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KRINOCK LECTURE SERIES

ABSOLUTE PRIORITY AND NEW VALUE

JAMES J. WHITE*

I. INTRODUCTION

The absolute priority rule is a specific application of the broader doctrine that reorganization plans must be “fair and equitable.” Both have their origins in the railroad reorganization cases of the early 20th century.¹ The general doctrine is now codified in section 1129(b)(2) of the Bankruptcy Code² and the rule is codified in subsection 1129(b)(2)(B)(ii) which provides that the debtor must pay a nonconsenting class of unsecured creditors in full or “the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property.”³ At least when it is applied rigorously, this simple rule is a powerful brake on the debtor’s behavior and a strong influence on the negotiation that is likely to occur over a reorganization plan.

It means that the shareholders of the debtor — whether a small closely held company or a large publicly held one — or the partners of a partnership, cannot keep anything unless they either pay the unsecured creditors in full or get the agreement of all of the unsecured creditor classes. Because the rule is a part of 1129(b), it need not be satisfied unless the plan is to be “crammed down,” that is to say, unless there is a class of creditors that has

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1. See *Kansas City Terminal R.R. v. Central Union Trust Co.*, 271 U.S. 445 (1926); *Northern Pac. Ry. Co. v. Boyd*, 228 U.S. 482 (1913).

2. 11 U.S.C.A. § 1129(b)(2) (West 1979 & Supp. 1991).

3. 11 U.S.C.A. § 1129(b)(2)(B)(ii) (West 1979 & Supp. 1991).

not accepted the plan under section 1129(a)(8)(A). Because the most obvious escape from the rule is to negotiate with the creditor class that is objecting and thus to procure its acceptance (by a vote of more than one-half in number and at least two-thirds in amount) the initial consequence of the rule is to make the debtor more willing to negotiate, but in fact the rule protects against a multitude of evils. Assume, for example, that the debtor procures a particularly persuasive appraiser who appears before a sympathetic judge and that the appraiser and debtor convince the court that the value of the property in the bankruptcy estate is much lower than the creditors believe it to be. But for the absolute priority rule, the creditors would have no recourse. Being stuck with the court's finding about the value, the best interest rule in section 1129(a)(7)(A)(ii) (promising them only as much as they would get on a hypothetical liquidation based on the low estimation) would assure them only a small recovery. With the absolute priority rule, each class can protect itself by vetoing the plan.

Assume alternatively that the proposed plan uses a present value discount rate that is unacceptable to the creditors, or that the plan puts unacceptable contingencies on the payments to be made under it. Against all of these manipulations stands the absolute priority rule.

Of course, strict application of the absolute priority rule on behalf of a stubborn, vindictive, or ignorant class of creditors could forestall what might be the most efficient plan. If, for example, the debtor was in fact the most efficient operator of the business to be reorganized and if the reorganization plan would truly produce more than might be gained on liquidation by the creditors, a stubborn or ignorant creditor class insisting upon full payment might cause the debtor to abandon such a plan and so leave all parties in a worse position than if the plan had been adopted. Perhaps because of my biases, I believe the former problem (improper debtor manipulation) is more significant than the latter (creditor ignorance and vindictiveness), but I understand that others could come to different conclusions.

This wall, the absolute priority rule, has protected reorganization creditors quite effectively against debtor onslaught for nearly eighty years. In the past decade, however, debtors have successfully breached the wall in a handful of cases under the banner of "new value." In these cases, the junior claimants (usually shareholders of a debtor corporation or partners of a debtor partnership) have argued that they may retain a stake in the reorganized company without making full payment to nonconsenting creditor classes because they are contributing "new value" and thus are not merely junior claimants "retaining" their interest "on account of

such junior claim." Whether the wall can be repaired against this attack, or whether it will be routinely and continuously subject to breach because of the new value rule, remains to be seen. Some courts embrace the new value exception while others completely deny its validity.

II. HISTORY OF THE NEW VALUE EXCEPTION

The doctrine that a reorganization must be "fair and equitable" was itself originally a judge-made rule. It is commonly traced to the case of *Northern Pacific Railway Co. v. Boyd*.⁴ Boyd was a creditor of the original railroad that had gone through an equity reorganization. In that reorganization, the old bondholders and stockholders, mostly the same people, used the reorganization in effect to "squeeze out" the intermediate unsecured debt. Because the senior creditors and the shareholders were the same people, the senior creditors' agreement to a plan that favored the shareholders said nothing about its fairness to creditors who were not also shareholders. Ultimately Boyd, a squeezed intermediate creditor, won in a Supreme Court decision that established that such a squeeze out was impermissible because it was not "fair and equitable."

Professor Ayer has described the next major set of Supreme Court developments, those occurring shortly before World War II, as follows:

That was the situation as it stood when the Supreme Court decided *Case v. Los Angeles Lumber Products Co.* in 1939. The facts of *Case* are simple: the debtor holding company had liabilities of \$3.8 million and held a subsidiary that owned the Los Angeles Shipyard and Drydock — an asset valued at \$830,000. The plan was to cancel old securities and issue new ones in their place. Some twenty-three percent of the new securities would go to the former stockholders. Both lower courts confirmed the plan, but a unanimous Supreme Court reversed.

The case is both historically and doctrinally important. In terms of political history, the case marks a milestone in the career of Justice William O. Douglas, who wrote the opinion for the unanimous Court. Douglas had served on the Court less than a year at the time of the decision, having come from the chairmanship of the Securities and Exchange Commission. At the SEC, he was one of the principal architects of the New Deal corporate law reforms, and one of the authors of Chapter X of the Bankruptcy Act. His opinion adopts much of the substance of an *amicus* brief filed by the SEC.

As an instance of decisionmaking strategy, the case is notewor-

4. 228 U.S. 482 (1913).

thy because it is the first major absolute priority case in which the Court interprets a statute. And indeed, Justice Douglas' interpretation has become so rooted in the culture of the law that it is a surprise to note just how attenuated it is. For the statute — Bankruptcy Act, section 77B, the precursor of Chapter X — nowhere states that claims must be paid by a principle of absolute priority. Instead, Justice Douglas deploys a provision in subsection (f), which provides that a plan must be "fair and equitable." These words, Justice Douglas writes, "are words of art which prior to the advent of Section 77B had acquired a fixed meaning through judicial interpretations in the field of equity receivership reorganizations." Strictly speaking, this is poppycock, and Justice Douglas knew it. None of the Supreme Court's absolute priority cases used that particular phrase in that particular way. Indeed, Justice Douglas himself cites only one prior use of the term in case law, and that is in an appellate opinion which the Supreme Court later overturned. On the other hand, the question was at least open, and it was reasonable to infer that the drafters intended to import at least some kind of absolute priority rule into Section 77B.

But what kind of rule? Substantively, the remarkable fact about *Case* is that over ninety percent of all bondholders had accepted the plan. Justice Douglas held that this fact was "immaterial on the basic issue of its fairness." The only possible inference was that this time, the Supreme Court meant business.

Case interpreted old Section 77B, already superseded before the Supreme Court issued its opinion. But the Court soon made clear that the "fair and equitable" language also applied under the superseding Chapter X. The Court also articulated one further principle necessary to make the absolute priority rule work in practice. Thus, in *Consolidated Rock Products Co. v. Du Bois*, the Court held that in order to apply the absolute priority rule, a finding as to the value of the reorganized enterprise must be made. On reflection, this seems obvious. If the creditors hold claims worth \$10 and the debtor is worth \$8, then it violates the absolute priority rule to leave any interest with the debtor; if the debtor is worth \$12, then it does not. Nevertheless, this obvious truth seems to have eluded a number of earlier courts. *Consolidated Rock Products* also established that the criterion of "value" for purposes of the rule was not merely the value of the enterprise in liquidation. Rather, it was the (presumably higher) value of the business as a going concern.⁵

In *Case v. Los Angeles Lumber Co.*,⁶ Justice Douglas rejected the argument of the old shareholders who sought to receive shares of the reorganized corporation; these shareholders had argued that their "familiarity with the operation of the business" and financial

5. Ayer, *Rethinking Absolute Priority After Ahlers*, 87 MICH. L. REV. 963, 974-76 (1989) (footnotes omitted).

6. 308 U.S. 106 (1939).

standing and influence constituted new value that would entitle them to shares in the new corporation. Nevertheless, Justice Douglas stated in dictum that payment of proper "new value" would entitle the shareholders to a piece of the reorganized company. He found it "clear that there are circumstances under which stockholders may participate in a plan of reorganization of an insolvent debtor."⁷ He noted that the old stockholders could share where there was "necessity . . . [to make] a fresh contribution and receive in return a participation reasonably equivalent to their contribution. . . ."⁸ Of course, all of this was dictum for the holding rejected the plan as violating the absolute priority rule. Justice Douglas quoted at length from and relied upon the earlier and confusing Supreme Court case of *Kansas City Terminal Railway Co. v. Central Union Trust Co.*⁹ That case permitted a plan under which a creditor would receive certain securities of the new corporation and shareholders would receive similar securities only if they paid a specific assessment. Professor Ayer summarizes the case as follows:

The gist of this analysis is that Justice McReynolds' opinion in *Kansas City Terminal*, while it does indeed contain intimations of an absolute priority rule and also of a new value exception, is equivocal at best, and can be read as supporting something quite different. All this is captious or fanciful in the absence of evidence that the opinion was actually (mis)read this way. Fortunately, evidence was already at hand in the interpretation by the lower court on remand, approving a revised reorganization plan. The plan allocated value to all classes, including equity. Since neither absolute priority nor its recently-hatched new value corollary guided the Court, the governing principles of the case are obscure. There was no pretense of a valuation, no pretense of an allocation of value in terms of claims, and no pretense that shareholders were being compensated according to their contribution. The plan was simply confirmed, and the Supreme Court denied *certiorari*.

