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203 N. LASALLE FIVE YEARS LATER: ANSWERS TO THE OPEN QUESTIONS

PAUL B. LEWIS*

I. INTRODUCTION

From the advent of the new Bankruptcy Code in 1978 until the U.S. Supreme Court's opinion in *Bank of America National Trust and Savings Association v. 203 N. LaSalle Street Partnership*,¹ the ongoing vitality of the so-called new value exception to the absolute priority rule had been a heavily litigated topic and one much debated among academics.² In *203 N. LaSalle*, the Court finally confronted the issue directly.³ The Court's

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1. 526 U.S. 434 (1999).

2. See generally, Walter W. Miller, Jr., *Bankruptcy's New Value Exception: No Longer a Necessity*, 77 B.U. L. REV. 975 (1997); Robert M. Zinman, *New Value and the Commission: How Bizarre!*, 5 AM. BANKR. INST. L. REV. 477 (1997); Nicholas L. Georgakopoulos, *New Value, Fresh Start*, 3 STAN. J. L. BUS. & FIN. 125 (1997); David R. Perlmutter, *Navigating a Proposed "New Value" Plan Through the Cross-Currents of the Confirmation Process: An Arduous Journey for the Debtor of a Single-Asset Real Estate Case*, 17 WHITTIER L. REV. 427 (1996); Michelle Craig, *The New Value Exception: A Plea for Modification or Elimination*, 11 BANKR. DEV. J. 781 (1995); Julie L. Friedberg, *Wanted Dead or Alive: The New Value Exception to the Absolute Priority Rule*, 66 TEMP. L. REV. 893 (1993); Anthony L. Miscioscia, Jr., *The Bankruptcy Code and the New Value Doctrine: An Examination into History, Illusions, and the Need for Competitive Bidding*, 79 VA. L. REV. 917 (1993); Elizabeth Warren, *A Theory of Absolute Priority*, 1991 ANN. SURV. AM. L. 9 (1992); Lynn M. LoPucki & William C. Whitford, *Bargaining over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125 (1990); Kenneth N. Klee, *Cram Down II*, 64 AM. BANKR. L.J. 229 (1990); John D. Ayer, *Rethinking Absolute Priority After Ahlers*, 87 MICH. L. REV. 963 (1989); Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738 (1988); Raymond T. Nimmer, *Negotiated Bankruptcy Reorganization Plans: Absolute Priority and New Value Contributions*, 36 EMORY L. J. 1009 (1987).

3. On two prior occasions, the Court had granted certiorari in new value cases. In 1988, the Court decided *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988). *Ahlers* considered the question of whether the promise by the owners of a failing family farm of future "labor, experience and expertise" was sufficient for the confirmation of a plan of reorganization that otherwise did not satisfy the requirements of the absolute priority rule. *Id.* at 199. While

opinion, while implicitly recognizing the continuing validity of the new value exception, left open numerous questions about how and when the exception should be applied.

In Part II of this Article, I address the controversy surrounding the new value exception to the absolute priority rule. In Part II, I provide an overview of plan confirmation in Chapter 11, including the development of the absolute priority rule, and I trace the pre-*203 N. LaSalle* history of the new value exception to the absolute priority rule. In Part III, I discuss the Court's opinion in *203 N. LaSalle*. In Part IV, I identify some policy issues and note certain potential strategies for debtors and creditors in light of *203 N. LaSalle*. And in Part V, I identify some of the "open issues" following *203 N. LaSalle* and discuss whether and how lower courts have provided answers to these open questions.

II. PLAN CONFIRMATION IN CHAPTER 11 AND THE EVOLUTION OF THE NEW VALUE EXCEPTION TO THE ABSOLUTE PRIORITY RULE

A. Plan Confirmation Requirements

To confirm a plan of reorganization under Chapter 11 of the Bankruptcy Code, thirteen requirements must be satisfied.⁴ Each of these requirements is mandatory, except one—that the plan be consensual.⁵ Creditors vote on a plan by class.⁶ A favorable vote can be obtained in either of two ways. Any class of claimants whose interests are unimpaired⁷ under the plan is automatically deemed to accept the plan.⁸ Alternatively, an impaired class may vote in favor of a plan. To do so, both the majority of creditors in the class must vote in favor of the plan, and the claims of those voting for the plan must have a dollar value equal to at least two-

