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Living in Limbo: Single Asset Reorganizations within the Financially Distressed Fifth Circuit.

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BANKRUPTCY—LIVING IN LIMBO: SINGLE ASSET REORGANIZATIONS WITHIN THE FINANCIALLY DISTRESSED FIFTH CIRCUIT. *In re Greystone III Joint Venture*, 948 F.2d 134 (5th Cir. 1991).

I. STATEMENT OF FACTS AND POSTURE OF THE CASE

The facts in *In re Greystone III Joint Venture*[1] are standard to most single asset cases: a partnership, owning only one substantial asset secured by a non-recourse debt considerably in excess of the asset's fair market value, files a chapter 11 reorganization. Here, Greystone's only asset was an office building in downtown Austin with a fair market value of $5.825 million and a debt of $9.3 million.[2] They also owed $145,000 in taxes and about $10,000 in trade debt.[3] The reorganization plan submitted by Greystone reduced the secured claim of the non-recourse lender, Phoenix Mutual Life Insurance Company (Phoenix), to $5.825 million pursuant to Bankruptcy Code section 506(a).[4] The plan also created a second class of claims for the deficiency granted to Phoenix under section 1111(b)(1)(A).[5] A third, separate class of claims contained only the trade creditors.

In classifying the different claims, Greystone considered the requirements under sections 1129(a)(7), (10) and 1129(b). Section 1129(a)(10) requires that at least one impaired class accept the plan for final confirmation.[6] Greystone attempted to satisfy this requirement by separately classifying the deficiency claim so the trade creditors' vote would not be diluted.[7] Greystone provided for section 1129(b)'s prohibition of unfair discrimination against rejecting classes by affording equal treatment of both the trade claims and Phoenix's deficiency claim.[8] Section 1129(a)(7) requires that

1. 948 F.2d 134 (5th Cir. 1991).

2. Appellee's Request for Rehearing En Banc at 2, *In re* Greystone III Joint Venture, 948 F.2d 134 (5th Cir. 1991).

3. *Id.*

4. 11 U.S.C. § 506(a) (1979).

5. *See Id.* § 1111(b)(1)(A) (although state law only permitted Phoenix recourse against the property, the Bankruptcy Code gave them a greater claim status against the estate for the deficiency).

6. *Id.* § 1129(a)(10).

7. *See In re* Greystone III Joint Venture, 102 B.R. 560, 561 (Bankr. W.D. Tex. 1989) (noting Phoenix's objection to separate classification).

8. *See id.* at 561 (trade debt and deficiency were to each receive about three cents on dollar).

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every holder of a claim within an impaired class[9] either accept the plan, or at least receive an amount under the plan not less than that under a chapter 7 liquidation.[10] Here, because the trade creditors had recourse claims, they each accepted the plan knowing they could sue the individual partners for the deficiency.[11] Phoenix rejected the proposed plan.[12] However, they were guaranteed at least an amount equal to what they would have received in a chapter 7 liquidation. The plan allowed for this liquidation value through the secured claim, but additionally provided for a partial payment of the deficiency claim.

The plan further provided for Greystone's partners to retain their equity ownership through a substantial cash infusion. Phoenix objected to this retention of interest claiming a violation of the absolute priority rule. Greystone argued, however, that the $500,000 cash infusion satisfied the "new value exception" set out by the United States Supreme Court in *Case v. Los Angeles Lumber Products Company*.[13] Phoenix, therefore, rejected the plan, forcing Greystone to seek a "cram-down" under section 1129(b).[14] The "cram-down" provision allows confirmation of a plan as long as at least one class of impaired creditors accepts the plan, and it neither unfairly discriminates nor is unfair or inequitable to the objecting classes. Because the trade creditors accepted the plan, the bankruptcy judge confirmed the plan over Phoenix's objections.[15]

On November 19, 1991, the Fifth Circuit Court of Appeals rendered a panel opinion reversing both the bankruptcy court and the district court. The circuit court found that the plan impermissibly classified substantially similar claims into separate classes. Thus, because no class of impaired claims accepted the plan as required by section 1129(a)(10),[16] the cram-down was ineffective and the confirmation order had to be reversed. Additionally, the court held that the adoption of the Bankruptcy Code of 1978 invalidated the "new value exception."[17] Consequently, a plan proposing the injection of new capital in return for keeping an interest in the continu-

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9. 11 U.S.C. § 1124 (1979 & Supp. 1991). A claim is considered impaired where the plan alters the legal, equitable, or contractual rights of the claim holder or if the plan does not contemplate the full cash payment of the allowed amount. *Id.*

10. 11 U.S.C. § 1129(a)(7) (1979 & Supp. 1991).

11. *Greystone* 102 B.R. at 561.

12. *Id.*

13. 308 U.S. 106 (1939) (recognizing need for equity holder to infuse cash into reorganizing debtor in return for new equity in debtor).

14. 11 U.S.C. § 1129(b) (1979 & Supp. 1991).

15. The district court affirmed the bankruptcy court's decision. *In re* Greystone III Joint Venture, 127 B.R. 138 (W.D. Tex. 1990).

16. 11 U.S.C. § 1129(a)(10) (1979 & Supp. 1991).

17. *Greystone*, 948 F.2d at 142.

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ing entity violates the absolute priority rule of section 1129(b)(2)(B).[18]

On February 27, 1992, the Fifth Circuit issued an order withdrawing portions of Judge Edith Jones' panel opinion.[19] The portion deleted dealt with the "new value exception" to the absolute priority rule. In the new opinion, the Fifth Circuit reversed both the district and bankruptcy courts' holdings concerning the "new value exception."

II. Analysis of the Fifth Circuit's Decision

A. *Classification of Claims*

Judge Edith Jones, writing for the panel, concluded that chapter 11 required classification of claims for two reasons: First, proper classification allows the plan to treat creditors similarly according to their priority of claims and other legal rights;[20] and second, each class must separately vote to either confirm or reject the plan.[21] A plan may be confirmed either (1) when the majority of each impaired class approves the plan or, (2) when at least one impaired class approves it, and the debtor meets the other "cramdown" requirements in section 1129(b).[22] The court further reasoned that

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18. 11 U.S.C. § 1129(b)(2)(B) (1991).

19. *See In re* Greystone III Joint Venture, No. 90-8529 (5th Cir. February 27, 1992) (order granting rehearing in part and denying rehearing en banc). The response to the petition for rehearing reads as follows:

PER CURIAM

A majority of the panel having voted to grant rehearing in part, the opinion of the court in disposing of this appeal is as follows:

Part IV of the panel opinion, found at 948 F.2d 134, 142-42 (5th Cir. 1991), is hereby withdrawn and deleted from the opinion. In connection with that determination, the last paragraph of Part III also is deleted. Further, in the first sentence of the second paragraph of the opinion, the word "three" is changed to "two," and the last sentence of that paragraph is deleted. Part V of the opinion is renumbered to IV. In withdrawing this portion of the panel opinion we emphasize that the bankruptcy court's opinion on the "new value exception" to the absolute priority rule has been vacated and we express no view whatever on that part of the bankruptcy court's decision.

Other than these revisions, the original opinion is reinstated and the petition for panel rehearing is DENIED. Further, no member of the panel or judge in active service having requested that the court be polled on rehearing en banc, *see* FED. R. APP. P. and Local Rule 35, the suggestion for rehearing en banc is DENIED.

EDITH H. JONES, dissenting:

How one should approach issues of a statutory construction arising from the Bankruptcy Code has been clouded, in my view, by *Dewsnup v. Timm*, ___ U.S. ___, 60 U.S.L.W. 4111 (1991). Nevertheless, in reaffirming what I wrote about the "new value exception" in Part IV of the original opinion, and therefore in voting against a rehearing, I would hope to stand with Galileo, who, rebuffed by a higher temporal authority, muttered under his breath, "Eppur si muove." ("And yet it moves.") *Id.*

20. *In re* Greystone III Joint Venture, 948 F.2d 134, 137 (5th Cir. 1991).

21. *See id.* at 138.

22. 11 U.S.C. § 1129(b) (1979).