The point of all this is that neither of the cases taken as seminal for the new value doctrine can be read as an application of the new value doctrine. *Kansas City Terminal* "states" it, but in a self-contradictory manner, and accepts the ruling of the lower court when that court chose not to apply it. *Case* "states" it well enough (indeed, one is tempted to say that Justice Douglas understood Justice McReynolds' opinion far better than Justice McReynolds understood it himself) but then refuses to apply it on the particular facts.¹⁰

7. *Id.* at 121.

8. *Id.*

9. 271 U.S. 445 (1926).

10. Ayer, *supra* note 4, at 1006-07 (footnotes omitted).

III. THE NEW VALUE EXCEPTION AFTER 1978

The next event in the history of the new value exception is the passage of the Bankruptcy Reform Act of 1978.¹¹ As we see above, the absolute priority rule for the first time appears in section 1129(b)(2)(B)(ii) of the Code. What started as a rule of equity in *Boyd*, and cases like it, has now become a rule of statutory law explicitly adopted by Congress. Note, too, that there is no mention of a new value exception to the absolute priority rule. What inference does one draw from that? One possibility is illustrated by the opinion of Bankruptcy Judge Clark in *In re Greystone III Joint Venture*.¹² There, Judge Clark finds:

It is fair to assume that Congress was aware of *Case* when it passed the Bankruptcy Code. That Congress did not expressly codify *Case*'s holding should be of no moment, as the term of art carried with it the judicial glosses that had been placed upon it. . . . It is a time-honored principle of statutory construction that legislators are presumed to be aware of judicial glosses placed on prior statutory enactments, and that subsequent amendments and codifications are presumed to have been carried into the new statute unless expressly repudiated.¹³

In *In re Winters*,¹⁴ Judge Bentz draws the opposite inference. First, the judge quotes from the House Report that describes the absolute priority rule's application as follows:

If the debtor is unable to obtain the consents of all classes of creditors and stockholders, then the court may confirm the plan anyway on the request of the plan's proponent, if the plan treats the non-consenting classes fairly. The bill defines "fairly" in terms of the relative rights among the classes. Simply put, the bill requires that the plan pay any dissenting class in full before any class junior to the dissenter may be paid at all. The rule is a partial application of the absolute priority rule now applied under chapter X and requires a full valuation of the debtor as the absolute priority does under current law.¹⁵

Noting that absolute priority is brought into play in the current law only if the class — as opposed to an individual creditor — votes against the plan, the court points out that Congress made several changes in the court-made rule. Judge Bentz then

11. Pub. Law No. 95-598, 92 Stat. 2549 (codified as amended in scattered sections of 11 U.S.C.A. (West 1979 & Supp. 1991)).

12. 102 Bankr. 560 (W.D. Tex. 1989).

13. *Id.* at 575 n.20.

14. 99 Bankr. 658 (W.D. Pa. 1989).

15. *Id.* at 662 (quoting H.R. REP. No. 595, 95th Cong., 2d Sess., 221-24, reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6181-84) (citation omitted).

concludes:

Congress, with apparent deliberation, did not mention the “infusion of new capital” as a consideration in applying the fair and equitable test. Thus, the discussion in *Los Angeles Lumber Products Co.* about “infusion of new capital” is no longer an element to be considered a “fair and equitable” issue for confirmation under 11 U.S.C. § 1129(b)(2)(B).¹⁶

What does one do in the face of such diametrically opposed inferences drawn by sensible persons from the same Congressional enactment? Perhaps neither the language of section 1129 nor the statutory history gives an unequivocal answer to the Congressional intention. Whether the “words speak for themselves” in omitting mention of new value or whether these same words are covered by the invisible judicial gloss of *Case v. Los Angeles Lumber Products Co.*,¹⁷ I do not know. I suspect that the arguments based on the statutory history are partly reasons given for conclusions already reached and not syllogistic steps to such conclusions. Not above rationalizing my own prejudices, I cast my lot with those who find no new value exception in the language. I am impressed by Judge Pusateri’s point that Congress did not merely invoke the “fair and equitable standard” but in fact included a series of subsections that specifically defines the fair and equitable standard in several circumstances.¹⁸ Having taken one large step beyond a mere statement of the fair and equitable rule by its statement of section 1129(b)(2), why did Congress not go the next small step and spell out the new value exception if it intended the exception to exist? I believe that this omission gives at least a breath of support for the inference that Congress did not intend the new value exception to continue.

Additional support for that position rests in the disparate application of the fair and equitable standard announced in *Boyd* (as codified in section 77B(f) of the Bankruptcy Act) and section 1129(b)(2)(B)(ii) of the Bankruptcy Reform Act of 1978. The absolute priority rule is now applicable only when the plan proponent is seeking a “cramdown” on an impaired class that rejected the plan. If the requisite majority of creditors (at least two-thirds in amount and more than one-half in number, section 1126(c)) in each class has accepted the plan, then the plan can be approved even though some junior parties take and some senior parties are not paid. The absolute priority rule does not apply. In contrast,

16. *Id.* at 663 (citation omitted); accord *In re Drimmel*, 108 Bankr. 284 (D. Kan. 1989).

17. 308 U.S. 106 (1939).

18. *In re Drimmel*, 108 Bankr. 284, 289 (D. Kan. 1989).

confirmation under section 77B(f) required class approval *and* compliance with the fair and equitable standard (including the absolute priority rule).

When one considers the “new value” exception to the absolute priority rule, this distinction is important. Since the absolute priority rule was a threshold condition for confirmation of any plan under section 77B(f), the judge-made “new value” exception found in *Case* gave plan proponents some leverage when dealing with an obstinate *minority* of creditors who could otherwise block confirmation.¹⁹

Today, obstinate inflexible minority creditors within an accepting class cannot demand plan compliance with the absolute priority rule, for section 1129(b)(2)(B)(ii) applies only when the class as a whole has rejected the plan. Thus, to the extent one views the new value exception as a means of silencing minority creditors within an accepting class, there is no longer any need for such an exception under the Bankruptcy Reform Act of 1978, given the revised confirmation standard of section 1129.²⁰

There is one additional statutory argument for the new value exception. This is the argument based upon the prepositional phrase “on account of such junior claim” that appears at the end of the absolute priority rule quoted above. It states that the equity holder cannot retain any interest “on account of such junior claim.” Could that equity holder retain an interest “on account of” new value that was contributed?²¹ To the extent that current equity holders are able to retain interests in existing reorganized corporations because only they can propose plans under 1121’s exclusivity rule or because of insiders’ knowledge of the reorganized corporation, they *are* receiving a benefit “on account of such junior claim or interest.” It is their very status as the debtor in possession that entitles them to the exclusivity period (holding competitors at bay) and that grants them the knowledge sufficient to make a plan. Thus, with Judge Pusateri,²² I find the statutory argument based on the preposition (on account of) not persuasive.

Since 1978, the Sixth and the Seventh Circuits have applied the new value exception.²³ Both assume and neither questions the

19. The Supreme Court noted that the “new value” would be used “not only to provide new working capital but also to pay dissenting creditors.” *Case*, 308 U.S. at 121 n.15. Minority creditors are those creditors within an accepting class which have rejected the plan (less than two-thirds in amount and no more than one-half in number in their class).

20. It is important to note that if *Case* were decided today under § 1129 then the plan would have been confirmed since over 90 percent of the objecting creditors’ class had accepted the plan.

21. That argument is made in *In re Snyder*, 99 Bankr. 885 (S.D. Ill. 1989).

22. *Drimmel*, 108 Bankr. at 290.

