying economic

233. Auctions exist in many forms. 1 THE NEW PALGRAVE: A DICTIONARY OF ECONOMICS, Auctions 138-44 (John Eatwell, Muray Milgate & Peter Newman, eds. 1987). The most common is the English increasing-bid auction. *Id.* at 138. In this type of auction, an auctioneer solicits increasing oral bids with the final bid obtaining the item auctioned. In a Dutch auction the seller starts with a high price and lowers it by increments until a bidder accepts. *Id.* In a first price auction, bidders dispense with the oral outcry. Instead, they engage in one round of bidding which consists of the submission of sealed written bids. The highest bid wins. *Id.* at 138-39. The United States Treasury auctions securities in this manner. *Id.* at 139. Finally, in second price auctions, sealed bids are submitted, and the *second* highest bid wins. *Id.* at 138. The United States Treasury has experimented with variants of second price bids, and Citicorp and Exxon have each issued securities using this method. *Id.*; see also RALPH CASSADY, JR., AUCTIONS AND AUCTIONEERING 56-81 (1967); BRIAN LEARMOUNT, A HISTORY OF THE AUCTION 127-37 (1985). Much of auction theory attempts to select the form of auction that is optimal from the seller's perspective. See note 238 *infra*.

234. Many auctions, however, give prospective bidders advance notice of the sale and allow them to view the items auctioned. See R. CASSADY, JR., *supra* note 233, at 143-44. This time lag and opportunity to inspect can provide information to bidders to help them formulate their own assessment of the auctioned item's worth and, derivatively, their bidding strategy.

235. *Id.* at 135.

236. For example, a creditor may select a creditor-sponsored plan over an owner-sponsored plan for which the consideration is nominally higher, because the creditor discounts the owner's plan consideration due to the owner's participation.

237. To carry the auction analogy further, the winning bid in an English auction is typically the highest offer. The prevailing plan in reorganizations is the plan that receives confirmation. All other things being equal and creditors being revenue maximizers, the plan which offers the most to creditors will be accepted. Creditor preference, in turn, should be determinative when more than one plan meets Chapter 11's confirmation standards. See 11 U.S.C. § 1129(c) (1988).

assumptions found in the reorganization setting.²³⁸ These models can be applied to the reorganization context to derive optimal strategies for construction of an auction system.²³⁹ Auction theory, for example, can assist the bankruptcy reorganization process by providing bases from which to select the optimal form of the auction.²⁴⁰ It can also identify aspects and factors of different forms of auctions that will tend to maximize the revenue received.²⁴¹

In particular, auction theory suggests that owner participation can increase the final bid price, and thus the return to creditors, in at least two ways.²⁴² First, recent studies indicate that an increase in the number of bidders tends to increase the final bid price.²⁴³ If owners may bid, this increases the pool of potential bidders. In theory, the increased competition for the reorganized debtor will lead to a higher acquisition price. Anecdotal evidence in bankruptcy tends to confirm this theory. More bidders mean

238. See, e.g., 1 THE NEW PALGRAVE: A DICTIONARY OF ECONOMICS, *Auctions*, *supra* note 233, at 138-44.

A wealth of theoretical work exists with respect to auctions. See, e.g., McAfee & McMillan, *supra* note 198; Paul Milgrom, *Auction Theory*, in *ADVANCES IN ECONOMIC THEORY: FIFTH WORLD CONGRESS I* (Truman F. Bewley ed., 1987) [hereinafter Milgrom, *Auction Theory*]; Milgrom, *The Economics of Competitive Bidding*, *supra* note 198, at 261; Paul R. Milgrom & Robert J. Weber, *A Theory of Auctions and Competitive Bidding*, 50 *ECONOMETRICA* 1089 (1982); William E. Vickery, *Counterspeculation, Auctions and Competitive Sealed Tenders*, 16 *J. FIN.* 8 (1961); see also Steven B. Katz, Note, *Designing and Executing a "Fair" Revlon Auction*, 17 *FORDHAM URB. L.J.* 163 (1989) (applying auction theory to the design of auctions of corporate assets mandated by *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986)).

This abundance of literature is not surprising. Auctions have a respectable and aged pedigree. See R. CASSADY, JR., *supra* note 233, at 28-29. Indeed, the first case in the first casebook dealt with an auction: CHRISTOPHER COLUMBUS LANGDELL, *A SELECTION OF CASES ON THE LAW OF CONTRACTS* 1 (1871).

239. Auction theory can be viewed as a form of applied game theory. For an excellent introduction of the application of game theory to legal studies, see Ian Ayers, *Playing Games with the Law*, 42 *STAN. L. REV.* 1291 (1990) (book review). Professor Ayers reviews ERIC RASMUSSEN, *GAMES AND INFORMATION: AN INTRODUCTION TO GAME THEORY* (Basil Blackwell ed., 1989), which is an excellent and accessible introduction to game theory generally. For an application of game theory to bankruptcy that differs from the approach taken in this article, see Douglas G. Baird & Randal C. Picker, *A Simple Noncooperative Bargaining Model of Corporate Reorganizations*, 21 *J. LEGAL STUD.* 311 (1991).

240. See note 238 *supra*; see also Milton Harris & Artur Raviv, *Allocation Mechanisms and the Design of Auctions*, 49 *ECONOMETRICA* 1477 (1981); Eric Maskin & John Riley, *Optimal Auctions with Risk Averse Buyers*, 52 *ECONOMETRICA* 1473 (1984).

241. See, e.g., McAfee & McMillan, *supra* note 198, at 711-14; Milgrom, *Auction Theory*, *supra* note 238, at 16-26.

242. Any rigorous adaptation of auction theory to Chapter 11 reorganizations would incorporate the already noted differences between the two, and would probably take into account the effect of other differences. This article, however, does not attempt such a goal. Rather, given the fluid setting of most bankruptcies, it uses the strong analytic similarity between auctions and reorganization confirmation to attempt to provide broad justifications for owner participation in business reorganizations. In this regard, it does not attempt to construct specific strategies applicable to participants in reorganizations. For an attempt to transfer auction principles on a more detailed scale to changes of control in public companies, see Katz, *supra* note 238.

243. See, e.g., Lance Brannman, J. Douglas Klein & Leonard W. Weiss, *Concentration and Winning Bids in Auctions*, 29 *ANTITRUST BULL.* 27, 30-31 (1984); Charles A. Holt, Jr., *Uncertainty and the Bidding for Incentive Contracts*, 69 *AM. ECON. REV.* 697 (1979); McAfee & McMillan, *supra* note 198, at 710-11.

higher dividends.²⁴⁴

Second, owner bidding provides relevant information to other potential bidders. It signals a price which knowledgeable insiders are willing to pay, or at least a price at which they wish to start the bidding. Auction theory anticipates that providing maximum information, including any other bidder's valuation, increases seller's revenue.²⁴⁵ Indeed, one of the leading scholars in this field, Paul Milgrom, has called the link between the reduction of private information held by bidders and the increase of seller's revenues the "common thread" running through auction theory.²⁴⁶

The logic behind Professor Milgrom's insight is simple. The existence and availability of information from owners or any other source reduces bidders' uncertainty and assists bidders in ascribing a value to the item auctioned.²⁴⁷ It also reduces or eliminates the value of each bidder's private or exclusive information about the debtor. As more information is disclosed and the amount of private information is reduced, the ability of each bidder

244. *In re Lionel*, 722 F.2d 1063 (2d Cir. 1983), provides an interesting example of this effect. There, the debtor's management agreed to sell the debtor's 82% stake in a valuable subsidiary for \$43 million. After a hearing contesting the sale, at which three other bidders appeared and attempted to bid, a new contract of sale was entered into for \$50 million. Equity holders thought the stock was worth more and appealed. The Second Circuit Court of Appeals held that the circumstances did not warrant the expedited sale, and reversed. On remand, a new bidding procedure was used, the \$50 million bidder having dropped out, which yielded a final sale price of \$76,865,000. Matt Perry, *Joint Venture Beats DCA for Lionel's 82% Dale Stake*, 31 ELECTRONIC NEWS 43 (1985).