the Court stated that "the statutory language and the legislative history of § 1129(b) clearly bar any expansion of any exception to the absolute priority rule beyond that recognized . . . at the time Congress enacted the 1978 Bankruptcy Code," the Court did not expressly recognize the validity of the new value exception. *Id.* at 206. In addition, in 1994, the Court granted certiorari on a new value exception case called *Bonner Mall Partnership v. U.S. Bancorp Mortgage Co. (In re Bonner Mall Partnership)*, 2 F.3d 899 (9th Cir. 1993), *cert. granted*, 510 U.S. 1039 (1994). However, this case settled before the Court had an opportunity to decide it.

4. 11 U.S.C. § 1129(a)(1)–(13) (2000).

5. *Id.* § 1129(a)(8).

6. See 11 U.S.C. § 1122 (stating that all holders of claims and interests may vote on the plan); 11 U.S.C. § 1126(a) ("The holder of a claim or interest allowed under section 502 of this title may accept or reject a plan.").

7. A class is said to be impaired unless certain specified requirements are met which essentially leave unaltered the rights of the party in question. See 11 U.S.C. § 1124.

8. 11 U.S.C. §§ 1124, 1126(f).

thirds of the dollar value of all of the claims in the class.⁹

As long as the plan is consensual, the debtor's ability to retain ownership is determined contractually based upon the agreement of the parties, rather than upon the underlying rule of law. If the plan is not consensual, however, and an impaired class rejects the plan, the plan can still be confirmed in what is known as a cramdown,¹⁰ so long as certain requirements are met. These requirements include that at least one class of impaired creditors who are not insiders has accepted the plan,¹¹ that the plan does not discriminate unfairly, that the "best interests test" is satisfied,¹² and that the plan is deemed to be "fair and equitable."¹³

There are two methods of satisfying the fair and equitable requirement, depending on the status of the creditor's claim. For dissenting secured creditors, a plan is fair and equitable and can be crammed down if the secured creditor effectively receives the full economic equivalent of its secured claim.¹⁴ The Code provides three methods of accomplishing this.¹⁵ First, a dissenting secured creditor may keep its lien and receive payments on the plan's effective date equal to the amount of the secured claim;¹⁶ second, the creditor may receive the indubitable equivalent of its claim;¹⁷ or third, the property can be sold free and clear of the lien, with the creditor's security interest attaching to the proceeds of the sale.¹⁸ This lien on proceeds may then be treated under either of the other two options.¹⁹

For impaired, dissenting unsecured creditors, a plan is deemed to be fair and equitable if it satisfies the terms of the absolute priority rule. The absolute priority rule has its origins both in the interpretation of the phrase "fair and equitable" and in contract law. Because creditors have priority over equity under state law, for a plan to be fair and equitable, this order of priority must be retained in a reorganization.²⁰ Hence, the derivation of the absolute priority rule, which holds that in respect to a class of dissenting unsecured creditors, no junior class of claimants can

9. 11 U.S.C. § 1126(c).

10. 11 U.S.C. § 1129(b).

11. See 11 U.S.C. § 1129(a)(10).

12. The best interest test requires the dissenting impaired class of creditors to receive at least as much as it would in a Chapter 7 liquidation. See 11 U.S.C. § 1129(a)(7).

13. See 11 U.S.C. § 1129(b)(1).

14. 11 U.S.C. §§ 1129(b)(2)(A)(i)-(iii).

15. *Id.*

16. *Id.* § 1129(b)(2)(A)(i).

17. *Id.* § 1129 (b)(2)(A)(iii).

18. *Id.* § 1129 (b)(2)(A)(ii).

19. *Id.*

20. See *N. Pac. Ry. Co. v. Boyd*, 228 U.S. 482, 502-05 (1913).

receive a penny in a cramdown unless all senior classes are paid in full.²¹ Thus, a plan is fair and equitable with respect to an impaired, unsecured class if that class will receive full compensation for its allowed claim before any junior class receives any distribution.²²

The absolute priority rule sets the parameters for one end of the negotiation in bankruptcy between the debtor and its unsecured creditors. The prospect that the debtor may ultimately liquidate frames the other end of the dynamic. In a consensual, negotiated reorganization, the unsecured creditors may receive some value even if the debtor's assets are fully encumbered. This is not the case in a liquidation—secured creditors will receive everything, and the claims of the unsecured creditors will be valueless. Thus, the threat of liquidation creates incentives for a class of unsecured creditors to accept a plan that impairs its interests.