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the integrity of confirmation voting depended upon proper, good faith classification.[23]

In reversing the lower courts' decisions, the Fifth Circuit determined that Greystone had violated the Bankruptcy Code and had gerrymandered the classes in order to obtain an affirmative vote of at least one class of impaired creditors.[24] Greystone submitted defenses to this which both the bankruptcy court and the district court accepted as valid. Greystone claimed: (1) that the Bankruptcy Code under section 1122 did not prohibit the classification of similar claims into separate classes;[25] (2) that Phoenix's unsecured deficiency claim differed legally from those of the trade creditors; and (3) that "good business reasons" justified the separate classifications.[26] Judge Jones addressed each defense before dismissing them as fallacious.

1. Flexible Classification

The circuit court examined section 1122(a) very closely. It concluded that although the plain language of the statute required each claim within a class to be substantially similar, a "fair reading" suggested that such similar claims should be placed into the same class.[27] Judge Jones reasoned that any other interpretation would render the exception under section 1122(b) moot.[28] Section 1122(b) allows the debtor to group small unsecured claims together for administrative purposes.[29] If 1122(a) allowed debtors such free reign to classify, then no need for the 1122(b) administrative simplification exception would exist.[30] Thus, the court used the existence of 1122(b) to infer that only one exception existed to the "requirement" that substantially similar claims be placed into the same class.[31]

Additionally, the court recognized the long standing, unwritten rule that debtors shall "not classify similar claims differently in order to gerrymander an affirmative vote on a reorganization plan."[32] In conditioning the previous analysis, the court maintained that if section 1122(a) did allow the differing classification, it would only be permitted for reasons independent of vote

23. *Greystone*, 948 F.2d at 138.

24. *Id.* at 139.

25. 11 U.S.C. § 1122 (1979).

26. *Greystone*, 948 F.2d at 138.

27. *In re* Greystone III Joint Venture, 948 F.2d 134, 139 (5th Cir. 1991).

28. *Id.* at 138-39.

29. 11 U.S.C. § 1122(b) (1979).

30. *Greystone*, 948 F.2d at 138-39.

31. *Id.* at 138-39.

32. *Id.* at 139. Judge Jones condemned Greystone for using "gerrymandering intent" in separating the claims. However, she neither defined the elements necessary to show such intent, nor applied the non-existent definition to the facts involved. *See* Randolph J. Haines, *Greystone Becomes Tombstone*, NORTON BANKR. L. ADVISER, January 1992, at 2-3.

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manipulation.[33]

Although the circuit court found that "[o]ne cannot conclude categorically that section 1122(a) prohibits the formation of different classes from similar types of claims,"[34] a large composite of case law comes to that very "categorical" conclusion.[35] In interpreting section 1122(a), these cases have determined that it does not require grouping similar claims together but rather ensures the homogeneity of each group.[36] This explanation comports more evenly with the plain language of the section. Section 1122(a) clearly prescribes that only claims of a substantially similar nature may be placed within one class.[37] The exception in 1122(b) provides that small, unsecured claims may be grouped within one class for administrative convenience without regard to similarity.[38] The language of section 1122 plainly dictates what a class *may not* contain, with only the one exception, while the circuit court's interpretation completely reverses that logic by concluding section 1122 dictates what a class *must* contain with one exception.[39]

The inconsistency between allowing the undersecured creditor a deficiency claim and allowing the debtor more flexibility in classification reaches its zenith during a single asset real estate case. Because the deficiency creditor will most likely dwarf the other unsecured claims,[40] the resulting "mega" vote of the deficiency creditor would effectively disenfranchise all other similarly classified creditors.[41] The debtor faces a Hobson's choice: either classify the deficiency claim separately and risk the appearance of gerryman-

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33. *Greystone*, 948 F.2d at 139.

34. *Id.* at 138.

35. *See, e.g.*, *In re* U.S. Truck Co., 800 F.2d 581, 587 (6th Cir. 1986) (separating union's unsecured claim for rejection of collective bargaining agreement from other equally situated unsecured creditors); *In re* AG Consultants Grain Division, Inc., 77 B.R. 665, 674-76 (Bankr. N.D. Ind. 1987) (upholding debtor's flexibility to classify claims); *In re* White Horse Grain Co., 60 B.R. 16, 18 (Bankr. E.D. Pa. 1986) (allowing separate classification of bailment creditors from other unsecured creditors).

36. *U.S. Truck*, 800 F.2d at 585 (quoting *Barnes v. Whelan*, 689 F.2d 193, 201 (D.C. Cir. 1982).

37. 11 U.S.C. § 1122(a) (1979) (establishing that only substantially similar claims may be placed in class).

38. *Id.* § 1122(b).

39. *See Greystone*, 948 F.2d at 139 (suggesting that section 1122(a) provides for substantially similar claims to be placed in same class).

40. Here, the total of all unsecured claims equaled roughly $30,000 while Phoenix's deficiency claim totaled $3.45 million—over 100 times greater.

41. In order for the plan to be approved, the classes must vote either for or against it. 11 U.S.C. § 1126(c) (1979). A class accepts a proposed plan when claims holding at least two-thirds in amount and more than one-half in number have accepted the plan. *Id.* Here, where Phoenix overwhelmingly would dominate a single class, no chance of acceptance, without Phoenix's approval, would be possible. *See In re* Triple R Holdings, 134 B.R. 382, 389 (Bankr. N.D. Cal. 1991) (clearly Congress did not intend one creditor to have veto power).

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dering, or group the claims together allowing the deficiency claim to block any attempt at reorganization. Judge Jones expressed concern that separately classifying the claims disenfranchised the deficiency creditor.[42] However, requiring them to be classed together would not only disenfranchise the "true" creditors of the entity, but also would give the secured claimant an absolute veto over the plan.[43] It is doubtful that Congress intended for a single creditor to have such power.[44]

Judge Jones' concern over Phoenix's possible disenfranchised vote is completely unjustified. The proposed plan does not take Phoenix's vote away. In fact, the separate classification provides greater leverage.[45] Not only does the vote control its own class, but also controls the acceptance of the plan. Without Phoenix's acceptance of the plan, the debtor is forced to seek confirmation through the more onerous "cram-down."[46] This "class-vote" which Phoenix yields is a powerful tool enabling them to force a cram-down on Greystone. Although the question of disenfranchisement does not create much concern, there must be a limit to the flexibility of classification.

Even though section 1122 clearly does not prohibit the separate classification of similar claims, flexibility is limited.[47] Judge Jones points to this limitation by noting that separate classification based solely on gerrymandering an affirmative vote is bad faith[48] and falls outside the ambit of 1122(a)'s classification flexibility.[49] Without some limitation on the classification

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42. *See Greystone*, 948 F.2d at 141 (the separate classification nullifies Phoenix's voting effect).

43. In a footnote, Judge Jones advocates that without the vote, "Phoenix has no leverage to persuade the Debtor to consider a more reasonable settlement." *Id.* at 140 n.6. This flowery language seems to suggest that Phoenix is a meek and powerless creditor. On the contrary, if the classes were grouped together, the sheer oppressive size of Phoenix could control the entire process.

44. *See Triple R Holdings*, 134 B.R. at 389 (splitting claims was not to provide blocking vote to veto plan).

45. *See* Randolph J. Haines, *Greystone Becomes Tombstone*, NORTON BANKR. L. ADVISOR, January 1992, at 1, 4 (discussing impact of separate classification on Phoenix's undersecured claim).

46. *See id.*

47. *See, e.g., In re* Holywell Corp., 913 F.2d 873, 880 (11th Cir. 1990) (holding that although debtor has discretion when classifying, power is limited); Hanson v. First Bank of South Dakota, 828 F.2d 1310, 1313 (8th Cir. 1990) (power to classify limited but 1122(a) does not prohibit separate placement of similar claims); *U.S. Truck*, 800 F.2d at 586. (agreeing that some limit to classification power exists).

48. *Greystone*, 948 F.2d at 139. *But see In re* Sun Country Development, Inc., 764 F.2d 406, 408 (5th Cir. 1985) (holding that plan proposed for legitimate purpose of reorganization satisfies good faith requirement).