The battle for acquisition of Financial News Network ("FNN") provides a more recent example of the power of auctions to increase bids. There, a joint venture between Dow Jones & Co. and Group W Satellite Communications agreed to pay \$90 million for FNN's assets, the purchase to be made from FNN's Chapter 11 bankruptcy estate. Kevin Goldman, *Dow Jones-Westinghouse Group, NBC Sweeten Their Bids at Auction for FNN*, WALL ST. J., May 8, 1991, at B6. After FNN's filing, a unit of the National Broadcasting Company appeared, and ultimately bid \$115 million for FNN. When the joint venture responded by bidding \$115 million as well, the bankruptcy court ordered an auction. The results were dramatic: the joint venture increased its bid to \$167.1 million, of which \$125 million was to be paid in cash, and NBC bid \$146 million, of which \$140 million was to be paid cash. *Id.* Since FNN owed its creditors \$145.4 million, the auction boosted their return from a 62% dividend to payment in full.

A final example is the Chapter 11 bankruptcy of DeLaurentiis Entertainment Group, Inc. There, a third party, Carolco Pictures, Inc., initially agreed to acquire the debtor for \$18.5 million. See Kathleen A. Hughes, *Carolco Pictures Expects to Acquire De Laurentiis [sic] Firm*, WALL ST. J., March 6, 1989, at B5. The debtor's owners mounted a competing bid, with the final price rising to \$39 million. Debtors' Joint disclosure Statement Pursuant to Section 1125 of the Bankruptcy Code for the Debtors' Modified Second Amended Joint Plan of Reorganization (Mar. 1, 1990) at 14-16, *In re DeLaurentiis Entertainment Group Inc.*, Case No. LA-88-17251-AA (Bankr. C.D. Cal. 1990).

245. Milgrom, *Auction Theory*, *supra* note 238, at 4-5; Milgrom, *The Economics of Competitive Bidding*, *supra* note 198, at 278-80; Milgrom & Weber, *supra* note 238, at 1112.

246. Milgrom, *Auction Theory*, *supra* note 238, at 20 n.24; Milgrom & Weber, *supra* note 238, at 1110-11. Milgrom's formulation focuses on the reduction of profits of bidders through the use of private information. "The intuition . . . is that the auctions yielding the highest average prices are those that are most effective at undermining the privacy of the winning bidder's information, thereby transferring [sic] some profits from the bidders to the seller." *Id.* at 4; see also Christopher D. Hall, *A Dutch Auction Information Exchange*, 32 J. L. & ECON. 195 (1989) (exploring information transmitting function of Dutch auction rules and practices); Kenneth Hendricks & Robert H. Porter, *An Empirical Study of an Auction with Asymmetric Information*, 78 AM. ECON. REV. 865 (1988) (exploring informational advantages inherent in oil leasing auctions when bidder owns leasing tracts close to tracts being auctioned).

247. Each bid discloses that one player believes that the item auctioned has that value. This

to extract a profit based upon secret or exclusive information diminishes. Other bidders will incorporate the information into their bids and increase them accordingly. This reduces the profit the bidder possessing exclusive information can extract based upon that information.

Practice in acquisitions reflects this insight. Rare is the nonbankruptcy acquisition that proceeds without "due diligence." In bankruptcy, the Bankruptcy Rules anticipate similar concerns and explicitly allow parties to compel any entity to provide information in connection with the confirmation of a plan.²⁴⁸

3. Summary.

The lack of a necessary connection between owners' contributions and creditors' benefits dooms any exception to the absolute priority rule, at least from the perspective of the direct participants.²⁴⁹ But this conclusion does not lead to outright rejection of owner participation. Owner bids can increase creditor dividends in at least two ways. First, they may increase competition with other bids. Second, they may make more and potentially higher quality information available to all bidders. As long as the rules for owner participation are fair to others, and the absolute priority rule is met, the Code should not be construed to prevent owners from bidding for their companies.

Two impediments, however, interfere with this argument. First, owners are handicapped by *Case's* necessity requirement. Under some views of this *dicta*, owners must show that their contributions are the only possible sources of new and required capital.²⁵⁰ Second, creditors and third-party investors are impeded by many of the Code's innovations which unfairly skew the reorganization process in owners' favor. Owners, for example, initially have the power to exclude competing plans. Even if they lose this power, they may manipulate confirmation and valuation rules to force competitors into settlements not warranted by their relative position. Presented below is a proposal that addresses these concerns.

fact both confirms other bidders' notions of similar value and may provide a base upon which to further increase the price.

Owners are in a unique position to convey this type of information through a bid price. They have a greater ease of access to relevant business information and have a greater experience with the debtor's business and operating procedures. Their bid can be said to quantify this collection of information.

248. BANKR. RULE 2004(b) (1991) (court may order the examination of any party, and the examination may "relate to the operation of any business and the desirability of its continuance, . . . and any other matter relevant to . . . the formulation of a plan").

249. The analysis, of course, discounts certain remote externalities, such as any benefit to the debtor's community from continued operations.

250. See, e.g., *In re Mortgage Inv. Co.*, 111 B.R. 604, 619-20 (Bankr. W.D. Tex. 1990) (requiring a rigorous showing of necessity, which "serves 'the narrow purpose of affording the debtor the capital necessary to survive'") (quoting *In re Greystone III Joint Venture*, 102 B.R. 560, 575 (Bankr. W.D. Tex. 1989)).

B. *New Wine in Old Bottles: A Proposal for Fair Owner Participation*

1. *Case reconsidered.*

If reasons exist to permit owners to participate in the reorganization process, then how should we facilitate that participation? Before the Code's adoption, the standard answer was to follow *Case* and aligned precedents. Courts have used this answer even after adoption of the Code. This is not surprising: Congress incorporated prior decisional law through the adoption of old terms of art, such as the fair and equitable standard, and left the charting of the contours of the fair and equitable requirement to the judiciary.²⁵¹

Most of this received learning, however, is based upon the false premise that *Case*'s new value principles constitute an exception to absolute priority.²⁵² As discussed above,²⁵³ that premise is invalid. What effect does this realization have upon courts who must deal with *Case*? If courts desire to capture the gains from owner participation outlined above, then the answer is not much. Because of the equivalence of the absolute priority rule and the *Case* dicta, compliance with *Case* is compliance with the absolute priority rule.

But *Case* goes beyond the absolute priority rule. It assumes that there will be "the necessity, at times, of seeking new money 'essential to the success of the undertaking' from the old stockholders."²⁵⁴ Only "[w]here that necessity exists,"²⁵⁵ may owners participate. This necessity requirement obviously impedes owners. They suffer under a requirement that is inapplicable to others. As the rule was judicially created, the judiciary may amend or delete it if its underlying logic is no longer valid.²⁵⁶

2. *Discarding necessity.*

Case and some of its progeny explicitly condition owner participation upon a showing that an owner's contribution is "necessary."²⁵⁷ This re-

251. See text accompanying note 15 *supra*.

252. See text accompanying notes 20-21 *supra*.

253. See text accompanying notes 167-201 *supra*; text accompanying notes 316-322 *infra*.

254. *Case*, 308 U.S. at 121 (footnote omitted); see text accompanying note 250 *supra*.

255. *Case*, 308 U.S. at 121.

256. As noted when the Code was in its final stages of consideration:

Although many of the factors interpreting "fair and equitable" are specified in paragraph (2), others, which were explicated in the description of section 1129(b) in the House report, were omitted from the House amendment to avoid statutory complexity and because they would undoubtedly be found by a court to be fundamental to 'fair and equitable' treatment of a dissenting class. For example, a dissenting class should be assured that no senior class receives more than 100 percent of the amount of its claims. While that requirement was explicitly included in the House bill, the deletion is intended to be one of style and not one of substance.