Taken in conjunction with the rest of the Bankruptcy Code, the absolute priority rule provides for a distribution in a cramdown that mirrors the priority scheme established under state law. Also, taken at its face, the absolute priority rule seriously calls into doubt the chance of old equity of a company whose assets truly cannot meet its liabilities ever participating in the reorganized debtor absent creditor agreement. This continued involvement by old equity, presumably, represents the very purpose the debtor sought bankruptcy protection in the first place.

B. The New Value Exception to the Absolute Priority Rule

The new value exception to the absolute priority rule raises the question of whether existing shareholders who make additional, necessary cash contributions to a reorganized entity

21. Title 11 U.S.C. § 1129(b)(2) provides:

For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements:

(B) With respect to a class of unsecured claims -

(i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or

(ii) 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.

22. Prior to the adoption of the 1978 Bankruptcy Code, the absolute priority rule went even further in this regard. Under former Chapter X of the Bankruptcy Act, absolute priority had to be maintained for all classes of creditors, irrespective of whether each class consented to the plan. 11 U.S.C. §§ 501-676(c)(3) (1976). Under Chapter 11, absolute priority may be waived by a class that consents to do so. 11 U.S.C. § 1129.

can retain their equity in the reorganized entity when the proposed reorganization plan is neither consensual nor satisfies the absolute priority rule.²³ The absolute priority rule states that shareholders have to pay dissenting, general unsecured creditors in full before they are allowed to retain any interest in the new firm. The exception suggests that notwithstanding a plan's inability to satisfy the absolute priority rule, the infusion of new capital by the equity may justify its retention of an equity interest in the reorganized debtor.

To understand the new value exception, a brief historical overview is necessary. The statutory language of the old Bankruptcy Act of 1898 provided, *inter alia*, for creditors to consent to plans of reorganization that impaired their interests, and it required plans of reorganization to be "fair and equitable." However, the 1898 Bankruptcy Act did not define what that phrase "fair and equitable" meant.

As noted, the absolute priority rule resulted both from an interpretation of the phrase "fair and equitable" and as a rule of contract law. Because creditors have priority over equity under state law, it follows that for a plan to be fair and equitable, this order of priority must be retained.²⁴ Hence, the derivation of the absolute priority rule, in which the last penny of a senior class has priority over the first penny of a junior class.

The idea of a new value exception arose in dicta as a result of the equitable principles inherent in the bankruptcy process. The first case to note the exception was *Kansas City Terminal Railway Co. v. Central Union Trust Co.*²⁵ In dicta, the Court noted that it had the right to modify on equitable grounds the strict priority scheme over the objection of junior creditors when the senior secured creditor, whose claim exceeded the value of the firm, consented, as long as the shareholder of the debtor agreed to

23. The Supreme Court phrased the question as follows:

The issue in this Chapter 11 reorganization case is whether a debtor's prebankruptcy equity holders may, over the objection of a senior class of impaired creditors, contribute new capital and receive ownership interests in the reorganized entity, when that opportunity is given exclusively to the old equity holders under a plan adopted without consideration of alternatives. We hold that old equity holders are disqualified from participating in such a "new value" transaction by the terms of 11 U.S.C. §1129(b)(2)(B)(ii), which in such circumstances bars a junior interest holder's receipt of any property on account of his prior interest.

Bank of Am. Nat'l Trust & Sav. Ass'n. v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 437 (1999).