49. *See Greystone*, 948 F.2d at 139 (attempt to hide gerrymandering through assertion of "good reasons" violates spirit of rule); *see also* Piedmont Assoc. v. Cigna Property & Casualty Ins. Co., 132 B.R. 75, 78 (Bankr. N.D. Ga. 1991) (separation cannot occur for purposes of vote manipulation).

power, the potential for abuse would be significant.[50] A great divergence of case law exists on the flexibility question.[51] However, most courts accept some reason, independent of voting, to authorize separate classification.[52]

2. The Legal Character of the Claims

Because Greystone did not attempt to justify the separate classification under the exception in 1122(b), case law demonstrates that some basis other than vote manipulation may be presented to support the separation.[53] Greystone's offered basis for separately classifying the deficiency debt from that of the trade claims revolved around the legal difference between Phoenix's code-created recourse claim and the trade creditors' state-created recourse claim.[54] Judge Jones venomously rejected this reasoning accusing the bankruptcy court of "resorting to policy considerations" in order to favor the cram-down of Greystone's plan.[55] In rejecting Greystone's logic, she reiter-

50. *U.S. Truck*, 800 F.2d at 586 (without limitation on classification, potential for abuse great).

51. Cases which support flexible classification include the following: *In re* AOV Industries, 792 F.2d 1140 (D.C. Cir. 1986); *In re* LeBlanc, 622 F.2d 872 (5th Cir. 1980); Scherk v. Newton, 152 F.2d 747 (10th Cir. 1945); *In re* Mason & Dixon Lines, Inc., 63 B.R. 176 (Bankr. M.D.N.C. 1984); *In re* Wolff, 22 B.R. 510 (Bankr. 9th Cir. 1982); *In re* Huckabee Auto Co., 33 B.R. 132 (Bankr. M.D. Ga. 1981).

Cases which support rigid classification include the following: Granada Wines, Inc. v. New England Teamsters and Trucking Industry Pension Fund, 748 F.2d 42 (1st Cir. 1984); *In re* Johnson, 69 B.R. 726 (Bankr. W.D.N.Y. 1987); *In re* Fantastic Homes Enterprises, Inc., 44 B.R. 999 (Bankr. M.D. Fla. 1984).

52. *See, e.g.*, *Holywell*, 913 F.2d at 880 (asserting that debtor has discretion but when sole reason for votes then not proper); *U.S. Truck*, 800 F.2d at 586-87 (holding that although separate classification amounted to gerrymandering, additional reasons justified confirmation); *In re* S&W Enterprise, 37 B.R. 153, 161 (Bankr. N.D. Ill. 1984) (manipulating unsecured claims solely for voting reasons not tolerated).

53. *See In re* U.S. Truck Co., 800 F.2d 587, 581 (6th Cir. 1986) (allowing for separate classification where unsecured creditors had different stake in future viability of continuing entity); *see also In re* LeBlanc, 622 F.2d 872, 879 (5th Cir. 1980) (allowing for separation of trade creditors because they continued to grant services); *In re* AG Consultants Grain Div., Inc., 77 B.R. 665, 671 (Bankr. N.D. Ind. 1987) (allowing separate classification of unsecured creditors which continued doing business with continuing entity).

54. *See In re* Greystone III Joint Venture, 102 B.R. 560, 569-70 (Bankr. W.D. Tex. 1989) (discussing legal difference of code-recourse and law-recourse). The code granted Phoenix recourse against the estate for the deficiency only in the case of reorganization, otherwise, Phoenix's only avenue would be to foreclose on the property valued substantially lower than the debt. *Compare* 11 U.S.C. § 1111(b) (1979) (exception granting Phoenix deficiency recourse against bankruptcy estate) *with id.* § 506(a) (limiting the claim of undersecured creditors to amount of collateral) *and id.* § 723 (providing that only trustee has claim against general partners where bankruptcy estate has deficiency of property); *see also In re* DRW Property Co., 57 B.R. 987, 992-93 (Bankr. N.D. Tex. 1986) (deficiency creditor has no claim against the estate of the debtor's general partners).

55. *See In re* Greystone III Joint Venture, 948 F.2d 134, 140 (5th Cir. 1991).

ated her conclusion that the separate classification violated section 1122 by gerrymandering an affirmative vote. Further, she concluded that not only did such classification virtually eliminate the election for undersecured creditors[56] granted under section 1111(b),[57] but also that the bankruptcy court overstated its concern for the viability of the cram-down procedure by allowing it.[58]

Judge Leif Clark, who authored the bankruptcy court's opinion, made a convincing analysis of the claim's legal difference.[59] There is authority to support the separate classification of unsecured claims based on their dissimilar legal character.[60] "Classification is simply a method of recognizing differences in the rights of creditors that call for a difference in treatment."[61] In the present case, the code allows recourse against the estate for Phoenix's deficiency claim.[62] It grants recourse status because chapter 11 allows the

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56. *See, e.g.*, *In re* Los Angeles Land of Investments, Ltd., 282 F. Supp. 448, 453 (D. Haw. 1968) (classification based upon legal character acceptable) *aff'd*, 447 F.2d 1366 (9th Cir. 1971); Scherk v. Newton, 152 F.2d 747, 751 (10th Cir. 1945) (holding classification should recognize differences of the rights); *In re* Palisades-on-the-Desplaines, 89 F.2d 214, 217 (7th Cir. 1937) (holding valid classifications based on legal difference and that court has broad discretion in classification for promotion of reorganization). On the facts in this case, Greystone's separate classification possibly eliminated Phoenix's election of recourse status. However, one could surmise that Phoenix chose to elect recourse status in order to recouperate more than the fair market value of the building. If they believed that the value of the building would increase in the future to a level near the original, indisputably over-inflated value given at the creation of the debt, then Phoenix would have elected to retain a non-recourse claim for the entire loan amount under section 1111(b)(2). Nevertheless, simply because the particular facts of a case render the election ineffective, does not mean that Greystone's reason totally lacked support. *See* 3 NORTON BANKR. L. & PRAC. § 58.02, Pt. 58, pp. 4-5 (1990) (undersecured creditor probably will make election under § 1111(b)(2) when it believes collateral will increase in value).

57. 11 U.S.C. § 1111(b)(2) (1979). The election allows for the undersecured creditor to opt into a secured claim for the entire amount of the debt instead of a secured claim for the fair market value and an unsecured claim for the deficiency as provided in sections 506(a) and 1111(b)(1). The payments under the plan, however, need only be structured to compensate for the present value of the asset. *Id.*

58. *See id.* (court "reprimanding" the bankruptcy court for using policy considerations); *see also In re* Bjolmes Realty Trust, 134 B.R. 1000, 1003 (Bankr. D. Mass. 1991) (legal nature of claim has to do with creditor's rights against debtor or debtor's property).

59. *Greystone*, 102 B.R. at 569-70.

60. *See, e.g.*, *Los Angeles Land of Investments, Ltd.*, 282 F. Supp. at 453 (classification reflects determination of legal character of claims); *Scherk*, 152 F.2d at 751 (holding that classification should recognize differences of the rights of creditors); *Palisades-on-the-Desplaines*, 89 F.2d at 217 (holding that creditors with differing legal claims against the estate's property should be placed into different classes); *Bjolmes Realty Trust*, 134 B.R. at 1001-03.

61. *Scherk*, 152 F.2d at 751; *see also Greystone*, 102 B.R. at 569-70 (discussing separation based on legal difference).

62. *See* 11 U.S.C. § 1111(b) (1979) (allowing undersecured creditor unsecured deficiency claim against debtor's estate).

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debtor to keep the encumbered property over the objection of the secured creditor.[63] When the debtor sells the property either before confirmation or pursuant to the plan's terms, or abandons it, the deficiency recourse status disappears.[64] The code-created recourse does not grant Phoenix recourse against the individual partners. It is powerless to affect rights outside of bankruptcy.[65] The trade creditors, on the other hand, not only have a claim against the estate but also have a claim against the individual partners' estates.[66]

Phoenix's total claim consisted of one secured and one unsecured. Because code section 1122(a) only allows substantially similar claims within one class, both of Phoenix's claims are classified separately.[67] However, this separate classification exists in name only.[68] If they were truly separate, the claims would possibly vote differently. The secured claim would probably reject the plan trying to force a foreclosure, while the unsecured claim would probably accept the plan because it provided for a greater pay-out. In reality though, the separate classification grants Phoenix additional voting leverage.[69] Therefore, the secured portion of an undersecured creditor will greatly influence how the unsecured portion will vote.[70] No policy exists which would require the undersecured creditor's entire claim to dominate the voting of all classes.[71]

The deficiency claim differs legally from that of the trade creditors. However, whether this difference weights greatly enough to merit a separate clas-

63. *See Greystone*, 102 B.R. at 570; *see also* 3 NORTON BANKR. L. & PRAC. § 58.01, pt. 58, pp. 2-3 (1990) (creditor at disadvantage where debtor retains property and property valued substantially below debt).