124 CONG. REC. 32,407 (1978) (statement of Rep. Edwards) (emphasis added); *id.* at 34,006 (1978) (statement of Sen. DeConcini) (emphasis added).

257. See, e.g., *In re Mortgage Inv. Co.*, 111 B.R. 604, 619 & n.25 (Bankr. W.D. Tex. 1990); *In re Aztec Co.*, 107 B.R. 585, 588 (Bankr. M.D. Tenn. 1989); *In re Greystone III Joint Venture*, 102 B.R. 560, 574 (Bankr. W.D. Tex. 1989), *aff'd*, 127 B.R. 138 (W.D. Tex. 1990).

Several courts have noted the necessity requirement, but have not required an affirmative show-

quirement may not have continuing vitality due to its origins in the false belief that *Case* provides an exception to the absolute priority rule. As shown above, *Case* contains no such exception.²⁵⁸ Owners who comply with the *Case* dicta effectively comply with absolute priority. It is thus odd and potentially detrimental to impose upon owners a condition that is not applicable to any other class of participants. At best, the necessity rule may help differentiate owners who wish to continue in good faith from those who wish to exploit their position. But this is a loose fit, and other existing rules address the problem more directly.²⁵⁹

New funds were often thought necessary in equity reorganizations to pay cash to dissenters.²⁶⁰ But the Code contains significant changes to equity reorganization practice. In particular, it grants a broad discharge.²⁶¹ As a result, dissenters need not be paid in full, or provided for other than as set forth in the terms of the confirmed plan. The cost of this capital was one focus in *Case*.

Justice Douglas also stated that new funds were often necessary to provide working capital in railroad reorganizations.²⁶² By imposing a necessity requirement, Justice Douglas attempted to ensure that old shareholders would supply funds and retain their interest only when the market did not provide this working capital at a lower cost.²⁶³ But in reorganizations under the Code, cash is required only to the extent necessary to meet the feasibility requirement.²⁶⁴ If a debtor requires large infusions of cash to continue operations in the near term, there is substantial doubt that a Court will consider the plan feasible.

The decline in the need for cash to pay dissenters together with the demonstrated equivalence of *Case* with the absolute priority rule diminish the need for the necessity rule.²⁶⁵ Thus rethought, the rule should be

ing of necessity by owners unless plan opponents raise the issue. *Teamsters Nat'l Freight Indust. Negotiating Comm. v. U.S. Truck Co., Inc.* (*In re U.S. Truck Co., Inc.*), 800 F.2d 581, 588 n.10 (6th Cir. 1986); *Official Creditors' Comm. ex rel. Class 8 Unsecured Creditors v. Potter Material Serv., Inc.* (*In re Potter Material Serv., Inc.*), 781 F.2d 99, 102 (7th Cir. 1986).

258. See text accompanying notes 167-201 *supra*.

259. See, e.g., 11 U.S.C. § 1129(a)(3) (1988) (plan must be proposed in good faith).

260. *Case*, 308 U.S. at 121 n.15; see also 2 A.S. DEWING, *supra* note 30, at 1427-33.

261. The Code provides that:

The provisions of a confirmed plan bind the debtor, any entity issuing securities under the plan, any entity acquiring property under the plan, and any creditor, equity security holder, or general partner in the debtor, whether or not the claim or interest of such creditor, equity security holder, or general partner is impaired under the plan and whether or not such creditor, equity security holder, or general partner has accepted the plan.

11 U.S.C. § 1141 (1988).

262. *Case*, 308 U.S. at 121 n.15.

263. In addition, with Section 77B's extension of the discharge to dissenting claims, one function of shareholder assessments became obsolete. The reorganized debtor no longer had to pay dissenting creditors in full to avoid a long fight over whether the reorganization plan contained a fair offer.

264. In other words, cash is necessary only to show that the debtor's reorganization is not likely to be followed by the need for further financial reorganization. 11 U.S.C. § 1129(a)(11).

265. Another possible justification for the necessity rule is to prevent owners from playing valuation games with the debtor. This concern is addressed through the overbid mechanism discussed below. See text accompanying notes 309-315 *infra*.

discarded.

3. *The preservation of new value concepts.*

As previously indicated, the process by which a plan of reorganization is confirmed is analogous to an auction for control of the reorganized debtor.²⁶⁶ Participants initially bid by proposing a plan. The plan, in turn, sets the consideration that each class of claims receives, and identifies the new owners. The court's role is to confirm the winning bid.

Viewing plan confirmation as an auction provides the first step in analyzing the role of the owner, and a basis for rethinking *Case*. A new value plan is simply a bid in the auction for control of the reorganized debtor, proposed by holders of prepetition interests, which leaves some class paid less than in full, and which does not require creditor consent.²⁶⁷ Any other plan is simply another bid.

The best bid should win the auction. This still leaves undetermined exactly what the best bid is, or should be. Two means of evaluation exist. As in *Case*, a court can make the decision, taking into account, but not being bound by, creditor preferences. Alternatively, creditor preferences alone can control. The Code answers this question. It requires courts to defer to creditor preferences when more than one competing plan qualifies for confirmation.²⁶⁸ Given this background, methods and procedures which provide incentives for the promulgation of competing creditor plans accomplish two goals: they increase the number and amount of bids; and they provide creditors with alternatives beyond those offered by the debtor.

With this in mind, I offer the following standard for owner participation. It is consistent with both the Code and, except for the necessity requirement, with *Case*. A holder of a prepetition equity interest satisfies the fair and equitable requirement if it proposes a plan in which it retains or receives an equity interest in the reorganized debtor, without payment in full of all creditors, only if it sustains the burden of showing that: (1) it will contribute money or money's worth to the debtor; and (2) the value of the interest retained or received in the reorganized debtor will be no greater than the value of the contribution.

In addition, this standard needs to be augmented by revised procedural rules to equalize the bargaining positions of the parties. If owners submit a new value plan, exclusivity terminates. Second, a competing plan proponent will not be required to prove reorganization value to eliminate the class pro-

266. See text accompanying notes 229-241 *supra*.

267. Under the Code, a plan proponent must request nonconsensual confirmation. 11 U.S.C. § 1129(b)(1). As a result, it will be relatively easy to ascertain if a plan proponent requests confirmation without relying on the assent of all classes.

268. Section 1129(c) provides that if more than one plan is confirmable, "the court shall consider the preferences of creditors and equity security holders in determining which plan to confirm." *Id.* § 1129 (c). This language can be interpreted as giving equal weight to creditor and owner preferences. But as it pertains to insolvent debtors, such a reading runs contrary to the intent of the absolute priority rule, and is also contrary to the holdings of the few cases which construe the section. See notes 306-307 *infra*.

posing the new value plan. Finally, if any creditor or class of creditors thereafter proposes a plan that gains creditor acceptance, then that creditor plan will be confirmed.

This first part of the owner participation test does not substantively differ from *Case's* dicta. It requires the contribution of money or money's worth, and follows the exchange principle set forth in *Group of Institutional Investors v. Chicago, Milwaukee, St. Paul & Pacific Railroad*,²⁶⁹ to set the parameters of this requirement. Courts should test the financial equivalence of the proffered contribution against this standard: an owner cannot use property²⁷⁰ with transitory value as the basis of its exchange with its creditors. After all, the owner's contribution is being exchanged for the creditors' surrender of their claims to the debtor.

Three examples—cash, promises of future labor, and offers to guarantee postconfirmation debt—illustrate the operation of the exchange principle. With cash, the enduring quality of the property is clear. It is thus an acceptable form of new value. As noted in *Ahlers*, the fleeting quality of an unenforceable promise of future labor is unacceptable.²⁷¹ Offers to guarantee postconfirmation debt illustrate the application of the exchange principle to forms of property less tangible than cash, but more tangible than a promise of future labor.²⁷² A guaranty may differ from a promise of future labor because, like a promissory note, it has value to the extent of the creditworthiness of its backer.²⁷³ As a result, if an owner's guaranty of postconfirmation debt has value which can be translated into money or money's worth, it may qualify.²⁷⁴ The determination, however, should proceed on a case by case

269. 318 U.S. 523, 563 (1943); see text accompanying note 110 *supra* (discussing the exchange principle).