24. See *N. Pac. Ry. Co.*, 228 U.S. at 508 (requiring creditors to be paid before stockholders).

25. 271 U.S. 445 (1926).

contribute new value to the reorganized company.²⁶ The critical aspect of this determination is that in *Kansas City*, the senior creditor's claim exceeded the value of the firm's assets. Thus, the junior claimants would have received nothing in a liquidation. As such, the key to this dicta is that the proposal in question did not materially differ from a scenario whereby the firm was sold to the secured creditor, who then allowed the old equity to buy into the new firm.²⁷

The next case of historical relevance is *Case v. Los Angeles Lumber Products Co.*²⁸ In *Case*, a major theoretical transformation occurred. The bankruptcy judge in *Case* allowed the existing equity to retain an interest in the reorganized debtor based on the promise of continuing management, influence and good will in the community.²⁹ Unlike in *Kansas City*, the *Case* judge allowed this retention over the objection of the senior creditors. The Supreme Court reversed the holding. Justice Douglas said that what was proffered was insufficient to allow equity to retain an interest in a non-consensual plan. What was proposed by the equity was not tangible cash and had no place in the asset column of the balance sheet of the business.³⁰ But, without commenting on the factual differences between *Kansas City* and *Case*, Justice Douglas indicated that the Court had not categorically rejected a new value exception. It might be a different story, he stated, if the shareholders would contribute "money or money's worth" to get the business back on its feet.³¹

The 1978 Bankruptcy Code codified the meaning of the phrase "fair and equitable." As the term applies to dissenting, unsecured creditors, it is defined as satisfying the absolute priority

26. *Id.* at 454–55.

27. For a more recent case employing the same analysis, see *In re Genesis Health Ventures, Inc.*, 266 B.R. 591, 617–18 (Bankr. D. Del. 2001):

The objectors are correct that the new Management Incentive Plan, while characterized as consideration for continued employment, borders on payments to management on account of their pre-petition equity interests. . . . Such an allocation might indeed be violative of the absolute priority rule, in light of the relatively small dividend proposed to be paid to unsecured creditors, and the extinguishment of equity interests otherwise. Nevertheless . . . the issuance of stock and warrants to management represents an allocation of the enterprise value otherwise distributable to the Senior Lenders, which the Senior Lenders have agreed to offer to the top executives as further incentive to them to remain and effectuate the debtor's reorganization. The Senior Lenders are free to allocate such value without violating the "fair and equitable" requirement.

28. 308 U.S. 106 (1939).

29. *Id.* at 112–13.

30. *Id.* at 122–123.

31. *Id.* at 122.

rule of § 1129(b)(2). Following 1978, the meaning of the phrase thus appeared to no longer depend upon common law analysis. This did not end the debate. Prior to the Court's 1999 decision in *203 N. LaSalle*, courts had essentially taken three approaches to the question of the new value exception. One approach followed the reasoning of *Dewsnup v. Timm*,³² in which the Supreme Court stated that the 1978 Bankruptcy Code did not alter pre-Code judicially created practice unless the legislative history contained at least some discussion of the intent to do so.³³ Thus, this argument proceeds, since the Code is silent on the subject and the legislative history is virtually silent, the rule of *Case* survived the enactment of the 1978 Code.³⁴

A second, opposite approach, was based on the fact that § 1129(b)(2)(B)(ii) of the 1978 Bankruptcy Code replaced the *Case* standard of "fair and equitable" with a Congressionally enacted standard. This new standard contains no reference to a new value exception. As a result, according to this argument, since the words of the statute are clear on their face, the appropriate conclusion appears to be that the new value exception failed to survive the enactment of the 1978 Code.³⁵

The third approach suggests that the new value exception is not an exception to the absolute priority rule at all. The absolute priority rule prohibits retention of one's interest in a reorganized entity "on account of" old interests. In cases where old equity is

32. 502 U.S. 410 (1992).

33. *Id.* at 419-20.

34. Courts that had followed this view include *In re Bonner Mall P'ship*, 2 F.3d 899, 912 (9th Cir. 1993) ("When Congress amends the bankruptcy laws, it does not start from scratch. The Bankruptcy Code should not be read to abandon past bankruptcy practice absent a clear indication that Congress intended to do so.") (citations omitted); *Coones v. Mut. Life Ins. Co.*, 168 B.R. 247, 255 (D. Wyo. 1994) (upholding the new value exception because it is "a well-established pre-Code principle which Congress failed to explicitly repudiate when it enacted the 1978 Bankruptcy Code"); *In re Sovereign Group 1985-27, Ltd.*, 142 B.R. 702, 707 (E.D. Pa. 1992) ("Where Congress intends for legislation to change the interpretation of judicially created concepts, it makes that intent specific; absent such specific intent, it is presumed that Congress did not intend to change prior-existing law.").