64. *See DRW Property*, 57 B.R. at 992-93 (once property voluntarily or involuntarily disposed of, recourse status disappears).

65. *See Greystone*, 102 B.R. at 570 (holding that § 1111(b) does not grant recourse claim against partners but only debtor's estate); *see also* 3 NORTON BANK. L. & PRAC. § 58.02, pt. 58, p. 2 (1990) (1111(b) retains situation outside of bankruptcy, either debtor keeps up with liability or loses property).

66. The difference becomes even more clear when considered in the light of a chapter 7 liquidation. The trade creditors could go against the individual debtors because of their personal liability for partnership debts. Only the trustee of the partnership's bankruptcy estate could assert a claim against the individual partners' estates for a deficiency on the property of the partnership. *See* 11 U.S.C. § 723 (1979). The secured creditors deficiency claim would no longer exist. *See id.*

67. *Greystone*, 102 B.R. 561-62; *see also* 11 U.S.C. § 1122(a) (1979).

68. *Bjolmes Realty Trust*, 134 B.R. at 1003 (finding that undersecured class vote controlled by secured class vote).

69. *Id.* at 1003 (noting unsecured portion of undersecured creditor is separate in name only).

70. *See id.*

71. *See id*; *see also In re* Triple R Holdings, 134 B.R. 382, 389 (Bankr. N.D. Cal. 1991) (holding no intent for absolute veto).

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sification, does not as conspicuously present itself.[72] Judge Clark offers valid support for classification based upon a claim's legal character.[73] Notwithstanding this support, Judge Jones makes the equally valid assertion that if the trade debt had been higher, or if other impaired classes existed which favored the plan, the separate classification and cram-down would not have presented such a dilemma.[74] Finally, although Judge Jones condemned the use of policy, it plays a major role in the entire bankruptcy system.[75] The equitable power wielded by bankruptcy courts allows for exceptions to any strict rules of classification.[76] Some additional reason, therefore, should exist to warrant separate classification whether it be policy or factual.

3. Good Business Reason

Greystone asserted that in addition to the legal difference, "good business reason" existed to justify the separate classification. Judge Jones disposed of this argument because it failed to "distinguish between the classification of claims and the treatment of claims."[77] Had Greystone's plan provided for special treatment of the trade creditors,[78] such business reasons would probably justify separate classification. However, the plan provided for equal treatment of both the deficiency claimant and the trade creditors, thus generating no basis for the separate classes. Judge Jones therefore set aside the bankruptcy court's decision as clearly erroneous because she found no support in the record justifying separate classification.[79]

72. *See Greystone*, 948 F.2d at 139-40 (discussing whether legal claim difference merits separation); *see also* Hanson v. First Bank of South Dakota, 828 F.2d 1310, 1313 (8th Cir. 1987) (denying separate classification of deficiency claim from trade creditors); *In re* Meadow Glen, Ltd., 87 B.R. 421, 426-27 (Bankr. W.D. Tex. 1988) (separate classification of deficiency claim from trade claims violates spirit of 1111(b)).

73. *Greystone*, 102 B.R. at 569-70.

74. *Greystone*, 948 F.2d at 140.

75. *See, e.g.*, Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1933) (establishing fresh start policy as overriding bankruptcy concern); *In re* Grier, 124 B.R. 229, 234 (Bankr. W.D. Tex. 1991) (commenting on nature of bankruptcy courts as courts of equity); *Greystone*, 102 B.R. at 568 (bankruptcy courts are courts of equity); *see also* Thomas H. Jackson, *The Fresh-Start Policy in Bankruptcy Law*, 98 HARV. L. REV. 1393, 1395-96 (1985). The fresh start policy is embodied in bankruptcy laws and is not related to "creditor-oriented distribution." *Id.*

76. *See LeBlanc*, 622 F.2d at 879 (equity powers of bankruptcy court may even allow discrimination where facts demand it); *Greystone*, 102 B.R. at 568 (bankruptcy courts may allow exceptions to strict rules of classification through equity).

77. *In re* Greystone III Joint Venture, 948 F.2d 134, 141 (5th Cir. 1991).

78. Such special treatment raises other problems with violations either of the absolute priority rule or the unfair treatment standard. *See, e.g.*, Hanson v. First Bank of South Dakota, 828 F.2d 1310, 1313 (8th Cir. 1987) (denying separation of deficiency and trade creditor); *In re* Meadow Glen, Ltd., 87 B.R. 421, 426-27 (Bankr. W.D. Tex. 1988) (separating classification of deficiency claim from trade claims violates code).

79. *Greystone*, 948 F.2d at 141.

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The bankruptcy court presented the business reasons as a rudimentary fact of reality. Trade creditors simply do not extend credit based on a company's ability to pay long-term debt.[80] Instead, trade creditors base loans on short-term capabilities.[81] Where the debtor fails to maintain payments, "trade creditors . . . have little recourse but to refrain from doing business with the enterprise."[82] Although this is in fact, a business reality, Judge Jones' argument again rings in. No provision for separate treatment exists within the plan, it simply calls for treating them equally.[83] Because the asserted business reasons would demand a more favored treatment of the trade creditors,[84] they should have had their own class which received a greater percentage of their debt. Otherwise, the recalcitrant debtor risks losing access to trade services in the market.[85] However, where the plan calls for equal treatment, it does not address those business reasons.

4. Greystone's Classification

The law behind Greystone's separate classification is unclear at best. A large number of cases allow flexible classification,[86] while an equal amount do not.[87] Interestingly enough, however, many of the cases which uphold the separate classification of similar creditors end up rejecting the plan anyway. They find the plan discriminatory or unfair, and thus in violation of section 1129(b)(1).[88] The courts interpret the "unfair discrimination" standard to mean that a plan must treat similarly situated creditors equally.[89]

80. *See In re* Greystone III Joint Venture, 102 B.R. 560, 570 (Bankr. W.D. Tex. 1989).

81. *Id.*

82. *Id.*

83. *See id.* at 561 (plan proposed paying trade and deficiency both a little over three cents on the dollar).

84. *See Greystone*, 102 B.R. at 570 ("Good business reasons also justify separate *treatment*" (emphasis added)).

85. *Greystone*, 948 F.2d at 141.

86. Cases supporting flexible classification include the following: *In re* AOV Industries, Inc., 792 F.2d 1140 (D.C. Cir. 1986); *In re* LeBlanc, 622 F.2d 872 (5th Cir. 1980); Scherk v. Newton, 152 F.2d 747 (10th Cir. 1945); *In re* Mason & Dixon Lines, Inc., 63 B.R. 176 (Bankr. M.D.N.C. 1986); *In re* Wolff, 22 B.R. 510 (Bankr. 9th Cir. 1982); *In re* Huckabee Auto Co., 33 B.R. 132 (Bankr. M.D. Ga. 1981).

87. Cases supporting rigid classification include the following: Granada Wines, Inc. v. New England Teamsters and Trucking Industry Pension Fund, 748 F.2d 42 (1st Cir. 1984); *In re* Johnson, 69 B.R. 726 (Bankr. W.D.N.Y. 1987); *In re* Fantastic Homes Enterprises, Inc., 44 B.R. 999 (M.D. Fla. 1984).

88. *See, e.g.*, Hanson v. First Bank of South Dakota, 828 F.2d 1310, 1313 (8th Cir. 1990) (rejecting separation of deficiency and trade creditor); *In re* Meadow Glen, Ltd., 87 B.R. 421, 426-27 (Bankr. W.D. Tex. 1988) (separate classification of deficiency claim and trade claims violates code).