270. The term "property" has an expansive usage inappropriate to the new value context. Unsecured claims may receive "property," which is used in its broadest sense, as long as the present value of the property given to the holders of unsecured claims is equal to the allowed amount of the claims. Some kinds of property, such as securities, may require difficult valuations by the court; in such circumstances the court need only determine that there is a reasonable likelihood that the property given the dissenting class of impaired unsecured claims equals the present value of such allowed claims.

124 CONG. REC. 32,407-08 (1978) (statement of Rep. Edwards); *id.* 34,007 (statement of Sen. DeConcini); see also *Ahlers*, 485 U.S. at 208 (noting that although the term "property" is not defined, "the relevant legislative history suggests that Congress' meaning was quite broad"); H.R. REP. NO. 595, *supra* note 105, at 413 ("[P]roperty" includes both tangible and intangible property.).

271. *Ahlers*, 485 U.S. at 204-05.

272. See, e.g., note 170 *supra*.

273. Although guaranties are property that is often exchanged, their value in any particular case may be suspect. Lessons from fraudulent transfer law tell us that guaranties cannot be valued at their face amount; there must be some discount given for the probability of payment by the principle debtor. See, e.g., *In re Xonics Photochemical, Inc.*, 841 F.2d 198 (7th Cir. 1988) (stating that probability that guaranty will not be called upon reduces valuation of guaranty for insolvency purposes).

There is also an obvious tension, noted earlier at note 160 *supra*, between new value as interpreted in connection with the fair and equitable requirement, and new value as defined in 11 U.S.C. § 547(a)(2) (1988).

274. *In re Pullman Constr. Indus. Inc.*, 107 B.R. 909 (Bankr. N.D. Ill. 1989), dealt with the proffer of a guaranty as new value. It stated that a "guarantee of a post-petition line of credit has some value, but it is not a substantial present contribution of money or money's worth because it represents a contribution promised in the future." *Id.* at 949. The court's holding is broad enough to

basis.²⁷⁵

The second part of the owner participation test—measuring the value of the interest retained or received against the value of the contribution—also draws upon *Case*. As shown above²⁷⁶ and in Appendix A,²⁷⁷ any requirement of equivalence between the value of the interest retained and the value of the contribution made is congruent with the absolute priority rule. As a consequence, any plan which complies with the test stated above or the test as stated in *Case* will return, by definition, to creditors at least the reorganization value of the debtor.²⁷⁸ This satisfies the absolute priority rule.

These requirements for owner participation flow from basic rules for the conduct of an auction. An owner must support its bid with consideration; and the contribution of money or money's worth satisfies that requirement. Further, the buyer must pay the consideration to the seller; the requirement of reasonable equivalence fills this bill. Auction theory, however, enables us to go beyond this position. It permits the construction of rules that promote the conduct of a fair auction, in which the seller receives maximum revenue. The final portion of the owner participation test incorporates procedural safeguards against unfair exploitation by owners of their special position.²⁷⁹

encompass the guaranty of a commercial surety, which, if bought by the owner, could constitute "money or money's worth." At best, the court was discounting the guaranty according to the court's view of the creditworthiness of the guarantor.

275. Some interpretive benefit can be gleaned from the federal tax lien statute which provides that the government's lien takes priority over all subsequent interests. 26 U.S.C. § 6321 (1988). There are exceptions, however, for holders of subsequently-arising security interests or subsequent purchasers who part with "money or money's worth." *Id.* § 6323(h)(1) (definition of security interest); *id.* § 6323(h)(6) (definition of purchase). Under these definitions, past consideration is not money or money's worth, *United States v. Phillips*, 715 F. Supp. 81, 84 (S.D.N.Y. 1989), although uncompensated services can be. *Treas. Reg. § 301.6323(h)-1(a)(3)* (1990). *Compare Horowitz v. Kaplan*, (*In re Waltham Watch*) 193 F.2d 64, 73-75 (1st Cir. 1951), *cert. denied*, 342 U.S. 946 (1952) (allowing manager of debtor to exchange uncompensated past services for plan consideration) *with In re C.P.M. Constr.*, 124 B.R. 335, 339-40 (Bankr. D.N.M. 1991) (holding that post-petition, pre-confirmation claim of owner for wages equal to difference between market wages and actual pay did not constitute new value under *Ahlers*).

276. *See* text accompanying notes 184-199 *supra*.

277. *See* text accompanying notes 316-322 *infra*.

278. The proposed test does not require that owners make any "minimum" contribution. Some courts disagree, believing that a minimum nexus between the amount contributed and the debt extinguished is essential. *See, e.g., In re Kendavis Indus. Int'l, Inc.*, 91 B.R. 742, 749 (Bankr. N.D. Tex. 1988) (deeming proffered contribution of \$5,000,000 insubstantial in light of \$500,000,000 in outstanding debt); *Travelers Ins. v. Olson (In re Olson)*, 80 B.R. 935, 937 (Bankr. C.D. Ill. 1987) (finding that contribution which would lead to 1.56% dividend is insubstantial). The requirement of reasonable equivalence, however, subsumes this minimum contribution test, as creditors will receive the reorganization value of the debtor. After that, their interest in the continuing debtor is well protected by other confirmation conditions, most notably feasibility. Under the Code, feasibility requires the plan proponent to show that confirmation is not likely to be followed by the need for further reorganization. 11 U.S.C. § 1129(a)(11) (1988). If full reorganization value is to be returned to creditors, then the contribution by the debtor will equal, at least on an accounting basis, the total net worth of the reorganized debtor. Traditional notions of appropriate capitalization allow creditors and courts to test whether the proffered contribution will provide the reorganized debtor with sufficient capital to thrive. Another way of stating the issue is that any requirement of "substantiality" duplicates the "feasibility" requirement. Since creditors receive full reorganization value, there is no need to test this desiderata twice.

279. Indeed, *Boyd* was concerned primarily, if not exclusively, with such procedural safeguards. Its strategy was to impose the burden of promulgating and proving a fair offer on plan

C. *Exclusivity, Valuation, and Creditor Preferences: Reduction of Entry Fees*

The Code gives owners the ability to block the filing of competing plans during the initial phases of the case,²⁸⁰ as well as a limited power to classify creditors.²⁸¹ It also restricts who may file a plan to "parties in interest,"²⁸² thus narrowing the field of prospective bidders. The practical effect of these powers is that owners may effectively control the field of prospective bidders. But the power to exclude is an emolument of ownership. As such, under a strict reading of *Boyd*, it is an incident of control of the debtor, to which creditors have first priority.²⁸³ But Congress made a policy choice against strict absolute priority and in favor of allocating these powers to debtors. This policy choice, at least as it affects insolvent debtors, can lead to situations in which a creditor's perceived cost of filing and confirming a competing plan increases or greatly reduces the anticipated gain. In the process, therefore, owners will have succeeded in capturing for themselves some of the debtor's value.

Under the current system, creditors bear costs not borne by owners. These costs include the lawyers' fees in seeking termination of exclusivity, and possibly some costs entailed in proving the debtor's value. These costs bear a similarity to entry fees in auctions.²⁸⁴ In auctions, however, entry fees screen serious from frivolous bidders.²⁸⁵ In reorganizations, the other costs inherent in proposing and confirming a plan amply satisfy that criterion.²⁸⁶

proponents. If a creditor did not participate in a fair offer, it was left without a remedy. See text accompanying notes 78-79 *supra*.

280. 11 U.S.C. § 1121(c) (1988).