23. *In re U.S. Truck Co., Inc.*, 800 F.2d 581 (6th Cir. 1986); *In re Potter Material*

existence of the exception. In a recent Seventh Circuit case,²⁴ Judge Posner has made clear that the earlier Seventh Circuit application of the new value exception in *In re Potter Material Service, Inc.*²⁵ should not be read to bind the Seventh Circuit to that position. "We emphasize, however, that the issue is an open one in this circuit, *Potter* notwithstanding. A point of law merely assumed in an opinion, not discussed, is not authoritative."²⁶ Thus, even though two circuits appear to embrace the new value exception as having continued existence after 1978, they are weak authority for that position since the existence was assumed in both cases and not contested in either.

The court of appeals' decisions are yet less persuasive than they might otherwise be because they were both decided prior to the Supreme Court decision in *Norwest Bank Worthington v. Ahlers*.²⁷ In *Ahlers*, the Court held that "sweat equity" — the addition of extra labor — is not sufficient to satisfy the new value requirement, assuming *arguendo* that the new value exception exists.²⁸ In an amicus brief in that case, the Solicitor General had argued that the new value exception did not survive the 1978 enactment and urged the Court to decide the case on that basis. The Court declines that offer, but it makes clear that one should not draw an inference that the new value exception continues to exist from its refusal to deny its existence:

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.²⁹

IV. APPLYING THE RULE

Assuming, *arguendo*, that the rule lives, how does one apply

Serv., Inc., 781 F.2d 99 (7th Cir. 1986); *cf. In re Anderson*, 913 F.2d 530 (8th Cir. 1990) (proposed reorganization with \$5000 additional capital was insufficient to invoke the new value exception for farming business).

24. *In re Stegall*, 865 F.2d 140 (7th Cir. 1989); *see also* *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351 (7th Cir. 1990) (Easterbrook, J., rejecting new value on facts of that case).

25. 781 F.2d 99 (7th Cir. 1986).

26. *Stegall*, 865 F.2d at 142.

27. 485 U.S. 197 (1988).

28. *Id.* at 204.

29. *Id.* at 203 n.3 (citations omitted).

it?

Because the new value rule is not codified and must, therefore, be drawn from language of several Supreme Court cases, the precise shape of the rule is uncertain. When reading Justice Douglas' dictum in *Case v. Los Angeles Lumber Co.*,³⁰ most find three requirements for the new value rule to be satisfied. First, the new value must be given in cash or something roughly equivalent to cash. Second, the new value must be a "necessity" for reorganization, and third, the payment must be roughly equivalent to the going-concern value of the business. Since Justice Douglas held that the proposal in *Case* did not meet the new value test, we can only guess from his opinion what would meet it.

The requirement that any new value be contributed in the form of cash or something equivalent to cash has real bite. Part of the reason Justice Douglas rejected the proposal in *Case* was that the new value was to be composed in part of the connections and business acumen of the existing shareholders. More than any of the other *Case* requirements, that one stands on a firm footing.

It has been further strengthened in the Supreme Court's 1989 decision in *Norwest Bank Worthington v. Ahlers*³¹ and by a recent decision of Judge Easterbrook in the Seventh Circuit.³² In effect, the Ahlers suggested that they would add new value that would go to the benefit of the creditors by working longer hours or more productively than they would otherwise work. By its reversal of the decision of the Court of Appeals for the Eighth Circuit, the Supreme Court flatly rejected sweat equity as satisfying the new value exception.

Several decisions have accepted shareholders' or managers' guarantees as contributions of new value to the plan. In *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*,³³ Judge Easterbrook rejected the guarantee of the debtor's obligation as a contribution of new value. In that decision, he concluded that *Ahlers* by implication also rejected such a contribution. He analogized the contribution of new value to the purchase of stock in an existing corporation and pointed out that under Illinois law, one could not purchase new stock by promising to perform services. Moreover, he noted that the guarantee of a shareholder is of uncertain value (for it depends upon the creditworthiness of the guarantor) and that it does not become an asset on the balance sheet of the debtor nor is it alienable. All of these factors make its value uncertain. A guar-

30. 308 U.S. 106 (1939).

31. 485 U.S. 197 (1988).

32. *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351 (7th Cir. 1990).

33. *Id.*

antee lacks many of the usual characteristics of an asset that might be used as collateral, be sold to raise money or form the basis of the satisfaction of a debt.

The combination of Justice Douglas's original decision with *Ahlers* and cases like *Kham & Nate* shows that the courts are serious in requiring money or money's worth and that they will not accept assets of indeterminate or uncertain value or assets that have significant limitations on their alienability.

The second requirement — that the new value coming from the shareholders be a "necessity" — does not carry a clear message. What is "necessary"? First, a payment from the shareholders could be necessary because no others will pay the same amount. Yet that hardly seems to fit the conventional meaning of the word. Second, the payment could be necessary: (1) because no one else would pay any amount, and (2) if there is no payment, the debtor will have to be liquidated. Of course, that idea is inconsistent with the thought that there is a going-concern value that is to be protected by the reorganization and that would otherwise be lost on a liquidation. How can one say there is a going-concern value when no one but the existing shareholders will make any payment for it?

To the extent that "necessity" means that liquidation will occur unless there is a capital contribution to pay existing creditors (suppliers and such), the necessity requirement is itself in conflict with other ideas in the new value rule. Let me explain. If, as Professors Baird and Jackson have argued³⁴ and as Judge Easterbrook has held,³⁵ the existing creditors are to be treated as "owners" and the new value is to be treated as a "purchase" of the company from them as the owners, that payment should go into the pocket of those creditors. If instead of going into their pockets, it is to be used as working capital of the debtor, ultimately paid out to other existing and new creditors for current operations, it cannot properly be regarded as a payment to the existing creditors for the going-concern value "owned" by them. Thus, to the extent that the necessity requirement carries the implication of a need for a quick capital infusion to be paid out to new and existing trade creditors, it conflicts with the most sophisticated articulation of the rule, namely, that the new value is a purchase of the company from the existing creditors.

If the necessity requirement is to have any meaning and practical application, it is not exactly clear how it is to be applied. Per-

34. Baird & Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738 (1988).

35. *Kham & Nate's Shoes*, 908 F.2d at 1360-63.

haps the court in *In re Jartran*³⁶ is talking about this requirement when it recites how parties have attempted over a period of time to sell the company and that no one but the shareholders were willing to bid for it. If that is the meaning, then cases like *Greystone*³⁷ violate the necessity requirement, for in that case Judge Clark explicitly states that he is not going to conduct an auction for the company and implicitly states that he is going to prefer the existing shareholders' plan over the secured creditor's plan by allowing the exclusivity period to bar the secured creditors from presenting a competing bid.

In summary, I am doubtful about the meaning of the necessity requirement. Perhaps it should be disregarded. It may simply have been Justice Douglas' admonition in *Case* to other courts that the new value exception should be rarely applied and that normally one would expect the shareholders to be wiped out and for others to own the company after the reorganization.

Third, the new value given must roughly equal the going-concern value of the business. In *Jartran*,³⁸ the court uses the testimony of several sophisticated financial analysts to determine the going-concern value of the business and thus to decide whether the contribution of the shareholders equals this value. In other cases, the courts are less true to this rule and sometimes simply state there is no going concern and therefore anything to be paid equals or exceeds it.³⁹

It is ironic that this portion of the new value exception invites the court to make the very error that the fair and equitable doctrine is designed to protect against. That is, a principal reason for the fair and equitable doctrine is to keep the courts from making unfairly low valuations of the assets and so undermining the rights of the creditors. Yet, here, we return to the same forum to ask for valuation of the same property in applying the new value exception.

I believe that the third requirement is likely to be an empty rule. Only by arranging for others to investigate the value of the concern and allowing them to bid against the shareholders on a fair basis is one likely to determine the true going-concern value. Even experts as sophisticated as those in *Jartran* can make only

36. 44 Bankr. 331 (N.D. Ill. 1984).

37. *In re Greystone III Joint Venture*, 102 Bankr. 560 (E.D.N.Y. 1981).

38. 44 Bankr. 331 (N.D. Ill. 1984).

39. *In re Aztec Co.*, 107 Bankr. 585 (M.D. Tenn. 1989); *In re Greystone III Joint Venture*, 102 Bankr. 560 (W.D. Tex. 1989); *In re Jartran*, 44 Bankr. 331 (N.D. Ill. 1984); *In re Landau Boat Co.*, 13 Bankr. 788 (W.D. Mo. 1981); *In re Marston Enter., Inc.*, 13 Bankr. 514 (E.D.N.Y. 1981).

educated guesses.⁴⁰

As one sees when he reads the cases discussed below, the three rules distilled from *Case* do little to inspire confidence (at least in a mildly skeptical observer) that the new value exception will not tear a large hole in the fair and equitable rule and will not invite exactly the abuses that the fair and equitable rule is to prevent. On the other hand, some of the cases show reasons why the rule might help to produce efficiencies that could not otherwise be achieved.