89. *See In re* Johns-Manville Corp., 68 B.R. 618, 636 (Bankr. S.D.N.Y. 1986) (interpreting standard as ensuring dissenting creditors receive similar treatment with similarly situated

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Therefore, no plan may separate similar creditors and provide for different treatment.[90] Greystone followed this analysis under the flexible classification theory. The plan called for the equal treatment of both Phoenix's deficiency claim and the trade debt thus satisfying 1129(b)(1)'s "unfair discrimination" prohibition. At the fulcrum of the problem lies the reason behind separation. A debtor cannot group two similar creditors separately for the sole purpose of vote manipulation.[91] There must exist some additional justification to the separate classification.[92] Although Judge Jones criticized the use of policy, the bankruptcy court's equitable characteristic demands its use. The bankruptcy court's equitable power allows the court to permit exceptions to strict rules where the facts of a case compel a deviation.[93] The plan proposed by Greystone promotes reorganization.[94] It was offered in good faith.[95] Additionally, although it might appear to be gerrymandering, equity should allow the separate classification on the legal difference because without it, Greystone has absolutely no chance of confirming a plan over the whims of Phoenix.

B. *The "New Value Exception"*

Section 1129(b)(1) directs that a debtor propose a fair and equitable plan with respect to dissenting classes of creditors.[96] Within this standard, 1129(b)(2)(B)(ii) requires that the holders of any interest junior to the dissenting class receive no property until the dissenter is paid in full.[97] This rule is better known as the absolute priority rule.[98] It acts to encourage the payment of unsecured claims before the equity holders receive anything,

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creditors); *In re* Pine Lake Village Apartment Co., 19 B.R. 819, 830 (Bankr. S.D.N.Y. 1982) (defining "unfair discrimination" for cram-down purposes); *see also* Kenneth N. Klee, *All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code*, 53 AM. BANKR. L. J. 133, 141-43 (1979) (discussing "unfair discrimination" and "fair and equitable" test).

90. *See Pine Lake*, 19 B.R. at 830.

91. *See id.* at 831; *see also* 3 NORTON BANKR. L. & PRAC. § 59.05, pt. 59, p. 6 (1990) (denouncing separate class solely for vote manipulation).

92. *See* Piedmont Assoc. v. Cigna Property & Casualty Ins. Co., 132 B.R. 75, 78 (Bankr. N.D. Ga. 1991) (allowed separate classification for legitimate business reasons).

93. *See LeBlanc*, 622 F.2d at 879 (discrimination allowed under compelling facts); *see also* Comment, *Classification of Claims in Debtor Proceedings*, 49 YALE L.J. 881, 884-85 (1940) (discussing courts broad discretion in creating classes).

94. *See In re* AG Consultants Grain Div., Inc., 77 B.R. 665, 674 (Bankr. N.D. Ind. 1987) (different treatment allowed where: in best interest of creditors, fosters reorganization, does not violate absolute priority rule, and does not uselessly create more classes).

95. *See In re* Sun Country Development, Inc., 764 F.2d 406, 408 (5th Cir. 1985) (debtors pursuit of cram-down does not in and of itself violate good faith principles).

96. 11 U.S.C. § 1129(b)(1) (1979).

97. *Id.* § 1129(b)(2)(B)(ii) (1979 & Supp. 1991) (absolute priority rule).

98. *See* 3 NORTON BANKR. L. & PRAC. § 63.12, pt. 63, pp. 22-23 (1990) (discussing cram-down requirement of absolute priority).

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while simultaneously ensuring that a "plan will not redistribute a dissenting creditor's property rights to those with a junior . . . interest."[99]

The "new value exception" began as a corollary to the definition of "fair and equitable" under the old Bankruptcy Act. The United States Supreme Court, in *Case v. Los Angeles Lumber Products Company*,[100] fashioned this corollary recognizing instances where a fresh infusion of capital was necessary. In *Case*, while adjudicating the fairness and equitableness of a proposed reorganization plan, the Court recognized the existence of circumstances where a reorganization would need an infusion of capital in order to continue.[101] "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."[102] The Supreme Court injected the requirements of necessity and reasonably equivalent participation in an effort to strongly "reaffirm the paramount importance of preserving absolute priority."[103] Otherwise, a token contribution could substantially dilute the dissenting creditor's rights.[104]

1. Greystone's Assertion of the "New Value Exception"

Greystone asserted the veracity of its partners' proposed cash infusion through use of the "new value exception." In support of their assertion, Greystone maintained: (1) that the "new value exception" had a valid acceptance under the interpretation of "fair and equitable" prior to the adoption of the 1978 Bankruptcy Code; (2) that because the code did not explicitly overrule these judicial interpretations, they must have been incorporated into the code's standard; and (3) that even though section 1129(b)(1)(B) might not explicitly codify the "new value exception," the section's language leaves room for it.[105] In the original panel opinion, Judge Jones once again determined the inaccuracy of Greystone's argument by holding the non-existence of a post-code "new value exception."[106]

Judge Jones began by noting the difference between the acceptance requirements under the present Bankruptcy Code and those under the Bankruptcy Act in 1939. The provisions of the Bankruptcy Act in 1939 allowed confirmation only where the plan was "fair and equitable" and where *every*

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99. *In re* Greystone III Joint Venture, 948 F.2d 134, 142 (5th Cir. 1991).

100. 308 U.S. 106 (1939).

101. *Case*, 308 U.S. at 121 (recognizing circumstances where cash infusion necessary).

102. *See id.*

103. *In re* Greystone III Joint Venture, 102 B.R. 560, 574 (Bankr. W.D. Tex. 1989); *see Case*, 308 U.S. at 122 (where requirements met, creditors cannot complain that their rights are infringed upon).

104. *See Greystone*, 102 B.R. at 574.

105. *In re* Greystone III Joint Venture, 948 F.2d 134, 142-43 (5th Cir. 1991).

106. *See id.* at 143.

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creditor class voted to accept. Judge Jones asserted that the "new value exception" served the purpose of adding flexibility to the rigid requirements of the act. The present code allows for a more flexible, less-than-unanimous acceptance with the "fair and equitable" standard applied only to dissenting creditors.[107] The new code, she alleged, renders the exception unnecessary. She added that Congress rejected a proposal to modify the absolute priority rule, thus manifesting the intent to create a strict definition absent any "new value exception."[108]

Judge Jones further denounced Greystone's allegations by reproaching their tactics of parsing and word play.[109] Inferring the indeliberacy of Congress' code-drafting, she determined that section 1129(b)(2) established a fixed, self-contained definition of "fair and equitable."[110] She interpreted the word "includes" in section 1129(b)(2) as restricting the definition only to those given in subsections (A), (B), and (C).[111] However, section 102(3) defines the word "includes" as used in the Bankruptcy Code.[112] It states that "[i]n this title . . . (3) 'includes' and 'including' *are not limiting*."[113] Whether or not Judge Jones was attempting to judicially overrule section 102(3) is not clear because the section was never specifically mentioned.

Greystone also asserted that the "new value exception" did not fit under section 1129(b)(2)(B)(ii) because the retained interest did not arise "on ac-

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107. *See* 11 U.S.C.A. § 1129(b) (1979 & West Supp. 1991) (plan only needs to be "fair and equitable" to creditors who dissent from accepting a cram-down).

108. *Greystone*, 948 F.2d at 143. The proposed modification would have allowed intangible items to be counted as "money's worth." *In re* Bjolmes Realty Trust, 134 B.R. 1000, 1008 (Bankr. D. Mass. 1991) (citing H.R. Doc. No. 137, 93d Cong., 1st Sess., Pt. I, §§ 7-303(7), 7-310, Pt. II, 258 (1973)).

109. *Greystone*, 948 F.2d at 143. *Greystone* asserts that the code language explains that the definitions given are not the only possible definitions. It points out that the language, "fair and equitable . . . *includes* the following requirements." *Id.* (citing 11 U.S.C. § 1129(b)(2) (1979 & Supp. 1991)). The word "includes" connotes that there are more requirements than those actually listed. 11 U.S.C. § 102(3) (1979). Judge Jones dismissed this line of argument as mere wordplay.

110. *Greystone*, 948 F.2d at 143.