281. *Id.* §§ 1122 (stating the standard for classification); *id.* § 1123(a)(1) (requiring plans to classify all claims).

282. *Id.* § 1121(c). Some courts have expansively defined "party in interest." See, e.g., *In re First Humanics Corp.*, 124 B.R. 87, 90-91 (Bankr. W.D. Mo. 1991) (holding that pre-petition manager of debtor is a party in interest); *In re River Bend-Oxford Assocs.*, 114 B.R. 111, 114-16 (Bankr. D. Md. 1990) (holding that partners in limited partnership, which was one of two general partners in the debtor, were parties in interest). In addition, many courts now hold that a purchase of a pre-petition claim is sufficient to imbue party in interest status. *In re First Humanics Corp.*, 124 B.R. at 91-92; *In re Allegheny Int'l, Inc.*, 118 B.R. 282, 286 (Bankr. W.D. Pa. 1990); *In re American 3001 Telecommunications, Inc.*, 79 B.R. 271, 272 (Bankr. N.D. Tex. 1987).

283. *Boyd* stated that creditors were entitled to whatever value inhered in the debtor, 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." 228 U.S. at 508 (emphasis added). *Case* reiterated this point in establishing the initial contours of the absolute priority rule. 308 U.S. at 116.

284. Auction theory has studied the effect of entry fees upon seller's revenue and upon the optimal form of auction. See, e.g., Kenneth R. French & Robert E. McCormick, *Sealed Bids, Sunk Costs, and the Process of Competition*, 57 J. BUS. 417 (1984); R. Preston McAfee & John McMillan, *Auctions With Entry*, 23 ECON. LETTERS 343 (1987); William F. Samuelson, *Competitive Bidding with Entry Costs*, 17 ECON. LETTERS 53 (1985); see also *Piedmont Assocs. v. CIGNA Property & Casualty Ins. Co.*, CIV. A.1:91-CV1840JOF, 1991 WL 193700, at *3 (owner's ability to "create and structure the reorganization plan" allowed owner to unfairly propose purchase ownership interest in reorganized debtor); *In re Outlook/Century Ltd.*, 127 B.R. 650 (Bankr. N.D. Cal. 1991) (same).

285. See R. CASSADY, JR., *supra* note 233, at 79-80.

286. In addition, any plan proponent must demonstrate that its plan is proposed in good faith as part of its basic confirmation requirements. 11 U.S.C. § 1129(a)(3) (1988).

Moreover, entry fees tend to depress the final bid price, since external bidders will deduct their costs of preparing a bid from their final bid.²⁸⁷ Reduction or elimination of these costs will thus tend to increase the final bids and creditor dividends.²⁸⁸ It is therefore appropriate to reduce or eliminate procedures and practices that explicitly or implicitly impose entry fees upon nonowner bids.

1. *Termination of exclusivity.*

Exclusivity refers to the debtor's statutory right²⁸⁹ to exclude others from filing plans of reorganization during the first 120 days of a bankruptcy case. This 120-day period is often extended,²⁹⁰ especially in large reorganizations,²⁹¹ but it also may be shortened or terminated for cause.²⁹² This section argues that the filing of a new value plan constitutes such cause.

The power to control the identity and status of plan proponents includes the power to initiate negotiations on possible postconfirmation capital structures. Such power is considerable. If one assumes that creditors' returns are time sensitive, then the ability to impose delays allocates at least the time value of that delay to the debtor. This amount is simply an indirect, albeit real, entry fee. Creditors must wait out the debtor to achieve equality in bargaining positions. The same result would occur if creditors paid the debtor the time value of the delay and then immediately filed a plan.

Second, automatic termination of exclusivity²⁹³ whenever owners propose a new value plan would equalize the parties' bargaining positions. If creditors can file a competing plan without incurring the cost of fighting exclusivity, they no longer need to deduct such cost from their bid to achieve their desired profit. Termination of exclusivity can thereby provide a potent check on owners' latitude with respect to the initial setting of reorganization

287. French & McCormick, *supra* note 284, at 417-23; McAfee & McMillan, *supra* note 284, at 344.

Auction theory also has examined the ultimate effect of reserve prices; that is, the setting of the minimum price a seller will accept. *E.g.*, Milgrom & Weber, *supra* note 238, at 1111 & n.25. The result of this examination is that the optimum reserve price is "the average of the seller's own valuation and the highest possible valuation that a bidder could have." McAfee & McMillan, *supra* note 198, at 714. In the reorganization context, the liquidation value is the initial reserve price; no plan may be confirmed without unanimous creditor consent unless it returns to creditors at least the liquidation value of the company. 11 U.S.C. § 1129(a)(7)(A)(ii) (1988). Once owners propose a new value plan, the consideration set forth in it becomes the reserve price, although there may be situations in which creditors may bid less, such as when the owners' plan is based on unrealistic assumptions that could not have been confirmed even in the absence of a creditor plan.

For a similar insight in the area of contested tender offers, see Frank H. Easterbrook & Daniel R. Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1 (1982).

288. French & McCormick, *supra* note 284, at 438-39.

289. 11 U.S.C. § 1121(b).

290. Before an extension is granted, cause must be shown. *Id.* § 1121(d).

291. Lynn M. LoPucki & William C. Whitford, *Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125, 128 (1990).

292. 11 U.S.C. § 1121(d).

293. Technically, what is terminated is the exclusive right to file a plan during the first 120 days after a filing, *id.* § 1121(c)(2), and to solicit creditor votes during the first 60 days after the debtor files its plan, *id.* § 1121(c)(3).

value and plan structure. If creditors disagree with the amount of value allocated to them under the plan, they may automatically propose their own plan, thus neutralizing owners' use of their control of the debtor.

The text of the Code and judicial precedent both support categorizing the filing of a new value plan as sufficient "cause" to terminate exclusivity.²⁹⁴ If the debtor proposes a new value plan, then by definition it has admitted its insolvency because it is proposing to pay its creditors less than the full amount of their claims. It is also stepping back from consensual readjustment of its capital structure; owners seek confirmation of a new value plan over the dissent of an unpaid class. In such circumstances, allowing owners to perpetuate their control of the debtor by excluding creditor action violates *Boyd's* holding that the absolute priority rule protects incidents of ownership such as control. The filing of a new value plan and its concomitant admission of insolvency thus provides ample "cause" to terminate exclusivity.²⁹⁵

This result is also supported by the fact that exclusivity with respect to plans subject to the fair and equitable requirement is a Code innovation.²⁹⁶ Exclusivity was not relevant in Chapter X cases under the Act because a trustee was often in charge, and Chapter XI cases were not subject to the fair and equitable rule. As a consequence, courts have not had to grapple with the intersection of exclusivity and absolute priority. If *Boyd* remains good law, however, it is difficult to square the exercise of exclusivity when what is being debated is the confirmation of a nonconsensual, new value plan.

2. *No proof of reorganization value.*

Aside from the costs of terminating exclusivity, creditors face other disguised entry fees. One of the key motivations for compromise in Chapter 11 reorganizations is the daunting task of proving reorganization value.²⁹⁷ The fair and equitable standard requires such a showing every time a plan proposes to eliminate any class of claims or interests.²⁹⁸ If creditors propose a competing plan under the proposed model, then such a plan will likely elimi-

294. 11 U.S.C. § 1121(d); *In re Public Serv. Co.*, 88 B.R. 521, 537 (Bankr. D.N.H. 1988); *In re Crescent Beach Inn*, 22 B.R. 155 (Bankr. D. Me. 1982).

295. *Cf. United Savings Ass'n v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 376 (1988) (suggesting that a debtor's inability to propose a consensual plan in less than a year may be cause to terminate exclusivity).

296. Exclusivity previously existed only in Chapter XI arrangements under the Act. COMMISSION REPORT, *supra* note 116, pt. 1, at 244. Chapter XI was not subject to the fair and equitable rule. *See* note 152 *supra*.