V. THE CASES

The cases, decided by the courts under the 1978 Code, can be divided chronologically or by representative fact pattern.⁴¹ Chronologically, *Ahlers* may be a milestone. Remember that *Ahlers* was the Supreme Court's reversal of a decision of the Court of Appeals for the Eighth Circuit. The court of appeals decision was the warmest embrace ever given to the new value rule by a court after 1978. Both of the other court of appeals decisions that approved plans based upon the new value exception also preceded *Ahlers*.

40. If one read into the going concern equivalence requirement the implication that value should go into the hands of the "owning creditors," and should not be used for continuing operation of the business, there might be some bite to the requirement. The objection of the Supreme Court in *Ahlers* and of Judge Easterbrook of the Seventh Circuit in *Kham & Nate's Shoes* to "certain payments" as new value might ultimately rest on the proposition that these are not new value not because they are not new value to the debtor, but because they are not payments to the existing creditors as a purchase for their rights in the company. If, ultimately that is the interpretation placed on *Ahlers* and *Kham & Nate's Shoes* and by them upon the third requirement, it will have clarified the law and produced a desirable outcome.

41. I have found 16 cases that deal at length with the new value exception. Doubtless I have missed some, and there are many others that mention the exception in passing. I have divided the cases into four categories. The first category includes those cases which have accepted the existence of the new value exception and have applied it. Second are cases that accept the proposition but, for one reason or another, do not approve the debtor's plan. Third are cases that do not accept the plan and express doubt about the continuing vitality of the rule. The final category of cases do not accept the plan and find that the new value exception did not survive the 1978 enactment of the Code.

Accepted and applied: *In re U.S. Truck Co., Inc.*, 800 F.2d 581 (6th Cir. 1986); *In re Potter Material Serv., Inc.*, 781 F.2d 99 (7th Cir. 1986); *In re Greystone III Joint Venture*, 102 Bankr. 560 (W.D. Tex. 1989); *In re Jartran*, 44 Bankr. 331 (N.D. Ill. 1984); *In re Landau Boat Co.*, 13 Bankr. 788 (W.D. Mo. 1981).

New value exception accepted but not applied: *In re Mortgage Invest. Co. of El Paso*, 111 Bankr. 604 (W.D. Tex. 1990); *In re Pullman Constr. Indus., Inc.*, 107 Bankr. 909 (N.D. Ill. 1989); *In re Aztec Co.*, 107 Bankr. 585 (M.D. Tenn. 1989); *In re Sawmill Hydraulics, Inc.*, 72 Bankr. 454 (C.D. Ill. 1987); *In re Marston Enter., Inc.*, 13 Bankr. 514 (E.D.N.Y. 1981).

New value exception not applied and doubt expressed about its vitality: *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988); *Kham & Nate's Shoes No. 2 Inc. v. First Bank of Whiting*, 908 F.2d 1351 (7th Cir. 1990); *In re Stegall*, 865 F.2d 140 (7th Cir. 1989); *In re Ashton*, 107 Bankr. 670 (D.N.D. 1989).

New value exception abolished by the Congressional enactment of the 1978 Code: *In re Drimmel*, 108 Bankr. 284 (D. Kan. 1989); *In re Winters*, 99 Bankr. 658 (W.D. Pa. 1989).

Neither those cases, nor any of the bankruptcy cases decided prior to *Ahlers*, gave careful consideration to the possibility that the passage of the Code in 1978 had abolished the exception. Most courts addressed only the question of whether the terms of the plan before it satisfied the requirements of *Case v. Los Angeles Lumber Co.*⁴² In effect, these courts assumed — as presumably the lawyers had assumed — that the new value exception continued to exist.

As indicated above, the Justice Department amicus brief in *Ahlers* argued that the new value exception had been extinguished by the passage of the Bankruptcy Code in 1978. The Supreme Court explicitly refused to address that question and stated that one should not infer from its refusal either that the exception lived or that it died in 1978. The Supreme Court's response to the questions raised by the Justice Department alerted the lawyers and the courts to the possibility that the new value exception had been repealed and, as we see above, some lower courts have since held the exception did not survive the 1978 Code.

By striking down a particular application of the new value exception, *Ahlers* also caused courts to be more critical about the kind of contribution by the shareholders that could be recognized as new value. If the farmer's sweat equity was not new value, what did that tell about guarantees by the shareholder, payment of lawyers' fees and other debts or promises of future payment to new creditors of the existing business? Representative of these latter cases, that not only show skepticism about the continued existence of the exception but also restrict the kind of contribution that constituted new value, was Judge Easterbrook's decision in *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*.⁴³ It is possible

42. 308 U.S. 106 (1939).

43. 908 F.2d 1351 (7th Cir. 1990). There Judge Easterbrook commented as follows on the exception:

Bank asks us to hold that the new value exception vanished in 1978. We stop short of the precipice, as the Supreme Court did in *Ahlers*, 485 U.S. at 203-04 n.3, for two reasons: first, the consideration for the shares is insufficient even if the new value exception retains vitality; second, although Bank vigorously argues the merits of the new value exception in this court, it did not make this argument in the bankruptcy court. Despite Bank's failure to preserve its argument, the history and limits of the rule before 1978 are pertinent to our analysis because, as the Court held in *Ahlers*, 485 U.S. at 205-06, at a minimum the Code forbids any expansion of the exception beyond the limits recognized in *Case*.

Case rejected the argument that continuity of management plus financial standing that would attract new investment is "new value". According to the Court, only an infusion of capital in "money or money's worth" suffices. *Ahlers* reinforces the message, holding that a promise of future labor, coupled with the managers' experience and expertise, also is not new value. It remarked that the promises of the managers in *Case* "[n]o doubt . . . had 'value' and would have been of some benefit to any reorganized enterprise. But ultimately, as the Court said . . . , '[t]hey reflect merely

that we have seen the high point of the new value exception. Subsequent cases in the lower courts or in the Supreme Court may find that the exception did not survive the 1978 enactment. At minimum, the *Ahlers* decision has caused a searching skepticism in the lower courts about the meaning of the rule and the modes of satisfying it.

As a basis for considering the justifications for the rule, consider the facts of four cases in which the shareholders or partners proposed plans based on the application of the rule. In all four of these cases, the courts found the rule was applicable and satisfied, but in one of them the court rejected the plan for other reasons.

Here, I mean to direct the reader's consideration to the application of the rule to specific and generic sets of facts. The first two cases, *Greystone*⁴⁴ and *Marston*,⁴⁵ are known in the bankruptcy

vague hopes or possibilities.' The same is true of respondents' pledge of future labor and management skills." 485 U.S. at 204 (citations omitted). The Court observed, *ibid.*, again quoting from *Case*, that the promise was "intangible, inalienable, and, in all likelihood, unenforceable. It 'has no place in the asset column of the balance sheet of the new [entity].'"

Guarantees are no different. They are intangible, inalienable, and unenforceable by the firm. Beard and Parker may revoke their guarantees or render them valueless by disposing of their assets; although a lender may be able to protest the revocation, the debtor cannot compel the guarantor to maintain the pledge in force. Guarantees have "no place in the asset column" of a balance sheet. We do not know whether these guarantees have the slightest value, for the record does not reveal whether Parker and Beard have substantial unencumbered assets that the guarantees would put at risk. If Beard and Parker were organizing a new firm in Illinois, they could not issue stock to themselves in exchange for guarantees of loans. Illinois requires the consideration for shares to be money or other property, or "labor or services actually performed for the corporation", Ill.Rev.Stat.ch.32 ¶6.30. So Beard and Parker could subscribe for shares against a promise of labor, but the firm could not issue the shares until the labor had been performed. A guarantee does not fit into any of the statutory categories, and there is no reason why it should. One who pays out on a guarantee becomes the firm's creditor, a priority higher than that of stockholder. A guarantor who has *not* paid has no claim against the firm. Promises inadequate to support the issuance of shares under state law are also inadequate to support the issuance of shares by a bankruptcy judge over the protest of the creditors, the real owners of the firm.

Debtor relies on *In re Potter Material Service, Inc.*, 781 F.2d 99 (7th Cir. 1986), but it does not support the bankruptcy judge's decision. The new value in *Potter* was a combination of \$34,800 cash plus a guarantee of a \$600,000 loan. If Beard and Parker had contributed substantial cash, we would have a case like *Potter*. They didn't, and we don't. To the extent *Potter* implies that a guarantee alone is "new value", it did not survive *Ahlers*. *Potter* observed that the guarantor took an economic risk, 781 F.2d at 103. *Ahlers* holds that *detriment* to the shareholder does not amount to "value" to the firm; there must be an infusion of new capital. See John D. Ayer, *Rethinking Absolute Priority after Ahlers*, 87 Mich.L.Rev. 963 (1989). A guarantee may be costly to the guarantor, but it is not a balance-sheet asset, and it therefore may not be treated as new value. The plan of reorganization should not have been confirmed over Bank's objection.

Id. at 1362-63 (parallel citations omitted).