111. Section 1129(b)(2)(A) provides that where secured creditors are involved, the plan must provide that he retains the lien on the property to the extent allowed under section 506 whether the property is sold or not. Or, each holder must receive a deferred cash payment totaling the amount of the claim. Or, if a sale of the encumbered property is contemplated, the lien must transfer to the proceeds. 11 U.S.C. § 1129(b)(2)(A) (1979 & Supp. 1991). Section 1129(b)(2)(B) discusses unsecured claim treatment and states that the plan must provide that either the creditor retain a claim of equal amount at the date of confirmation, or that no junior class will receive anything prior to their payment. *Id.* § 1129(b)(2)(B). Section 1129(b)(2)(C) deals with classes of interests. There, the plan must provide that the holder receive a value equal to the greatest allowed amount fixed by liquidation, or that no junior interest holder gets anything prior to their interest. *Id.* § 1129(b)(2)(C).

112. 11 U.S.C. § 102(3) (1979).

113. *Id.* (emphasis added).

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count of" the relationship, but rather because of the infusion of new capital.[114] Judge Jones once again dismissed this as mere wordplay in an attempt to prevent the creditors from gaining control of the property.[115] However, the realities involved establish that the equity holders are not retaining their old interest in the entity, but rather they are "buying" new shares in the reorganized entity with the cash infusion. This new interest is not a retention of interest "on account of" their old interests.[116] Therefore, it does not violate the absolute priority rule.

2. Viability of the Exception

The divergence of opinion surrounding the survival of the "new value exception" equals, if not exceeds, that of the classification issue, especially since the Supreme Court's decision in *Northwest Bank Worthington v. Ahlers*.[117] In *Ahlers*, although the Court had an opportunity to rule on the existence of the "new value exception," it chose not to do so. Justice White indicated in a footnote that "our decision today should not be taken as any comment on the continuing vitality of the [*Case*] exception."[118] Instead of ruling on the validity, the Court determined whether the actions of the debtor met the conditions of the "new value exception."[119] The Court's reluctance to decide the exception's validity sent a message of doubt to the circuits.[120]

3. Issues in Applying the Exception

Although the "new value exception" has existed since *Case*, no clear method of application has evolved. Each method used contains the basic tenets laid out in *Case* and its progeny. However, the method in which the court evaluates the reorganizing entity has been subject to a variety of inter-

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114. *Greystone*, 948 F.2d at 143. Greystone alleged that the phrase, "on account of" contained in section 1129(b)(2)(B)(ii) did not cover receiving an interest on an additional investment. *Id.*; *see also* 11 U.S.C. § 1129(b)(2)(B)(ii) (1991). Judge Jones once again dismissed this as incorrect logic. *Greystone*, 948 F.2d at 143.

115. *Greystone*, 948 F.2d at 143.

116. *See* 11 U.S.C. § 1129(b)(2)(B)(ii) (1979); *see also Bjolmes Realty*, 134 B.R. at 1006 (upholding deliberateness of code's use of "on account of" to justify correctness of "new value exception").

117. 485 U.S. 197 (1988).

118. *Ahlers*, 485 U.S. at 203 n.3.

119. *See id.* at 202-03 (discussing exception to absolute priority rule of "new value exception").

120. *See* Neal Batson et al., *Restructuring The Debt(or)*, C638 A.L.I.-A.B.A. COURSE OF STUDY 1, 3 (1991) (mentioning concern raised by Supreme Court's *Ahlers* decision); *see also* 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, 425-26 (1991) (stating that *Ahlers* brought into question validity of new value exception).

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pretations and applications. For the modern "new value exception," there are two main avenues with which to examine the viability of the exception and a corresponding method of valuation: (1) the "realities-condemnation" method; and (2) the "realities-control premium" method. Both methods recognize the reality that some circumstances will require a cash infusion to the reorganizing entity in order to successfully continue, however, their methods of valuation are quite different.

a. Realities-Condemnation

The "realities-condemnation" method (condemnation method), recognizes the problem in setting a price for the new value to be invested. In order to prevent the retention of interest simply on a token contribution of cash, a price must be set which accurately represents that new interest in the present entity.[121] The second problem addressed by the condemnation method is evaluating the interest of the senior creditors given up to the investing equity holders. Because the senior creditors' rights are considered property, they must receive some sort of compensation for that property's worth.

In evaluating the business entity, the court must consider not only the proposed fair market value of the assets, but also must project and account for the possible future profits of a company which is currently insolvent.[122] The complexity involved in determining the projected profitability of a reorganizing debtor creates a mammoth task for the court.[123] While a sufficient amount of work may be done by experts, an expert will say only what their party wants them to say. Another, more feasible means of determining the market value of an ongoing entity is to actually put it on the market. Where the old equity holders invest money at a competitive auction, the price paid is assured to be a reasonable equivalent of the interest gained.

The second part of the condemnation method addresses the interest which the senior creditors give up to the contributing equity holders. This notion had its beginning in the United States Supreme Court's *Consolidated Rock Products Company v. Du Bois*.[124] The Court reasoned that by displacing the senior creditors' rights, the equity holders were, in a sense, "taking" property.[125] Logic follows then, that the deprived creditors should receive just

121. In *Greystone*, Judge Clark stressed that the "new value exception" was not a device which allowed pre-filing owners to "buy their way back into the venture." Instead, the purpose is to allow the *capital necessary to survive*. *See In re* Greystone III Joint Venture, 102 B.R. 560, 575 (Bankr. W.D. Tex. 1989).

122. *See Greystone*, 102 B.R. at 578-79 (discussing method of evaluating ongoing entity for purposes of capital infusion).

123. *See id.*

124. 312 U.S. 510 (1941).

125. *Id.* at 528-29.

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compensation for those rights given up. The Supreme Court in *Ahlers* recognized that impaired senior creditors had the right to control the debtor to the exclusion of the owners.[126] This control, the Court stated, has some kind of intrinsic value whether it is a possible share of future profits and dividends, or simply an increase in the entity's market value.[127] Therefore, another problem arises in the valuation of this "control right."

The valuation of the "control right" begins with the same method of valuing the entity. A prediction must be made which reflects estimated future earnings, a record of past earnings, and all other types of information which tend to create a reliable projection of future worth.[128] Once again, a difficult task. However, the *Consolidated Rock Products* Court established a simple standard to stand in place of a formula. "Practical adjustments, rather than a rigid formula, are necessary. The method of effecting full compensation for senior claimants will vary from case to case."[129] The court should look to the plan and determine whether or not the compensation provided for is reasonably equivalent to the rights taken.[130] The compensation could take the form of cash pay-outs, or rights in ownership participation, or even an option to purchase.[131] Whatever the compensation is, the court determines its reasonableness.

b. Realities-Control Premium

The "realities-control premium" method (control premium method) does not acknowledge the "taking" theory as advanced under *Consolidated Rock Products*.[132] Instead, it takes a market view for valuing the equity holders' new contributions.[133] The control premium method recognizes the value of "control rights," but does not treat compensation in the same direct man-

126. *See* Northwest Bank Worthington v. Ahlers, 485 U.S. 197, 207-08 (1988) (discussing value of retained ownership interest); *Greystone*, 102 B.R. at 578-79.

127. *See Ahlers*, 485 U.S. at 207-08.

128. *See Greystone*, 102 B.R. at 579.

129. Consolidated Rock Products Co. v. Du Bois, 318 U.S. 510, 529 (1941).

130. *See, e.g.*, *Ahlers*, 485 U.S. at 207-08 (discussing value of operation rights); *Consolidated Rock Products*, 312 U.S. at 528-29 (establishing "control right" theory and placing value thereon); *Greystone*, 102 B.R. at 579 (discussing flexibility of court to decide "control right" value on facts of case).

131. *See Greystone*, 102 B.R. at 579-80 (discussing possibilities of compensation).

132. *See In re* Bjolmes Realty Trust, 134 B.R. 1000, 1010 (Bankr. D. Mass. 1991) ("That transaction should be measured against market forces, making it unnecessary for the court to become embroiled in the vagaries of reorganization value or any standard of valuation"); *see also* James F. Queenan, Jr., *Standards For Valuation Of Security Interests In Chapter 11*, 92 COMM. L.J. 18, 62 (1987) (discussing idea of commercial reasonableness in valuations of entities at going concern rate).

133. *See Bjolmes Realty*, 134 B.R. at 1010 (market test only way to assure old equity holders are most feasible source of new capital).