35. For examples of this line of reasoning, see *In re Drimmel*, 108 B.R. 284, 289 (Bankr. D. Kan. 1989) (stating that it views "Congress' failure to include the exception in this new definition as the significant factor here rather than its failure to expressly repudiate the exception"); *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1361 (7th Cir. 1990) ("The language of the Code strongly suggests that [the new value exception] did not [survive], and we are to take this language seriously even when it alters pre-Code practices."); *Piedmont Assocs. v. CIGNA Prop. & Cas. Ins. Co.*, 132 B.R. 75, 79 (N.D. Ga. 1991) ("This court believes that the plain language of § 1129(b)(2)(B) and the intent of Congress precludes the existence of any new value exception to the absolute priority rule.").

contributing new capital, the argument goes, its retained interest in the reorganized debtor is based on this new contribution, “not on account” of a prior interest.³⁶ Thus, the absolute priority rule is not violated in such instances.

III. THE 203 N. LASALLE CASE

In 1999, the Supreme Court decided *Bank of America National Trust and Savings Association v. 203 N. LaSalle Street Partnership*.³⁷ The debtor in *203 N. LaSalle* was a single-asset limited partnership that owned fifteen floors of a downtown Chicago office building. Bank of America had lent the debtor \$93 million, secured by a non-recourse first mortgage on the debtor’s principal asset, its office space. Following default and the commencement of foreclosure proceedings, the debtor filed under Chapter 11.

36. *In re Bonner Mall P’ship* illustrates this approach. The case involved a traditional single-asset scenario, and the debtor’s plan provided, inter alia, for the partners to receive nothing on their claims. However, to raise additional capital for the new corporation, the partners would contribute a total of \$200,000 in cash to Bonner Mall Properties in exchange for 2 million of the 4 million authorized shares of the new corporation’s common stock. No other persons were designated to receive stock in exchange for such contributions. *In re Bonner Mall P’ship*, 2 F.3d at 905. The court held that the Code permits the confirmation of a reorganization plan that provides for the infusion of capital by the shareholders of the bankrupt corporation in exchange for stock if the plan meets the conditions that plans were required to meet prior to the Code’s adoption. Among its arguments, the Court stated that if the value added by the old equity was in fact new, substantial, in money or in money’s worth, was necessary for a successful reorganization, and was reasonably equivalent to the value or interest received, the plan would not violate the absolute priority rule because it would not give old equity property “on account of” prior interests, but instead would allow the former owners to participate in the reorganized debtor on account of a substantial, necessary, and fair new value contribution. *Id.* at 911.

37. 526 U.S. 434 (1999). Prior to *203 N. LaSalle*, *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988), was the only post-Code case in which the Supreme Court dealt with the new value exception. In 1994, the Court granted certiorari on a new value exception case called *U.S. Bancorp Mortgage Co. v. Bonner Mall P’ship*, 510 U.S. 1039 (1994). However, this case settled before ever reaching the Court. *Ahlers* considered the question of whether the promise by the owners of a failing family farm of future “labor, experience, and expertise” was sufficient for the confirmation of a plan of reorganization that otherwise did not satisfy the requirements of the absolute priority rule. *Ahlers*, 485 U.S. at 199. The Court found that the owner’s promise was “intangible, inalienable, and in all likelihood unenforceable”, and, quoting the language of *Case*, held that it “has no place in the asset column of the balance sheet of the new [entity].” *Id.* at 204 (quoting *Case*, 308 U.S. at 122–23). The Court went on to state that “the statutory language and the legislative history of § 1129(b) clearly bar any expansion of any exception to the absolute priority rule beyond that recognized in our cases at the time Congress enacted the 1978 Bankruptcy Code.” *Id.* at 206.