44. 102 Bankr. 560 (W.D. Tex. 1989).

trade as "single asset" cases. In both, the debtor's single asset was a piece of developed real estate. In *Marston*, it was an apartment complex of 184 units; in *Greystone*, it was a commercial building in Austin, Texas. The fourth case is *Jartran*.⁴⁵ *Jartran* lies at the opposite end of the complexity spectrum from *Greystone* and *Marston*. It involved the operation of a large, nationwide going-concern that was operated in Chapter 11 for almost three years by the purchasing shareholder. Only the third modification of the fifth plan was approved in *Jartran* and that case required the negotiation with and the agreement of many different creditors — secured, trade, general unsecured and unsecured holding claims such as lawsuits. The third case, *Potter Material*,⁴⁷ lies somewhere between the others. Potter was a modest operating business. A controlling shareholder operated the business, proposed the plan and was the beneficiary of the new value exception. I will first recount the facts of each of the four cases and then use them as a basis for considering the theoretical arguments in favor of and against the new value exception to the absolute priority rule.

A. In re *Greystone III Joint Venture*⁴⁸

In *Greystone*, the court approved a plan over the objection of Phoenix Mutual Life Insurance Company, the mortgagee on a commercial building. The plan proposed to give Phoenix the present value of the mortgaged premises, and, three cents on the dollar for both the trade debt as well as its \$3,475,000 deficiency. The plan would also pay taxes of more than \$108,000 and "assure payment" of seventy-five percent of the tenants' security deposit claims. The partners proposed to keep their interest by making a contribution of \$500,000 to the estate. This new value was to be used to pay the items specified above, including the three percent dividend to Phoenix. Phoenix objected that the plan was not fair and equitable.

In finding the new value exception was satisfied, the court rejects Phoenix's argument. It makes no findings about the going-concern value of the partnership. The court notes that Phoenix had indicated its willingness to pay off the unsecured creditors, complete the tenant "finish out obligations," but found that it was not a source of "working capital" because Phoenix would not make any such payment unless it could take over ownership of the property. In a telling footnote, Judge Clark emphatically rejects the

45. 13 Bankr. 514 (E.D.N.Y. 1981).

46. 44 Bankr. 331 (N.D. Ill. 1984).

47. 781 F.2d 99 (7th Cir. 1986).

48. 102 Bankr. 560 (W.D. Tex. 1989).

theory under which Judge Easterbrook and other commentators have proceeded, namely, the theory that the existing owners were "purchasing" the company for the new value and that they have a right to do so only to the extent that they give greater new value than others would give. Judge Clark responds to that suggestion as follows:

It is important to emphasize that, due to the nature of the *Case* capital infusion exception, it is inappropriate to approach the problem as though the ownership of the entire enterprise were up for sale. That is simply not the issue at all. Instead the question is whether there is an available source of capital to fund the plan. . . . In other words, the issue of where to get the cash to make the plan work is not an opportunity to undermine the plan. Instead, if the plan *fails*, then another party in the case with standing may propose an alternative plan.⁴⁹

B. *In re Marston Enterprises Inc.*⁵⁰

The shareholders⁵¹ proposed to purchase the sole asset of Marston Enterprises, an apartment complex containing 184 units. They proposed to pay \$900,000 for the complex and to take title to it. The payment was to go to the holder of the first mortgage for a mortgage debt of \$2,300,000. The unsecured portion of the mortgage debt, \$1,400,000, was to be discharged with no payment, as were the claims of other unsecured creditors. The new value apparently constituted the \$900,000 together with some other undetermined contribution to future operating expenses allegedly equal to \$300,000 to \$400,000. The plan was rejected because the shareholders had not been clever enough to construct even one class who would vote for the plan, and thus it did not qualify under section 1129(a)(10). The court in dictum, nevertheless, concluded that the new value exception had been met and presumably would have approved the plan but for the failure of an impaired class to vote for it. Had the plan been approved, the mortgagor would successfully have written the mortgage down to the amount found by the court to be the value of the property. Having discharged all of its unsecured debt with no payment, the debtor would have kept for itself the going-concern value, if any, over the \$900,000. Here, one might regard this "value" as a call option on any increase in value of the real estate.

49. *Id.* at 577 n.22.

50. 13 Bankr. 514 (E.D.N.Y. 1981).

51. The parties were actually shareholders of a co-debtor but were found to be *the* "shareholders."

C. *In re Potter Material Service, Inc.*⁵²

In *Potter Material*, the debtor proposed a payment of three percent to the unsecured creditors. The controlling shareholder proposed to keep the equity in the company by guaranteeing certain debt and by contributing sufficient new value. Twenty thousand of this new value was to pay off the debtor's lawyer for his representation of the debtor in bankruptcy and the other \$14,800 was to fund the three percent payment to the unsecured creditors.

The Court of Appeals for the Seventh Circuit affirmed a finding that the new value exception had been satisfied. The court concluded that this payment equalled the going-concern value of the company. There is no finding whether the going-concern value was considered in setting the three percent payment to the unsecured creditors or whether that number was arrived at by determining liquidation value of the company. In its brief, the creditors' committee complains that the controlling shareholder had drawn excessive payments out of the company before the bankruptcy and argues that he would do so afterwards. In effect, the creditors argue that the shareholder was taking the going-concern value for himself in the form of salary and personal expense payments.

D. *In re Jartran*⁵³

Jartran Truck and Trailer Rental Company competed with U-Haul, Ryder Systems, and Hertz in the market for rental of trucks and of trailers to be pulled by automobiles. Formed in 1978, the company began having economic difficulties as early as 1980. The difficulties intensified in 1981 and the owners sought a joint venture or a buy out partner. Early in 1981, the controlling shareholders signed a letter of intent to sell the company to Ameribond Securities Associates. That transaction contemplated the sale of a majority interest for a "capital infusion" of possibly \$20 million. Ultimately, the Ameribond deal fell through. In December of 1981, the Jartran shareholders struck a deal with Frank B. Hall and Co., Inc. Under the terms of the December 31, 1981 agreement, Hall agreed to purchase most of the shares of Jartran from the various shareholders. Although Hall acquired the stock on that date, most of the payments for the stock were deferred and contingent. On the same day (and presumably at Hall's direction), Jartran filed a petition under Chapter 11. For approximately three years, Hall ran the company, negotiated with the creditors and proposed various Chapter 11 plans. On September 29, 1984, Judge Fisher confirmed

52. 781 F.2d 99 (7th Cir. 1986).

53. 44 Bankr. 331 (N.D. Ill. 1984).

the third modification of Hall's fifth plan.⁵⁴ Hall's principal antagonist was U-Haul who presumably had various legitimate and perhaps some illegitimate interests in Jartran's future. In an opinion of more than eighty pages, Judge Fisher confirmed the plan over a multitude of objections by U-Haul.

The opinion well demonstrates the complexity of such a plan and the difficult judgments that have to be made in applying the best interest rule, the absolute priority rule, and other provisions of section 1129.

Among other things, U-Haul complained that Hall, as the principal shareholder, did not meet the new value exception in the case.⁵⁵ Aided by extensive and expert testimony from various financial experts, the court makes explicit findings not only about the liquidation value of the company, but also about its going-concern value and the value of the shareholders' equity. The court addresses the new value exception as follows:

The Court's estimate of the updated value of shareholders' equity is negative \$18,500,000, being the difference between the \$52,500,000 going concern value and the \$71,000,000 value of debt. Accordingly, one aspect of the *Los Angeles Lumber* test is satisfied. Inasmuch as the shareholders' equity is valueless, any contribution by Hall will necessarily be equal to or greater than the value of its 100% ownership interest.

The Court further finds that Hall is the most feasible source of the new capital and that its contribution is necessary to assure the viability of reorganized Jartran. As explained in greater detail *infra* in connection with U-Haul's contentions concerning § 1129(a)(3), the company was marketed for a substantial period prior to the filing of the petition herein. Other than the proposed Hall acquisition, no firm commitment for financing was obtained. Nor has Debtor received any such commitments since the filing of the petition on December 31, 1981. After a review of the entire record, the Court is satisfied that the Hall contribution is necessary to Jartran's successful reorganization within the purview of the *Los Angeles Lumber* decision.⁵⁶

To support its position, the Court notes that debtor engaged in a "thorough marketing effort, wherein its tax attributes were disclosed and highlighted. No viable offers materialized other than that of Hall"⁵⁷

Hall's contribution of new value constituted several million

54. *Id.*

55. The absence of any discussion of the question whether the new value exception had survived passage of the 1978 Code suggests that argument was not made by U-Haul.

56. *Jartran*, 44 Bankr. at 379 (footnote omitted).