297. Broude, *supra* note 11, at 453-54.

298. Although the conclusion is noncontroversial, the mechanism for enforcement is complex. Under the Code, a class of claims or interests that is eliminated under a plan is deemed to have rejected the plan. 11 U.S.C. § 1126(g) (1988). For example, if a creditor plan eliminates all pre-petition equity interests, the creditor does not need to solicit the votes of holders of those interests. The Code presumes rejection. Since at least one class has rejected the proposed plan, the plan proponent must then confirm, if at all, under § 1129(b), which allows confirmation notwithstanding the failure to receive the affirmative votes of all impaired classes. *Id.* § 1129(b)(1). If requested, however, such cramdown require compliance with the fair and equitable requirement, *id.*, which in turn requires a showing that no creditor is being paid more than in full.

nate or reduce the owners' interests. Creditors can convert their investment into the necessary consideration only through such dilution or elimination. Paradoxically, owners could force creditors to prove reorganization value merely by asserting that their interests could not be eliminated without proof of such value.

The proof of reorganization value is fraught with uncertainty. Reorganization value is elastic and easily manipulated. As the Bankruptcy Commission noted: "By a slight change of the capitalization rate, an insolvent company in which equity security holders are denied participation becomes a solvent company in which equity security holders are entitled to an interest."²⁹⁹ *Boyd's* creation of a "fixed principle" was intended to avoid the vagaries of valuation.

Further, bankruptcy valuation rules consciously spurn market-based valuations. Reorganization value is intended to be systematically higher than any real-life valuation.³⁰⁰ This protects junior classes and ensures that any transfer of ownership based upon lack of value is free of any taint of the bankruptcy proceeding. In other words, if all other confirmation requirements are met, there should be no discount in value due to a company's past failures, which in turn will adversely and disproportionately affect junior classes.

Use of reorganization value in the new value context is ironic. One justification for the new value rule is that owners should not be worse off than third parties who wish to propose a plan.³⁰¹ But use of reorganization value actually gives owners an edge. They can propose a plan based on market values³⁰² while simultaneously opposing a creditor plan using higher reorganization value.

The obvious response is to move from a system based on reorganization value to one in which market price dominates.³⁰³ In such a system, the price that interested parties will pay controls. This market-based approach is also

299. COMMISSION REPORT, *supra* note 116, pt. 1, at 257.

300. When the debtor is able to discharge prepetition debt with long-term obligations, adroit owners can arrogate to themselves most of the value of any increase in the debtor's value, yet delegate most of the risk of future operations necessary for that increase to the debtor's creditors. *See* Note, *supra* note 119, at 1793.

301. *See* text accompanying notes 222-227 *supra*.

302. It appears that new value cases adopt a market value approach to test the "reasonable equivalence" of the consideration. *See, e.g.,* *Teamsters Nat'l Freight Indus. Negotiating Comm. v. U.S. Truck Co., Inc.* (*In re* U.S. Truck Co., Inc.), 800 F.2d 581, 588 (6th Cir. 1986) (approving debtor's contribution of \$100,000 as reasonably equivalent in light of risk that debtor's labor troubles could impair worth of ownership interest, notwithstanding the fact that the debtor was earning over \$100,000 per month); *Official Creditors' Comm. ex rel. Class 8 Unsecured Creditors v. Potter Material Serv., Inc.*, (*In re* Potter Material Serv., Inc.), 781 F.2d 99, 104 (7th Cir. 1986) (affirming trial court's consideration of "'past earnings record, the state of the economy, the highly competitive nature of the [d]ebtor's business, the present financial position of the [d]ebtor, and the [d]ebtor's of future earnings'" in formulating going-concern value of \$10,000-\$15,000); *see also* *Piedmont Assocs. v. CIGNA Property & Casualty Ins. Co.*, CIV.A.1:91-CV1840JOF, 1991 WL 193700, at *4 (new value plan, if approved, would effectively permit owner to purchase debtor's assets "against the wishes of existing creditors outside the public market place").

303. *Klee, Cram Down II*, *supra* note 11, at 244.

consistent with the Code's design, which seeks to protect junior creditors from market skepticism. With a new value plan, the owners have spoken: their own estimate opened the bidding. To consciously tolerate two standards in such a system is unfair to creditors; it allows owners to select a low price for their bid, while holding creditor plans to a higher standard. Equity and auction theory again coincide to suggest a solution—The elimination of false costs effectively reduces entry fees.

3. *Tie goes to the creditor: the vindication of creditor preferences.*

If the above owner participation requirements are followed, creditors may receive two plans simultaneously. The Code expressly permits such a result.³⁰⁴ If creditors accept both plans,³⁰⁵ and both otherwise meet all of the other conditions for confirmation, then the creditor plan should win.³⁰⁶

Two other justifications for this result exist. First, since creditors have priority in the debtor's assets, they should be able to choose the form of their payment. An insolvent debtor's desires in this respect should not receive much weight.³⁰⁷ Next, plans may always be modified prior to confirmation.³⁰⁸ This permits owners to increase their bid when faced with a competing plan. In this way, each successive bid will reset reorganization value. Given the vagaries of such value, these fluctuations should come as no surprise and should not be held against the debtor.

4. *Credit-bids.*

The elimination of disguised entry fees is only one step in facilitating higher yields for creditors. None of the procedural rules can achieve this goal unless nonowners can propose competing plans. In addition to outside investors who view the debtor as a possible acquisition,³⁰⁹ creditors themselves should be encouraged to bid. Yet creditors often lack the inclination

304. 11 U.S.C. § 1129(c) (1988); BANKR. R. 3018(c) (1991).

305. Under bankruptcy balloting procedures, a vote for one plan does not exclude voting on others. 11 U.S.C. § 1129(c). It is thus possible that creditors will vote for their own, and for the owners', plan.

306. *In re Turner Eng'g, Inc.*, 109 B.R. 956, 960-61 (Bankr. D. Mont. 1989); *In re Bedford Springs Hotel, Inc.*, 97 B.R. 831, 834 (Bankr. W.D. Pa. 1989); *In re Rolling Green Country Club*, 26 B.R. 729, 735 (Bankr. D. Minn. 1982). Similarly, if there are more than two plans, creditor preferences should again control. See 11 U.S.C. § 1129(c); BANKR. R. 3018(c).

307. This is not as callous as it might seem. By definition, a new value plan only exists when the debtor is insolvent and at least one class of creditors does not agree with the owner's division of values. Until creditors are paid in full, the owners' preferences do not count for much. See *In re Sound Radio, Inc.*, 93 B.R. 849, 858-59 (Bankr. D.N.J. 1988) (approving debtor's plan even though creditors favored different plan, due to the fact that debtor's plan paid creditors in full).

308. 11 U.S.C. § 1127 (1988).

309. Under the Act, Chapter X trustees often found third parties willing to propose plans. Their tie to the trustee made them a "party in interest." See, e.g., *In re Imperial '400' Nat'l Inc.*, 374 F. Supp. 949 (D.N.J. 1974) (considering four plans from prospective purchasers); *In re Polycast Corp.*, 289 F. Supp. 707 (D. Conn. 1968) (trustee contacted over 40 companies to find acquisition partner before sponsoring plan with debtor's management group). The demise of a disinterested trustee gives a strange twist to the Code's requirement that only "parties in interest" may file a plan. Owners who wish to propose a new value plan rarely will want to encourage competition, regardless of the debtor's fiduciary duties. This tension provides yet another barrier to third-party bidding.

or the funds to match any new value proffered by owners directly. This perceived shortcoming, however, overlooks the reality that creditors can always convert their existing investment into equity in the new company.