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ner.[134] Essentially, the "control rights" are bought with the capital infusion and the creditors benefit indirectly through their interest in the entity's acquisition of the new capital.[135] However, the valuation process does not include a court's subjective view on reasonable equivalence.[136] Placing the entire reorganizing entity on the market should test whether the equity holders are truly the most feasible source of new capital.[137] Additionally, as in the condemnation method, the ultimate capital contribution will reflect an adequate price. Without the reliance on formulae for determining "going concern," "control right," or "reorganization" values, the margin for human error decreases substantially, and with it, the chances for inequity.

c. Problems Arising From the Realities Methods

Although beyond the scope of this article, several problems which arise on account of the auction advanced by both methods should be mentioned. First, if the entity is to be auctioned, the problem arises whether third parties should be allowed to bid. If the bidding is restricted only to the creditors and the debtor, the amount paid for the new interest might not accurately reflect the entity's worth in a situation where the creditors are not in the financial position to bid. However, if third parties are allowed to bid, then a takeover of the business could be effected without consideration of federal or state securities regulations. The inequity here results because this takeover, whether hostile or not, could only occur when the entity is in bankruptcy. The applicable non-bankruptcy laws would not allow such a takeover outside of bankruptcy.

A second problem arises with the new owners of the reorganized business. If the original plan was proposed by the debtor, would the new owners be considered the plan proponents for purposes of plan modification or conversion?[138] Could the new owners modify the existing plan, or even convert the case to a chapter 7 liquidation?[139] Any modification or conversion would potentially benefit the owners, but possibly injure the interests of the plan creditors.

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134. The terms "control premium" and "control rights" both reflect the same idea. They are that intangible amount over the value of the entity's assets which a buyer of the business entity as a whole would be willing to pay. *See* James F. Queenan, Jr., *Standards For Valuation Of Security Interests In Chapter 11*, 92 COMM. L.J. 18, 19 (1987) (defining "going concern value" as the asset value plus intangible possibility of future profits or appreciation).

135. The creditors of the reorganized debtor benefit from the debtors acquisition because the capital enables the debtor to keep up with the plan payments.

136. *See Bjolmes Realty*, 134 B.R. at 1010 (noting vagueness of valuation standards).

137. *Id.*

138. *See* 11 U.S.C. § 1127 (1979 & Supp. 1991) (only plan proponent may modify plan).

139. *See id.* § 1112 (debtor can convert or dismiss case under certain circumstances). If new owners control the debtor, they could vote to convert or dismiss. *See id.* § 1127.

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Each of these scenarios represents potential problems with the auction called for under both realities methods. Their discussion could easily constitute the subject matter of several articles. However, with careful planning and creative drafting, many of these problems could possibly be avoided prior to the auction. Because the control premium method reflects the more accurate picture of a reorganized business' value,[140] it represents the most feasible system for determining the amount of capital necessary for purposes of the "new value exception."

4. Arguments In Favor of Continued Application of the Exception

Roughly three arguments exist in favor of the "new value exception: (1) the Supreme Court in *Ahlers* did not overrule the exception and in deciding the case, applied its requirement of "money or money's worth"; (2) in enacting the Bankruptcy Code of 1978 or any of the subsequent amendments, Congress has not overruled *Case*'s interpretation of "fair and equitable" including the exception; and (3) although the new code was designed to be more flexible than the act, some restrictive elements remain in the realities of the system which warrant the application of the exception.

a. The Effect of *Ahlers*

Although *Ahlers* had a chilling effect upon the circuits' confidence in the "new value exception," the Supreme Court did not overrule it.[141] The Court explicitly stated that the decision said nothing of the exception's validity.[142] The issue adjudicated was whether the debtor's retention of interest through future work constituted "money or money's worth" as required under the "new value exception."[143] The Court held that future work did not amount to "money's worth," therefore the exception could not apply.[144] Thus, the Court's holding implicitly recognized the possible survival of the "new value exception."[145]

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140. The control premium method does not require the subjective valuation of the "control rights, " or the subsequent subjective determination of reasonable equivalence.

141. *See Ahlers*, 485 U.S. at 203 n.3.

142. *Id.*

143. Northwest Bank Worthington v. Ahlers, 485 U.S. 197, 205-06 (1988); *see also In re* Greystone III Joint Venture, 102 B.R. 561, 576 (Bankr. W.D. Tex. 1989). The new value exception as applied in the modern courts consists of the following:

> If and only if the cash infusion is needed, it must be actual money or money's worth, paid not merely promised, and the participation accorded the equity interests in exchange for this cash infusion must be commensurate, reasonably equivalent. The equity interests will be allowed back into the venture only to the extent of their new contribution, in order to preserve creditors' full rights of priority in the estate's assets.

Id. at 575.

144. *Ahlers*, 485 U.S. at 203-05.

145. Several cases released soon after the Fifth Circuit's *Greystone* opinion upheld the

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b. Legislative Acquiescence

Judge Jones asserted that Congress implicitly rejected the "new value exception" by refusing to modify the absolute priority rule with the adoption of the Bankruptcy Code of 1978.[146] Why, however, did Congress specifically chose this interpretation to "implicitly" overrule? It is fair to assume that Congress knows of the "new value exception" and the controversy surrounding it.[147] Congress does not shy away from explicitly overturning certain judicial holdings and has done so on numerous occasions.[148] The argument asserted by Judge Jones is tenuous at best. Because Congress has had ample opportunity to expressly overrule the "new value exception" and has chosen not to, it is logical to assume that it was incorporated into the present code.

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validity of the "new value exception." *See, e.g., In re* Triple R. Holdings, 134 B.R. 382, 389 (Bankr. N.D. Cal. 1991) (declaring "new value exception" survived 1978 Code); *In re* Woodscape Ltd. Partnership, 134 B.R. 165, 168-71 (Bankr. D. Md. 1991) (upholding exception's validity); *In re* Professional Dev. Corp., 133 B.R. 425, 427-28 (Bankr. W.D. Tenn. 1991) ("new value exception" allowed under new code).

146. *In re* Greystone III Joint Venture, 948 F.2d 134, 143 (5th Cir. 1991). Judge Jones reasoned that Congress implicitly rejected the "new value exception" because they rejected a proposed modification of the absoluted priority rule. *Id.* What she did not elaborate on, however, was the content of that modification which Congress rejected. The proposal attempted to provide that the "new value exception" would be extended to include contribution of intangible items such as work, knowledge, or other types of assets which courts had consistently rejected. *See In re* Bjolmes Realty Trust, 134 B.R. 1000, 1008 (Bankr. D. Mass. 1991) (citing H.R. Doc. No. 137, 93d Congr., 1st Sess., Pt. I, §§ 7-303(7), 7-310; Pt. II, 258 (1973)).

147. Dewsnup v. Timm, __ U.S. __, __, 112 S. Ct. 773, 779, 116 L. Ed. 2d 903, 912 (1992) (discussing that Congress does not start on "clean slate" when amending bankruptcy laws). The Court hesitates in considering arguments which interpret ambiguous code provisions in a manner that effects a "major change in pre-code practice" without considering legislative history. *Id.*

148. As recently as 1990, Congress reacted with lightning speed in overruling the Supreme Court case of *Pennsylvania Department of Public Welfare v. Davenport*, 495 U.S. __, 110 S. Ct. 2126, 109 L. Ed. 2d 588 (1990). In that case, the Court held that a criminal restitution penalty was dischargeable under chapter 13. *Id.* at __, 110 S. Ct. at 2134, 109 L. Ed. 2d at 600. To ensure their intent was known, Congress overruled the case in two separate acts. S. Rep. No. 101-434, 101st Cong., 2d Sess. 8 (1990), *reprinted in*, 1990 U.S.C.C.A.N. 4065, 4071 (section of act meant to "have the effect of overruling the Supreme Court's recent decision in" *Davenport*); H.R. Rep. No. 101-681(I), 101st Cong., 2d Sess. 165 (1990), *reprinted in*, 1990 U.S.C.C.A.N. 6472, 6571 (act meant to "correct the result" of *Davenport*).

In another example, a Supreme Court case had set a relaxed standard for the definition of "willful and malicious." *See generally* Tinker v. Colwell, 193 U.S. 473 (1904). Several years later, Congress recognized the relaxed standard's impropriety by legislatively overruling the Supreme Court's interpretation. They stated, "to the extent that other cases have relied on *Tinker* to apply a 'reckless disregard' standard, they are overruled." Pub. L. No. 95-598, 95th Cong., 2d Sess. 79 (1978), *reprinted in*, 1978 U.S.C.C.A.N. 5787, 5865.