The bankruptcy court confirmed a plan that provided for the following: Pursuant to 11 U.S.C. § 506, the Bank's \$93 million claim was split into a secured claim of \$54.5 million and an unsecured deficiency claim of \$38.5 million. Under the terms of the debtor's plan, the Bank's secured claim was to be paid in full over a period of seven to ten years by means of a note secured by a mortgage on the property. The plan classified the Bank's unsecured deficiency claim separately from the unsecured claims of trade creditors,³⁸ and proposed to discharge the Bank's unsecured claim for an estimated sixteen percent of its present value. The remaining \$90,000 of unsecured claims would be paid in full, without interest, on the plan's effective date. As no interest would be paid to the class of general unsecured creditors, this class was deemed impaired; thus, a vote in favor of the plan by this class would satisfy the § 1129(a)(10) requirement that at least one class of impaired claims accept the plan. Finally, under the plan, certain of the debtor's former partners would contribute \$6.125 million in new capital over a five-year period³⁹ in exchange for 100% ownership of the reorganized debtor. This provision was exclusive to the debtor's former equity holders; they were the only parties eligible to contribute new capital in exchange for new equity.

Bank of America objected to the plan on the grounds of the absolute priority rule—former equity holders would receive property even though the Bank's unsecured deficiency claim would not be paid in full. The bankruptcy court approved the plan nevertheless, and the district court affirmed. By a 2-1 decision, the Seventh Circuit affirmed the confirmation of the debtor's plan, holding that "the new value corollary remains a part of our bankruptcy jurisprudence."⁴⁰ The Seventh Circuit found that old equity retained its interest "on account of" its new "infusion of capital" rather than "on account of" its "prior equitable ownership of the debtor."⁴¹ The dissent argued that since there was nothing ambiguous about the statutory text of § 1129(b)(2)(B)(ii), and since the Bankruptcy Code's language includes no express new value exception, confirmation of the plan should have been denied.⁴²

Shortly after the Seventh Circuit's opinion in *203 N. LaSalle* came down, the Second Circuit rejected the Seventh Circuit's *203 N. LaSalle* reasoning in *Coltex Loop Central Three Partners v.*

38. The legitimacy of this separate classification was not raised before the Supreme Court.

39. The contribution was worth \$4.1 million in present value.

40. *In re 203 N. LaSalle St. P'ship*, 126 F.3d 955, 967 (7th Cir. 1997).

41. *Id.* at 964.

42. *Id.* at 971-73 (Kanne, J., dissenting).

BT/SAP Pool Associates (In re Coltex).⁴³ The facts of *Coltux* were materially similar to those of *203 N. LaSalle*.

Coltux also dealt with a partnership holding title to single-asset real estate. Like in *203 N. LaSalle*, the secured creditor in *Coltux* was vastly undersecured. The *Coltux* debtor proposed a cramdown plan under which the partners of the debtor would retain property in the reorganized entity and pay their unsecured creditors (including the secured creditor's deficiency claim) ten percent of the value of their claims.⁴⁴ Pursuant to the plan, the debtor had neither attempted to market the property for sale nor had it tried to identify any source of financing other than the partners' contributions of new value. Only the old partners were permitted to contribute to the plan; there was no opportunity for bids from other parties.⁴⁵

The Second Circuit held that partners were receiving property "on account of" their old equity position.⁴⁶ The court's reasoning was based on the absence both of competitive bids and of competing plans, as well as the lack of exposure to the market. The court stated that "old equity was the lender of first opportunity, rather than the lender of last resort."⁴⁷ But the *Coltux* court did not hold that the new value exception did not exist. Rather, the court ruled that had the market for the property been adequately tested, it might have been possible for old equity to show that it was not receiving its interest on account of its prior position.⁴⁸

In its *203 N. LaSalle* opinion, the U.S. Supreme Court did not expressly decide whether the Bankruptcy Code in fact includes a new value exception. Rather, the Court determined that even if the exception was encompassed within the Code, the debtor's proposed plan would still fail to satisfy § 1129 (b)(2)(B)(ii).⁴⁹ The core rationale of the opinion is that § 1129(b)(2)(B)(ii) was violated since the plan, adopted without consideration of alternatives and over the objection of a senior class of impaired creditors, gave the debtor's pre-bankruptcy equity holders the exclusive opportunity to contribute new capital and receive ownership interests in the reorganized entity.⁵⁰

The Court began its analysis by noting that the statutory

43. 138 F.3d 39 (2d Cir. 1998).

44. *Id.* at 44-45.