Creditors could, for example, receive the same return as that proposed by a new value plan by exchanging their debt for equity, and by canceling the old owners' interests. In this process, the need for fresh capital can be mitigated by a reduction in the amount of reorganization debt allocated to the creditors, with a concomitant increase in the equity for creditors in the reorganizing debtor. For example, assume a debtor proposes a new value plan in which unsecured creditors (the only class of creditors) receive \$100 of the \$200 they are owed, and that this \$100 is to be funded by a cash contribution by the owner. Under the first procedural rule mentioned above, unsecured creditors should be allowed to file a competing plan immediately. If that competing plan cancels one-half of the debt in return for all of the equity of the business, the consideration to creditors would be equivalent.³¹⁰ Moreover, since the reorganized debtor would have a clean capital structure with no outstanding debt, working capital needs could be met within the constraints of feasibility through working capital lines of credit.³¹¹

This suggestion harkens back to the practice of credit-bidding in railroad reorganizations. There, secured creditors effectively controlled reorganizations through their ability to credit-bid at a foreclosure. Critics of that practice argued that it depressed prices. The function of credit-bids in the context of a new value plan, however, is more expansive, as it checks possible owner underbids rather than serving as an initial price or bid.

A credit-bid plan also has the virtue of being self-funding from the creditors' perspective, since the extinguished claims, rather than provision of new value, provide the consideration.³¹² A similar procedure is currently available to nonrecourse secured creditors whose property is sold pursuant to a plan.³¹³ Although the Code does not generally allow such creditors to re-

310. Creditors should always be able to compete. The owner's initial decision to proceed by way of new value plan, although not determinative of insolvency, is good evidence that it exists. Since insolvency means the amount of claims exceeds the assets, the creditors will have sufficient bargaining power—that is, sufficient debt to exchange—in most, if not all, circumstances.

311. This may eliminate plans which assume increasing asset values. See, e.g., *In re FSLIC v. D&F Constr. Co. Inc. (In re D&F Constr. Co.)*, 865 F.2d 673 (5th Cir. 1989); *In re Lakeside Global II, Ltd.*, 116 B.R. 499 (Bankr. S.D. Tex. 1989). This, in turn, focuses the inquiry upon operating efficiency, which may be salutary in effect.

312. Professor Lucian Bebchuk has recently made a similar proposal for a self-funding plan, in which all consideration comes from the exchange and extinguishment of existing claims through an auction process, rather than from outside value. Bebchuk, *supra* note 193. Professor Bebchuk's analysis, however, follows a model in which all claims are ascertained before the auction, *id.* at 778, a requirement which limits his proposal's effectiveness. The proposal considered here leads to the same type of auction. A court will not be concerned that the participants reach some mythical valuation; rather, it will simply manage an auction between two or more participants. The participants will then set the value of the reorganized debtor by their bids.

313. 11 U.S.C. § 363(k) specifically provides that:

[a]t a sale under subsection (b) of this section of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property.

ceive a claim for any deficiency,³¹⁴ the Code does recognize the possibility of a debtor taking advantage of a low valuation and offers protection to that creditor through the vehicle of credit-bidding. Thus, if such creditors believe that the sale price is too low, they may credit-bid their claim at a higher amount, and purchase the property.³¹⁵ The proposal presented above expands this safeguard to protect entire classes of creditors, allowing them to credit-bid their debt to the level of reorganization value they select.

V. CONCLUSION

For over fifty years, the absolute priority rule has been the cornerstone of reorganization practice and theory. This rule requires creditors to receive the lesser of their claims or the reorganization value of the company before residual owners can continue to participate. Since the Code's adoption in 1978, owners have been seduced by an alleged exception to the absolute priority rule. Under this putative exception—first established in *dicta* and never reiterated until the Code's adoption—if owners contribute necessary new value to the debtor, they may preserve their interests to the extent of that contribution. But as shown above, labelling this rule an exception misuses the term. Application of the rule only yields results consistent with the absolute priority rule itself.

To view the new value rule as an exception to absolute priority is to sustain debtor control in derogation of the rights of the true owners, its unpaid creditors. New value never was tested under the Act, and has no justification under the Code. Analysis of the rule as an exception perpetuates a catachresis, and should cease.

Furthermore, courts' misperceptions regarding the existence of an exception have produced inconsistent and confusing results. These decisions have failed to appreciate the fact that the Code has radically altered reorganization strategy. The Code now allows waiver of the absolute priority rule on a class basis, allows owners to stay in control of a debtor, potentially excludes third party bidders from the process, and grants owners the exclusive right

The legislative history indicates that "a secured creditor may bid in the full amount of the creditor's allowed claim including the secured portion and any unsecured portion thereof in the event the creditor is undersecured, with respect to property that is subject to a lien that secures the allowed claim." 124 CONG. REC. 32,396 (1978) (statement of Rep. Edwards); *id.* at 33,795 (statement of Sen. DeConcini).

314. [If] property is being sold under a Chapter 11 plan, a non-recourse creditor will have its claim reduced to the allowed secured claim as provided by Section 506(a), will lose its unsecured claim, and can be left unimpaired if its allowed secured claim is paid in full on the effective date of the plan.
In re Realty Invests., Ltd., 72 B.R. 143, 145 (Bankr. C.D. Cal. 1987); *see also* 11 U.S.C. § 1111(b)(1)(A)(ii) (1988).

315. The non-recourse creditor may overbid the purchase price as set forth in the plan by means of credit bid as allowed by § 363(k). *See* *John Hancock Mut. Life Ins. Co. v. California Hancock Inc.* (*In re California Hancock, Inc.*), 88 B.R. 226, 230-31 (Bankr. 9th Cir. 1988) (affirming secured creditor's right to credit-bid regardless of which subsection of § 1129(b)(2)(A) debtor seeks to invoke); *In re Realty Invests.*, 72 B.R. at 146 (recognizing that since secured claim is set by value of property, credit bid under § 363(k) effectively sets new value and thus increases secured claim); *In re Woodridge North Apts., Ltd.*, 71 B.R. 189, 191 (Bankr. N.D. Cal. 1987).

to propose a plan in the initial stages of a case. Moreover, as plan proponents, owners enjoy the ability to set the tests for inclusion within any particular class.

These changes created significant benefits for equity participants in reorganizing companies. As a consequence, courts should not strain to find, in language written at a different time and during a different phase of reorganizations, an exception to one of creditors' primary rights in reorganizations—the absolute priority rule. They need not work so hard: as indicated above, a new value exception to the absolute priority rule simply does not exist.

This conclusion, however, does not require reinstating the presumption that owners cannot bid for their own company. A contested reorganization is much like an auction in that participants bid for control of an asset. Auction theory suggests that owner plans could be beneficial in several respects. First, bids by owners would increase the pool of available bidders. This would increase competition and would place upward pressure on the final price. Second, owner bids could provide critical information to other potential bidders as to the worth of the debtor. This information would reduce uncertainty and would allow bidders to bid more confidently. Third, participation by residual owners is consistent with the absolute priority rule if the residual owners pay and receive what a third party would pay and receive for the same company. Under this test, creditors should receive, at minimum, the reorganization value of a company.

Owners, however, exercise a measure of control properly belonging to creditors when they propose a reorganization plan to the exclusion of others, and typically possess unequal information regarding the debtor. According to the auction analogy, owners possess a right to set entry fees which may impede competitive bidders and depress final prices. To equalize the bargaining positions and, to some extent, the informational imbalance, owners' participation should be circumscribed by granting creditors a paramount right to overbid on similar terms, and by disabling debtors from using statutory exclusivity to fend off competing plans of reorganization. Finally, if the creditors propose a confirmable plan which receives the affirmative vote of creditors, courts should confirm that plan.

The final result is much like a playground split of a sandwich in which one child cuts the sandwich while the other gets to choose which portion she wants. Here, the debtor picks a value for the company by setting reorganization value. The creditors may then choose what they will receive: the consideration offered or the company itself. Application of this simplified analogy may yield only rough justice. In an area in which mathematical certainty is an illusion, however, this rough justice may be the best justice attainable.