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c. Flexibility

Originally, Justice Douglas, writing for the majority in *Case*, inserted the "new value exception" to allow flexibility in a rigid bankruptcy system.[149] The confirmation requirement of unanimity allowed renegade creditors to block attempts at reorganization which did not meet with their approval.[150] The "new value exception" permitted the infusion of capital from the shareholders necessary for the reorganization in return for an interest in the ongoing entity. Without the new capital, no attempt at reorganization could succeed, thereby increasing the attraction for liquidation.[151] Without the granting of the interest, no shareholder would make the investment.

With the advent of the code in 1978, Congress created a more flexible approach favoring reorganization.[152] The code dropped the unanimous requirement allowing for plans to be "crammed down" a renegade creditor.[153] However, the softening of the code requirements did not eliminate all the problems that the "new value exception" was created to remedy. First, a problem arises in single asset cases such as *Greystone*. Without the "new value exception," the mortgage creditor essentially forecloses not only on the debtor's mortgaged property, but on the debtor's entire business entity as well. After filing for reorganization, the debtor's owners might as well begin searching for a new business. Allowing the "new value exception" empowers the owners, where they are the most feasible source, to infuse cash for the continuation of the entity. If the owners were not allowed to retain some

149. *See* Case v. Los Angeles Lumber Products Co., 308 U.S. 106, 114 n.6 (1939); *In re* Greystone III Joint Venture, 948 F.2d 134, 143 (5th Cir. 1991) (noting that law during *Case* was much stricter and new value added flexibility).

150. *See Case*, 308 U.S. at 114 n.6 (examining then-current law requiring not only unanimous creditor class consent, but also subject to fair and equitable test and absolute priority rule); *Greystone*, 948 F.2d at 143 (discussing onerous burden of plan during *Case* era).

151. *See, e.g.*, *Case*, 308 U.S. at 121 (recognizing need for infusion of cash for reorganization of certain entities); Kansas City Terminal Ry. v. Central Union Trust Co., 271 U.S. 445, 454-55 (1913) (determining that additional funds would be needed for successful reorganization in some circumstances). In *Greystone*, Judge Clark maintained that:

> [t]here is nothing about the structure of the Code that alters this fundamental recognition of the practicalities of all enterprises. It still takes cash to run any enterprise and the cash flow of the enterprise is frequently inadequate of the task. The same equitable considerations that motivated the recognition of the "exception" in *Kansas City Terminal*, and reaffirmed its vitality under . . . *Case*, commend its preservation under the Bankruptcy Code, to assure that an overstrict application of the "fair and equitable" standard does not strangle the debtor and leave the reorganization stillborn.

Greystone, 102 B.R. at 575.

152. *See* H.R. REP. No. 595, 95th Cong., 2d Sess. 220-21 (1978), *reprinted in*, 1978 U.S.C.C.A.N. 5963, 6179-80 (allowing for plan confirmation without unanimous creditor agreement).

153. *See* 11 U.S.C. § 1129(b) (1991) (no longer requires unanimous acceptance but only acceptance of one impaired class).

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proportional interest, they might as well file for liquidation, essentially stripping the mortgage holder of that deficiency claim granted in section 1122(b).[154] The return on debts from liquidation amounts to substantially less than that on reorganization.[155] Therefore, it is in the best interest of the creditors to encourage reorganization.

The second problem, essentially hidden from this case, arises under small company reorganization efforts. The company needs an infusion of capital to continue operations in these cases.[156] However, it is most likely that none of the creditors would be willing to supply the cash even though they stood to benefit from reorganization. The only feasible means for the company's continuation is for the shareholders to invest new capital. Nevertheless, without the ability to retain an interest, no new capital would be contributed. Allowing the "new value exception" therefore encourages reorganization which benefits all creditors involved.[157]

III. CONCLUSION

The nature of the *Greystone* case represents only a small fraction of the potential single asset cases in Texas, as well as in the United States. During the "booming" 1980s, partnerships and small corporations bought into the commercial real estate market when prices and values were skyrocketing. The mortgage amounts represent the inflated values given during the boom. However, in the present "depression" the actual fair market values represent a mere fraction of the debt. Lenders experienced the decline through a series of abandonments and foreclosures totally wiping out their deficiencies as lost debt. The current savings and loan crisis illustrates the resulting effects.

With bankruptcy being the only option for the majority of these "lost venturers," the goal of the lender should be to encourage reorganization attempts instead of imposing restrictions on the debtor. Reorganization gives

154. *See* 11 U.S.C. § 1111(b) (1991) (only allowing the election under chapter 11). Had Greystone known that they would not be able to effect a reorganization without the complete approval of Phoenix, they might as well have filed a chapter 7 liquidation. Under a chapter 7, Phoenix would not have had the deficiency claim. They would recover nothing on their $3.475 million under a foreclosure unless they purchased the building themselves for the entire amount. *Id.*

155. *See* H.R. REP. No. 595, 95th Congr., 2d Sess. 220-21 (1978), *reprinted in*, 1978 U.S.C.C.A.N. 5963, 6179-80 (commenting on value of reorganization over liquidation).

156. *See, e.g.*, *Case*, 308 U.S. at 121 (recognizing need for injection of capital for reorganization of certain entities); *Kansas City Terminal*, 271 U.S. at 454-55 (determining that additional funds would be needed for reorganization); *In re* Greystone III Joint Venture, 102 B.R. 560, 575 (Bankr. W.D. Tex. 1989) (running reorganization takes cash flow which bankrupt debtor probably will not have).

157. *See* H.R. REP. No. 595, 95th Congr., 2d Sess. 220-21 (1978), *reprinted in*, 1978 U.S.C.C.A.N. 5963, 6179-80 (noting that reorganization benefits creditors more than liquidation).

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the lender a chance to recover more on their debts than through liquidation. The Fifth Circuit's original panel opinion in *Greystone* sent out the message that single asset or small corporation bankruptcies will be executed as cram-downs. However, these cram-downs will be executed by the major creditors and not the debtor as provided in the code. This message would have effectively encouraged debtors, such as Greystone, to file chapter 7 liquidations instead of attempting reorganization, thus compounding the current crisis.

Greystone presents a difficult issue. Although the classification issue borders on the realm of pure gerrymandering, the circuit court should recognize the policy issues advanced by allowing it: Reorganization is encouraged; the goals of bankruptcy are furthered; and previously over-inflated values are more accurately reflected with a little recovery on the deficiency. The harm done by allowing the separate classification will probably arise in increased judicial scrutiny of classification reasons. The advantages here outweigh any disadvantages.

The question concerning the "new value exception" does not represent as difficult a question. Without the exception, many reorganization attempts will be condemned to failure. Undertaking a reorganization without ready cash flow constitutes a feigned attempt destined for chapter 7 conversion. With the correct application, any potential infringements of the absolute priority rule can be avoided. Instances where the shareholders are not the most feasible source of cash do not constitute valid reasons for permitting the exception. The same is true where the infusion made is not substantial. Only where the entity needs an infusion of capital and the shareholders are the most feasible source will the exception be allowed. The potential benefit to small business or single asset reorganizations greatly exceeds any possible violation of creditor's rights through incorrect application.

The Fifth Circuit's withdrawal of the "new value" portion of the *Greystone* opinion created a void of authority throughout the circuit. Essentially, the court reversed on the classification issue and did not reach discussion of the "new value exception." Circuit level bankruptcy decisions play an important role since most bankruptcy law is made at the bankruptcy court level. These circuit level opinions serve to guide the bankruptcy courts on important, disputed issues. The effect of the Fifth Circuit's retreat, therefore, will only serve to maintain the confusion of the status quo with a little doubt thrown in for good measure.

In the depressed economic climate enveloping the country, any action resulting in the discouragement of reorganization should be strictly scrutinized. The potential losses which could occur would greatly increase the current downward economic trend. The Fifth Circuit's original opinion in *Greystone* posed a threat to the attempts at recovery. Now that the Fifth Circuit has withdrawn its opinion covering the "new value exception," and reversed the lower courts' holdings, a tremendous lack of authority is felt

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within the circuit. This void will increase the uncertainty of plans proposed for reorganizing small businesses and single asset partnerships, pushing these debtors toward liquidation.

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