57. *Id.* at 381.

dollars of guarantees, a \$5,000,000 equity contribution, and a commitment to an investment of \$52,000,000 to acquire certain secured claims. Apparently, the \$52,000,000 "investment" was Hall's purchase of the position of two of the secured creditors, Ford and Chrysler. In effect, this constituted a \$52,000,000 loan to Jartran by Hall. The court approved the plan.⁵⁸

VI. CONCLUSION

Three of the reasons why a creditor would argue for the rejection of the new value exception are quite clear and not difficult to understand. Whether one accepts one of these arguments will depend in part upon an empirical judgment. Whether one accepts the others will depend upon a policy judgment about the role of reorganization. Each of the creditor's arguments has to do with the bargain that the creditor believes he has made with the debtor and with the rights that arise out of that bargain.

First and most important, a creditor would argue that broad application of the new value exception will deprive him of something that the Supreme Court explicitly and Congress implicitly have granted to him, namely, a first claim on the going-concern value of the business. Consider a bar graph like the following.

A
X

Next, assume that the liquidation value is the area marked X and that the area marked A is the additional going-concern value. Finally, assume that the claims of the objecting creditor class exceed the sum of A and X. In such circumstances, the creditors have a right not merely to the liquidation value under section 1129(a)(7), but also to the going-concern value. This right was explicitly confirmed by the Supreme Court in *Consolidated Rock Prod. Co. v. Du Bois*.⁵⁹ None of the cases decided since 1978 dissents from that proposition; in fact, most of the cases decided since 1978 maintain that they are giving the creditors the entire going-concern value even though they are applying the new value exception.⁶⁰ They reach that conclusion by finding that the new value contributed exceeds the sum of the liquidation value and the going-concern

58. *Id.* 384 at n.115.

59. 312 U.S. 510 (1941).

60. *In re U.S. Truck Co., Inc.*, 800 F.2d 581 (6th Cir. 1986); *In re Potter Material Serv., Inc.*, 781 F.2d 99 (7th Cir. 1986); *In re Greystone III Joint Venture*, 102 Bankr. 560 (W.D. Tex. 1989); *In re Jartran*, 44 Bankr. 331 (N.D. Ill. 1984); *In re Landau Boat Co.*, 13 Bankr. 788 (W.D. Mo. 1981).

value.⁶¹

In these cases, creditors invariably argue one or both of the following: (1) that the court has undervalued the assets;⁶² and (2) that the court has overvalued the debtor's promise of future payment.⁶³

This basic creditor argument is about valuation and only about valuation. This argument rests on the empirical proposition that Chapter 11 is an organism constructed by Congress and composed of a debtor with unique and intimate knowledge of the business, of debtor's persuasive witnesses concerning value, and of a judge sympathetic to reorganization at almost any cost. In the creditor's view, this organism is congenitally required to undervalue the assets, overvalue the debtor's promises, and so to discriminate against the creditor's interests. In response, debtors will maintain that the courts are objective — or at least not biased in favor of debtors — and that there is no evidence of systematic undervaluation of assets or overvaluation of promises in any event.

Whether one is persuaded by the creditors' first argument might depend upon his judgment about the probability of bias in the valuation process. If one could show that the creditors' claims are empirically true, namely, that the combination of debtor knowledge, concentrated debtor interest, and a sympathetic judiciary produces an understatement of the true value of the assets or an overstatement of the value of debtor's promises in a large percentage of the cases, it would be easy to side with the creditors and to conclude that the new value exception should be rejected.

I know of no empirical studies that answer that question. The only data from which one might draw an inference of bias in favor of debtors is the fact that debtors are so anxious to buy. Why do debtors fight so vigorously for the right to pay full value?⁶⁴

Some might argue that even if the frequency of error in valuation is small, the law should neither be written nor interpreted to expose the creditors even to such occasional error. One making such an argument might point to the exclusivity period, to the automatic stay, and to the other rules that enable the debtor in possession to conduct the business as sufficient weapons in the

61. See, e.g., *In re Jartran*, 44 Bankr. 331, 367-68 (N.D. Ill. 1984).

62. They will maintain that the debtor's experts are not correct and that the going-concern value and possibly the liquidation value substantially exceed the number put forward by the debtor.

63. If the plan proposes a payment over time, one must value not only the assets in cash terms, but also the present value of these promises of future payments. If the court grants too high a value to these promises, creditors suffer the same consequences as if the assets are given too little value.

64. For reasons discussed below, I hesitate to draw an inference of bias from that fact.

debtor's hands.

The creditors' arguments will not end with questions about estimation of going-concern value of the business or calculation of the present value of the debtor's promises. Creditors may have bargained not merely for going-concern value A, but also for the greater value B that constitutes *this debtor's* idiosyncratic value. In many cases, the value of assets of a business in Chapter 11 can be portrayed as follows:

B
A
X

Here X is liquidation value, A is going-concern value, and B is an added increment of going-concern value idiosyncratic to *this* debtor.

Clearly, different persons value the same object differently. In a perfect market, such differences are slight, but one can imagine many markets for businesses where the variations would be great and where the debtor might value certain assets at considerably more than the market would. An obvious example is the debtor's value⁶⁵ in a homestead that may have been in the debtor's family for generations. Personal attachment to the land may cause the farmer to value the land at tens or hundreds of dollars an acre more than others who have no similar attachment to it. The same kind of sentimental attachment is possible in small business operations, but it seems much less likely to be found where the asset is a large commercial property or a publicly traded business. Yet, even in the latter cases there may be idiosyncratic value arising out of synergy, unique knowledge or expertise of the debtor, or, out of the debtor's ignorance of other opportunities. For any one of these reasons, the debtor may value the business by some increment B, which is greater than the general going-concern value and liquidation value attributed to the business by third parties.

In such cases, the creditor will argue that he has bargained for and is entitled to this additional increment of value, B. In the typical state-law foreclosure, the debtor must pay the full value of the debt in order to redeem.⁶⁶ Only when the creditor's full debt is paid must the creditor return the asset. Such a rule gives the credi-

65. For cases wrestling with this very question in another context, see *In re Dewsnup*, 908 F.2d 588 (10th Cir. 1990); *Gaglia v. First Fed. Sav. & Loan Ass'n*, 889 F. 2d 1304 (3rd Cir. 1989); *In re Lindsey*, 823 F.2d 189 (7th Cir. 1987).

66. See, e.g., U.C.C. § 9-506 (1990).

tor both the right and the power to extract this idiosyncratic value from the debtor.

Congress, the Federal Trade Commission (FTC), and the courts have all addressed the issue of a creditor's claim on debtor's idiosyncratic value in at least three settings. The FTC has found it an unfair trade practice for a secured creditor to take a non-purchase-money, nonpossessory security interest in certain household goods.⁶⁷ Section 522(f)(2) of the Bankruptcy Code produces a similar result by avoiding nonpossessory, nonpurchase-money security interests, even though perfected, in certain things such as household furnishings, the debtor's dog and trumpet, and the wooden leg of the debtor's child.⁶⁸ Arguably, some courts are doing the same thing by allowing debtors to use section 506(d) of the Bankruptcy Code in combination with Chapter 7 of the Bankruptcy Code to redeem their homes for far less than the value of the mortgages.⁶⁹ Finally, of course, there is Chapter 12 on farmer

67. The pertinent FTC regulation reads:

(i) *Household goods.* Clothing, furniture, appliances, one radio and one television, linens, china, crockery, kitchenware, and personal effects (including wedding rings) of the consumer and his or her dependents, provided that the following are not included within the scope of the term "household goods":

- (1) Works of art;
- (2) Electronic entertainment equipment (except one television and one radio);
- (3) Items acquired as antiques; and
- (4) Jewelry (except wedding rings).

16 C.F.R. § 44.2(a)(4) (1990).

68. Section 552(f) reads in full as follows:

(f) Notwithstanding any waiver of exemptions, the debtor may avoid the fixing of a lien on an interest of the debtor in property to the extent that such lien impairs an exemption to which the debtor would have been entitled under subsection (b) of this section, if such lien is—

- (1) a judicial lien; or
- (2) a nonpossessory, nonpurchase-money security interest in any—
 - (A) household furnishings, household goods, wearing apparel, appliances, books, animals, crops, musical instruments, or jewelry that are held primarily for the personal, family, or household use of the debtor or a dependent of the debtor;
 - (B) implements, professional books, or tools, of the trade of the debtor or the trade of a dependent of the debtor; or
 - (C) professionally prescribed health aids for the debtor or a dependent of the debtor.

11 U.S.C.A. § 522(f) (West 1979).

69. For cases in favor of this policy, see, e.g., *Gaglia v. First Fed. Sav. & Loan Ass'n*, 889 F.2d 1304 (3rd Cir. 1989); *In re Moses*, 110 Bankr. 962 (N.D. Okla. 1990); *In re Brouse*, 110 Bankr. 539 (D. Colo. 1990); *In re Zlogar*, 101 Bankr. 1 (N.D. Ill. 1989); *In re Tanner*, 14 Bankr. 933 (W.D. Pa. 1981).