APPENDIX A

ALGEBRAIC DEMONSTRATION THAT THE "EXCEPTION" IS ONLY A SPECIAL CASE OF THE RULE

That the "exception" and the absolute priority rule yield the same result can also be shown by algebraic means. As stated in *Case*, "where the debtor is insolvent, the stockholder's participation must be based on a contribution in money or money's worth, reasonably equivalent in view of all the circumstances to the participation of the stockholder."³¹⁶ If one assumes a contribution of money, this sentence tells us that the amount contributed must be "reasonably equivalent" to the stockholder's "participation." "Participation" is left undefined, but in *Case*, Justice Douglas found that a 23% stock interest represented an impermissible 23% interest in the "value of the enterprise."³¹⁷ As a consequence, if we assume that "participation" equates with or includes an ownership interest, we only need to find the value of the debtor, apply that interest, and the result will be the value of the participation.

These relationships can be represented algebraically. If we set:

C = the amount of the proposed capital contribution;

R = reorganization value, calculated on the basis of capitalized future earnings;

D = the value of debt securities or instruments distributed to creditors pursuant to the plan;

M = the value of cash or other tangible property other than debt obligations or equity securities to be distributed under the plan; and

P = the participation of the pre-petition owners, expressed as a decimal, then the following equation represents Justice Douglas' formulation of the "exception" to the absolute priority rule:

$$C = [(R + C) - (D + M)] * P$$

In short, the right hand side of the equation represents the value of the owner's interest in the reorganized company. This is calculated by first obtaining the "value" of the company by adding the reorganization value, R , and the proposed cash contribution, C , and by then subtracting the non-operating charges against income represented by reorganization debt, D , and by cash and other tangible property, M . None of C , D , or M is a component of R ; R is set by the economics of the debtor; and C , D , and M are values selected by the plan proponent and given force by confirmation. Once this amount is set, then the owner's share of that value is given by applying P , the percentage the owner proposes to retain. If the owner retains 100% of the equity interests, then $P = 1$, and P becomes superfluous to the equation.

Take as an example an owner of a corporation who wishes to contribute \$100 in cash to retain 100% interest in the debtor. Under the above equa-

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

317. *Id.* at 119.

tion, in order to determine the value of the interest received—that is, the value of stock to be issued to the old shareholder under the plan—a third valuation is required: that of R , or the value of the reorganized entity. Note, however, that the sales price—the amount of the contribution—does not itself determine that value.

The amount of value received, that is, the value of the stock interest the stockholder will receive, is thus inextricably linked to the value of the reorganized company. If the owner proposes to continue 100% ownership, then this value and the value of the stock interest match: in the notation above, $R = D + M$.³¹⁸

Against this background, reconsider the owner who wishes to contribute \$100 and receive \$100 worth of stock. Assume further that, under the principles already outlined, $R = \$100$. Assume also that the debtor has only one class of pre-petition debts, and they aggregate to \$200. Again, *Case* and the above equation require the owner to contribute new value reasonably equivalent to the shareholder's post-confirmation participation. To ascertain this value, calculate the value of the reorganized debtor *after* the owner makes her contribution, but *before* any allocation of value between owners and creditors. The debtor had \$100 of reorganization value, to which the owner added \$100 of cash. The value of the debtor, without any distribution to creditors or issuance of any stock to owners, is thus \$200. Under the above equation this would be the sum $R + C$.

If all debts were discharged in order to give the reorganized company a clean debt structure, then the value of the interest retained would equal \$200; D and M in this case would be zero. This is not, by any definition, "reasonably equivalent" to the \$100 contribution. The owner would pay \$100 (C), and receive a stock interest worth \$200 ($R + C$).

Allocating a portion of this excess value to creditors is one method to bring the exchange into balance. In short, making $(D + M)$ non-zero can bring the equation into balance. As set forth in *Group of Institutional Investors*,³¹⁹ the post-confirmation value of a reorganized debtor is its gross reorganization value (without any debt) less any pre-petition claims provided for in the plan. How is $(D + M)$ determined? In this example the answer seems easy: \$100, which could be paid to creditors in cash (M) or reorganization securities (D). After allocation of this amount to creditors, the reorganized debtor has a residual value of \$100, which is reasonably equivalent to the \$100 the owner contributed.

This result also has one other quality: it fully complies with the absolute priority rule. The \$100 in value received by creditors equals the debtor's

318. When such valuations are made, the Supreme Court has ruled that capitalized earnings are the appropriate test. *Group of Institutional Investors v. Chicago, M. St.P. & Pac. R.R.*, 318 U.S. 523 (1943); *Consolidated Rock Prods. Co. v. Du Bois*, 312 U.S. 510, 525-26 (1941); see also *In re Genesee Cement, Inc.*, 31 B.R. 442, 444 (Bankr. E.D. Mich. 1983); 5 COLLIER ON BANKRUPTCY ¶ 1129.03[4][f][ii] (15th ed. 1991). See *In re Jartran, Inc.*, 44 B.R. 331 (Bankr. N.D. Ill. 1984) for a modern application of these valuation techniques.

319. 318 U.S. at 541.

reorganization value, which is the full value of the creditors' interest in the debtor as of the date of the bankruptcy.³²⁰

These conditions can also be expressed through algebra, using the same variables. Recall that Justice Douglas also stated that "[a]s indicated in the *Boyd* case, the creditors are entitled to have the full value of the property, whether 'present or prospective, for dividends or only for purposes of control', first appropriated to payment of their claims."³²¹ The "full value of the property," especially given the context of *Du Bois*, equates with reorganization value. Thus, this entire value must be "first appropriated" to payment of creditor claims.³²² In short, all value must be allocated to creditors, even though the use of long term debt instruments may ultimately delay payment.

As a consequence, the absolute priority rule is satisfied when an amount equal to all reorganization value is allocated to creditors. Again, property distributed under a plan can consist of cash, debt instruments, or equity interests. For an insolvent company, the condition imposed by the absolute priority rule is that, at a minimum:

$$R = D + M + \{[(R + C) - (D + M)] * (1 - P)\}$$

The right hand side of this equation simply states that the value of the debt instruments, cash and the equity interests distributed to creditors under the plan must equal reorganization value. The next term, $\{[(R + C) - (D + M)] * (1 - P)\}$, is the complementary term to the value of the owners' retained interest expressed above. It assumes that all equity not distributed to owners is given to creditors, thus setting the decimal percentage of equity ownership by creditors equal to $1 - P$. Again, if owners allocate to themselves 100% of all equity interests, this equation states that the value of the debt securities and cash distributed must equal reorganization value.

If this equation is solved for C , an interesting similarity occurs. It produces exactly the same conditions for C as Justice Douglas' formulation of the "exception" to the absolute priority rule. The derivation is shown below.

Action Taken	Result
1. Original equation	1. $R = D + M + \{[(R + C) - (D + M)] * (1 - P)\}$
2. Multiply $(1 - P)$ by $[(R + C) - (D + M)]$	2. $R = D + M + \{(R + C) * (1 - P) - (D + M) * (1 - P)\}$
3. Multiply $(R + C)$ and $(D + M)$ by $(1 - P)$	3. $R = D + M + \{(R - RP + C - CP) - (D - DP + M - MP)\}$
4. Perform subtraction within brackets	4. $R = D + M + \{R - RP + C - CP - D + DP - M + MP\}$
5. Drop brackets and eliminate D and M	5. $R = R - RP + C - CP + DP + MP$

320. See text accompanying notes 103-113 *supra*.

321. *Consolidated Rock Prods. Co.*, 312 U.S. at 529 (citation omitted).

322. See note 107 *supra* and accompanying text.

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|---|----------------------------------|
| 6. Subtract R from each side of the equation | 6. $0 = -RP + C - CP + DP + MP$ |
| 7. Add RP and CP , subtract DP and MP from each side, and reverse sides of equation | 7. $C = (RP + CP) - (DP + MP)$ |
| 8. Factor out P from right side of equation | 8. $C = [(R + C) - (D + M)] * P$ |