For cases denying the debtor the ability to redeem its home for less than mortgage value, see, e.g., *In re Dewsnup*, 908 F.2d 588 (10th Cir. 1990); *In re Schrum*, 98 Bankr. 995 (W.D. Okla. 1989); *In re McLaughlin*, 92 Bankr. 913 (S.D. Cal. 1988); *In re Maitland*, 61 Bankr. 130 (E.D. Va. 1986).

For cases treating tangentially related issues, see *In re Folendore*, 862 F.2d 1537 (11th Cir. 1989); *In re Lindsey*, 823 F.2d 189 (7th Cir. 1987).

bankruptcy, where Congress explicitly rejected the absolute priority rule. In Chapter 12, Congress made a conscious policy judgment to deny the secured creditor a claim on the debtor's idiosyncratic value in his farm.⁷⁰

Although it may not be obvious that creditor is claiming the debtor's idiosyncratic value in all of these cases, I believe that element lies at the heart of all three. In the cases involving consumer goods under the FTC rules and under section 522(f), the assets, prosthetic devices, household goods and such, rarely have more than trivial value to third parties even though they may have great sentimental and even economic value to the debtor. Understanding this, the creditor exerts his power by threatening to deprive the debtor of this valuable asset even in circumstances where the creditor cannot profitably dispose of it to any third party.

The same issue is at work in the 506(d) case and in the farmer bankruptcy cases. In each of those, the debtor is seeking to retain his homestead; in each, it is plausible that the homestead has greater value to him than to any other party, partly for sentimental reasons and possibly for economic reasons.⁷¹ The conscious omission of the absolute priority rule in Chapter 12 seems directly aimed at allowing that increment of value to rest with the debtor. The same will be the consequence if the Third Circuit rule in *Gaglia v. First Federal Savings & Loan Association*⁷² is ultimately adopted by the Supreme Court or by Congress. There, a debtor in Chapter 7 sought to retain his home by the payment to the mortgagee of an amount equal to the value of the home (as found by the court) but less than the amount of the mortgage debt. The debtor, in such cases, discharges the additional increment of debt as unsecured. There is a common thread in all of these, namely, a debtor whose idiosyncratic value exceeds "market" value. In all of them, the creditor is deprived of that value.

The outcome in these cases could be justified on either of two grounds. First, one might argue that any seizure of the property from the debtor in these cases will be inefficient, for by hypothesis it will destroy an increment of value. As I indicate below, how the efficiency equation comes out is subject to dispute. The second ar-

70. White, *Taking from Farm Lenders and Farm Debtors: Chapter 12 of the Bankruptcy Code*, 13 J. CORP. L. 1, 14-15 (1987).

71. The farmer who has farmed a particular plot for years may value it more highly than another person for several reasons. First, it will cost the farmer to move. If he can stay on the land, he will avoid that expense. Second, his operation of the land may have given him an insight about how the land is best used, which crops thrive in which parts of the property. Of course, there may be other factors such as the synergistic relationship between a particular plot of land and an adjoining plot also owned by the debtor.

72. 889 F.2d 1304 (3rd Cir. 1989).

gument on behalf of the debtor is a forthright moral argument that the creditor is too powerful and that it is unfair to allow him to use this bare power to deprive the debtor of something that has little or no independent value to the creditor.

While Congress and the FTC might be justified on moral grounds in protecting the debtor's interest in his hunting dog or his child's wooden leg, that protection cannot be justified on the ground that such security claims are not efficacious. On the contrary, the judgment by Congress and the FTC rests on the proposition that such security claims are too efficacious, that they give the secured creditor too much power.

Whatever one believes about security interests in personal property of an individual debtor or about the debtor's farm homestead, I fail to see how the same moral judgment can be made in a typical Chapter 11 case where the parties are quarreling over commercial buildings, a large or even a small business. In my view, neither *Marston*,⁷³ *Greystone*,⁷⁴ *Jartran*⁷⁵ nor *Potter Material*⁷⁶ justifies the kind of sympathetic response one sees for the individual debtor in section 522(f) and in the FTC rules.

Nor is the efficiency argument persuasive to me. As I have argued at greater length elsewhere,⁷⁷ it seems quite plausible that denying the debtor the power to grant security in the asset when he wishes to grant it will produce an inefficiency. Being foreclosed from granting a security interest in this idiosyncratic value, the debtor may look for other alternatives. Because security interests are inexpensive, the other alternatives (whether they are allowing the debtor's daughter to be held hostage, or whether they come in some other form) are likely to be more expensive. Failing such alternatives, the creditor's obvious response is to charge a higher price for its loan or to lend less money. In my view, therefore, the second argument against the new value exception is unpersuasive. I believe that creditors do bargain for the debtor's idiosyncratic value and should be granted it.

There is yet a third increment of value for which the creditor might bargain. This is value C; it is an alternative to and inconsistent with B.

B	C
X	

73. *In re Marston Enter., Inc.*, 13 Bankr. 514 (E.D.N.Y. 1981).

74. *In re Greystone III Joint Venture*, 102 Bankr. 560 (W.D. Tex. 1989).

75. *In re Jartran*, 44 Bankr. 331 (N.D. Ill. 1984).

76. *In re Potter Material Serv., Inc.*, 781 F.2d 99 (7th Cir. 1986).

77. White, *supra* note 70.

This is the value to the creditor of *depriving* the debtor of the asset. This value might arise out of the linkage that the creditor sees between this transaction and others. If, for example, the creditor lends to many commercial real estate operators, it may be in his interest to have a reputation of never agreeing to a plan of reorganization in which the debtor retains an interest. This reputation might cause the debtor to put in additional capital to stay out of bankruptcy or to operate the property in a less risky fashion than would otherwise be true.

Assume, for the sake of the argument, that the value to be gained in the form of reputation with other debtors (C), combined with the liquidation value (X) exceeds the value that the debtor is willing to pay for the property. Should the creditor be deprived of this value in bankruptcy? I do not think so. If this bargain is routinely recognized in state law, why not respect it in reorganization? Here some may get off the train. They might argue that allowing a creditor to exercise its vindictive interest is repugnant even though such exercise is economically rational when one considers the effect on other transactions.

The debtor's argument might be made in the *Jartran* case in a slightly different form. Recall that in *Jartran*, the principal objector to the plan was U-Haul. The plan was crammed down over U-Haul's objection and by a finding that the new value exception had been satisfied. In that case, U-Haul's principal motivation may have been to stop the rehabilitation of a competitor. If one excluded any economic interest of U-Haul (beyond its direct claim against Jartran), and assumed the destruction of the going-concern increment, allowing U-Haul to veto the reorganization would appear inefficient because it might cause a destruction of that going-concern value.⁷⁸ Yet, if one alters the efficiency equation to include the value to U-Haul of business profits gained by Jartran's liquidation, a veto of Jartran's reorganization and the consequent liquidation of Jartran cannot be said to be inefficient if the value to U-Haul exceeds the loss of going-concern value because of the liquidation. Even here, I fail to see why the court should protect Jartran from the bitter consequences of its bargain.

Since increment B (the idiosyncratic value of the debtor) is known only to the debtor, and increment C (the strategic value to the creditor of depriving this debtor the business if he does not pay in full) is known only to the creditor, one can give the creditor a claim on those values only by rejecting the new value exception

78. Note that it is not necessary that such an outcome *would* destroy the going-concern value because secured creditors in that case might well have purchased the company and continued the operation.

to the absolute priority rule. Only by allowing the creditors to negotiate directly with the debtor will one be able to find the debtor's value B. Only by leaving it at the exclusive judgment of the creditor to decide whether to sell can one be sure that the value to the creditor in depriving the debtor of ownership will be realized. Because it makes possible the unilateral imposition of a plan in a "cramdown," the new value exception frees the debtor from the necessity of getting the creditors' agreement, and reaching a negotiated agreement. Thus, if one accepts either or both of these reasons as a legitimate part of the creditor and debtor bargain, he should reject the new value exception in Chapter 11.

To view the arguments from the other side, consider now the claims, moral and economic, that might be made on behalf of the new value exception to the absolute priority rule. To some extent I have considered those arguments above, but it may be useful to articulate them in greater detail.

The moral argument was mentioned above: that the power of the creditor should be restrained at least as it applies to idiosyncratic value of the debtor that has no significant and independent economic value to the creditor. Presumably, this is what convinced Congress and the FTC that the creditor should not have a non-purchase money, non-possessory security interest in the debtor's crib, dog or in his child's wooden leg. That argument is weaker here. Although the creditor is claiming the idiosyncratic value of the debtor, a priori, that claim is less offensive in the *business* than the *consumer* context.

By hypothesis, the idiosyncratic value of the debtor cannot be transferred to another and must therefore benefit the creditor only because the threat of destruction of that value causes the debtor to pay all or most of it to the threatening creditor. It is a common negotiating technique — and a generally permissible one — to threaten one's opponent with an act that will not directly benefit the threatener except insofar as it changes the behavior of the person threatened. Section 176 of the Restatement of the Law of Contracts (Second) makes such a threat improper where the threatened act would harm the recipient and would not benefit the party making the threat *only* if the resulting exchange "is not on fair terms."⁷⁹ There is nothing unfair about full payment of a cred-

79. Section 176 provides:

When a Threat Is Improper

(1) A threat is improper if

- (a) what is threatened is a crime or a tort, or the threat itself would be a crime or a tort if it resulted in obtaining property,
- (b) what is threatened is a criminal prosecution,
- (c) what is threatened is the use of civil process and the threat is made in bad

itor's debt; thus, this case would not fall within 176(b). I conclude that whatever moral opprobrium attaches to the creditor's use of the debtor's attachment to the old homestead in Chapter 12, or his baby's crib under 522(f) and the FTC rules, no similar opprobrium attaches to depriving the debtor of his interest in a business or in a piece of commercial property where for some reason the debtor values that property more highly than others.

The second moral objection to rejecting the new value exception arises from completely different considerations. This is the argument that it is unfair to deny a right to the debtor to bid for the company at a time when others would be free to make an identical bid and conceivably to buy the company at that price. It is a kind of equal protection argument, an argument that it is morally inappropriate to make the debtor into a pariah. The response is the classic response to any equal protection argument: the two parties are not similarly situated. The reason to foreclose the debtor's bid is that the debtor is in a different position than a third party bidder. In the first place, the debtor is the one who is running the Chapter 11 and who has the opportunity to manipulate it. Therefore, the creditors need protection against this debtor that they do not need against third parties. Second, because of the debtor's knowledge of the business, the debtor is more likely to be able to understand where the benefit lies, to hide the appearance of that benefit and so to profit.

Finally, of course, one might argue that the debtor should be denied certain rights granted a third party on the ground that the debtor was at the steering wheel when the car careened into Chapter 11. Whether one accepts this latter argument, it seems to me that the equal protection argument is unpersuasive and that the debtor is in a sufficiently different position to justify quite different treatment of the debtor and of third parties.

In my view, the moral arguments that might be made to support the new value exception are not persuasive. This is not a case where the creditor is wielding excessive power, nor can the debtor make himself appear to be a victim of unjustified discrimination.

The more powerful and obvious argument for the new value

faith, or

(d) the threat is a breach of the duty of good faith and fair dealing under a contract with the recipient.

(2) A threat is improper if the resulting exchange is not on fair terms, and

(a) the threatened act would harm the recipient and would not significantly benefit the party making the threat,

(b) the effectiveness of the threat in inducing the manifestation of assent is significantly increased by prior unfair dealing by the party making the threat, or

(c) what is threatened is otherwise a use of power for illegitimate ends.

RESTATEMENT (SECOND) OF CONTRACTS § 176 (1982).

exception is the same argument that justifies all of Chapter 11: only through reorganization (here read "the new value exception") can one save the going-concern value that would otherwise be destroyed in the individualistic frenzy of the hungry creditors. In some cases there is an asset, the going-concern value, that can be preserved only by the new value exception and that would be destroyed by a strict application of the absolute priority rule. To attack that argument as a basis for Chapter 11 is a job for another day. Restricting oneself to the new value exception, I would argue that the argument does not justify the exception.

First, consider how the new value exception might facilitate reorganization and so preserve going-concern value that would otherwise be destroyed. To begin with, the debtor might be the highest bidder for the asset and if the debtor is foreclosed from bidding, this final increment of value will be lost. Secondly, the most favorable possible reorganization might be foreclosed by the absolute priority rule if an intermediate creditor class can veto it, even though that class would get nothing either in liquidation or in reorganization. Such a class might object to a plan (proposed jointly by the debtor and senior creditors) in order to earn a bribe. Assume a case in which the liquidation value of the company is \$100 million, the going-concern value is \$120 million, and the senior secured debt is \$150 million. If another \$50 million of unsecured debt lies between the shareholders and the secured creditors and if the secured creditors wish the shareholders to operate the reorganized company, such a reorganization might be forestalled by the veto of the unsecured creditors, even though those creditors have no claim either on a liquidation or on the going-concern value of the business.

A final way in which the new value exception might allow reorganizations that would not otherwise occur can be illustrated by *Jartran*. In that case, Frank B. Hall purchased the shares and immediately put the company into bankruptcy. Hall ran the company and negotiated plans for three years. It ultimately caused a plan to be accepted in which Hall was the principal owner of the company. Presumably, Frank B. Hall's incentive for devoting the time, effort, and money to the operation and reorganization was that it hoped to reap a significant profit in the form of greatly appreciated value of the company. If no similar mode of payment could be devised for someone to operate the company and put it back on its feet, and if any trustee appointed by the court or the creditors would necessarily run it into the ground (as seems to have been the routine practice in Chapter X prior to the enactment of the 1978 Code), the new value exception would have saved an asset otherwise to be lost.

Note how speculative are these prospects of efficiency gains. In the first place, each assumes a going-concern value that is greater than the liquidation value. Often there is no going-concern value; too frequently liquidation value exceeds going-concern value.⁸⁰ For example, consider Eastern Airlines, a company that has been in bankruptcy as this is written for approximately two years. Initially, the debtor in possession thought it possible to pay the Eastern creditors in full.⁸¹ Recent news reports indicate that the creditors will be paid far less than that; the airline has run at a loss continuously since it entered Chapter 11.⁸² Surely the scars on creditors in that case tell that continued operation in Chapter 11 produced an inefficiency, not the reverse, and that then, now, and probably always, the liquidation value of Eastern Airlines exceeded its going-concern value. If one is going to calculate the efficiency gains from a continued Chapter 11 made possible by a new value exception, one should also subtract the losses made possible by continued operation under the shadow of the new value exception.

Second, it is not obvious that the only possibilities in cases like *Jartran* are operation by competent debtor versus an incompetent trustee. There is no obvious structural or legal inhibition upon the appointment of a competent trustee to run the business, who might leave it to others to negotiate a plan. Nor is it proven that the debtor must be given a large prize to stimulate him to operate the company.⁸³

The *Jartran* example also shows that the threat of an intermediate creditor without any valid claim can be met by other means. Frank B. Hall, the purchasing debtor, could have bought the secured creditors' position, could then have proposed a plan, and after the plan had been approved, made whatever contractual arrangement it wished to make with the existing debtor to operate the company. Payments in such a transaction to the debtor-operators could come in the form of salary, options, or even in stock of the reorganized company after the plan had been confirmed. Even

80. Although the statistics on the cost of Chapter 11 are few and far between, it is plain that operating a company in Chapter 11 brings many deadweight costs attributable only to the operation in Chapter 11 in the form of lawyers' fees, investment bankers' fees and accountants' fees. If, by hypothesis, these are companies with modest going-concern value, why should one assume that the going-concern value will always or even normally exceed the Chapter 11 costs?

81. Wall Street Journal, Nov. 15, 1990, at A3, col. 4.

82. Wall Street Journal, Jan. 22, 1991, at B3, col. 1.

83. Note that if Frank B. Hall wished to purchase the company, it could easily have purchased the secured creditor's position and, when the exclusivity period ended, could have proposed its own plan that would have left it as the purchaser of the company. Indeed, if the new value exception were not recognized, it would not be in the debtor's interest to fight so bitterly to maintain its exclusivity position.

under the current Chapter 11 regime, it seems unlikely that the new value exception is the only way to forestall an intermediate creditor holdup.

In the end, I find neither moral nor efficiency arguments for the new value exception persuasive. Although it is conceivable that a rejection of the new value exception will mean that the most efficient plan will not be achieved in some cases, that cannot be shown to be true. It is also possible that no efficiency will be lost by the rejection of the new value exception and that the parties will find a way to preserve any going-concern value in all cases by agreement and without resort to that exception. If one is willing to add the efficiency gains that arise out of a grant of security in the idiosyncratic value (B) and in strategic value (C), it seems more probable than not that abolition of the new value exception will enhance, not diminish, the efficiency of the most probable plans.

Once one takes even a small step beyond the consumer and his wooden leg, the moral arguments leave me unmoved. Believing as I do that the law should allow parties to make their own deals and should respect those deals, I think the burden of persuasion is on those who would impose the new value exception on the parties despite their contrary agreement. Lacking empirical data to support the debtor's efficiency argument, and being unmoved by the moral arguments, I would conclude that new value as a rule of law should be rejected and that the parties should be free to negotiate whatever deal they wish. Where we see people willingly entering into security agreements, knowing the price of state-law consequences and apparently embracing them, I believe a *prima facie* case has been made for the efficiency of such agreements and for their morality. For all of these reasons, I believe a court should conclude that the new value exception has failed to survive the 1978 Code and to deny plans based upon that exception.