45. *Id.*

46. *Id.* at 42.

47. *Id.*

48. *Id.* at 44-46.

49. *203 N. LaSalle*, 526 U.S. at 454.

50. *Id.* at 456-58.

language contained in the Bankruptcy Code is “inexact.”⁵¹ It thus proceeded to trace the development of the pre-Code absolute priority rule, now codified at § 1129(b)(2)(B)(ii), emphasizing that the new value exception pre-Code “never rose above the technical level of dictum in any opinion of [the] Court,”⁵² and that before the enactment of the current Bankruptcy Code, no court had ever relied on the dictum in *Case* to approve a plan that gave old equity a property interest after reorganization.⁵³

The Court next determined that the relevant legislative history did not eliminate the possibility that the codified absolute priority rule in fact encompasses a new value exception. The Court stated:

Although there is no literal reference to “new value” in the phrase “on account of such junior claim,” the phrase could arguably carry such an implication in modifying the prohibition against receipt by junior claimants of any interest under a plan while a senior class of unconsenting creditors goes less than fully paid.⁵⁴

Turning to the statutory language, the Court considered three possible meanings of the phrase “on account of.” The first was that the language “on account of” means something like “in exchange for,” or “in satisfaction of.”⁵⁵ The Court rejected this interpretation.⁵⁶ The second position, also rejected by the Court, is

51. *Id.* at 444.

52. *Id.* at 445.

53. *Id.* at 445–46.

54. *Id.* at 449.

55. *Id.* at 449–450.

56. It did so for two reasons, one textual, the other practical. As for the former,

[S]ubsection (b)(2)(B)(ii) forbids not only receipt of property on account of the prior interest but its retention as well. A common instance of the latter would be a debtor’s retention of an interest in the insolvent business reorganized under the plan. Yet it would be exceedingly odd to speak of “retaining” property in exchange for the same property interest, and the eccentricity of such a reading is underscored by the fact that elsewhere in the Code the drafters chose to use the very phrase “in exchange for,” § 1123(a)(5)(J) (a plan shall provide adequate means for implementation, including “issuance of securities of the debtor . . . for cash, for property, for existing securities, or in exchange for claims or interests”).

203 N. LaSalle, 526 U.S. at 449–50 (internal citation omitted).

As for the latter,

[t]he unlikelihood that Congress meant to impose a condition as manipulable as subsection (b)(2)(B)(ii) would be if “on account of” meant to prohibit merely an exchange unaccompanied by a substantial infusion of new funds but permit one whenever substantial funds changed hands. “Substantial” or “significant” or “considerable” or like characterizations

the more common understanding that “on account of” means “because of.”⁵⁷ Rather, the Court turned to a “less absolute statutory prohibition” that would better “reconcile the two recognized policies underlying Chapter 11, of preserving going concerns and maximizing property available to satisfy creditors.”⁵⁸ The Court suggested that presumably a new value plan would violate absolute priority

whenever old equity’s later property would come at a price that failed to provide the greatest possible addition to the bankruptcy estate, and it would always come at a price too low when the equity holders obtained or preserved an ownership interest for less than someone else would have paid. A truly full value transaction, on the other hand, would pose no threat to the bankruptcy estate not posed by any reorganization, provided of course that the contribution be in cash or be realizable money’s worth.⁵⁹

The Court, however, specifically declined to decide what level of causation was required to bar a new value plan.⁶⁰ Although the Court stated that “the Debtor’s exclusive opportunity to propose a plan under § 1121(b) is not itself ‘property’ within the meaning of subsection (b)(2)(B)(ii),”⁶¹ the Court observed that the debtor’s plan was “doomed . . . by its provision for vesting equity in the reorganized business in the Debtor’s partners without extending

of a monetary contribution would measure it by the Lord Chancellor’s foot, and an absolute priority rule so variable would not be much of an absolute.

Id. at 450.

57. While recognizing that “what activates the absolute priority rule” is “a causal relationship between holding the prior claim or interest and receiving or retaining property.” *Id.* at 451. The court’s rationale for rejecting this standard was the following:

If, as is likely, the drafters were treating junior claimants or interest holders as a class at this point then the simple way to have prohibited the old interest holders from receiving anything over objection would have been to omit the “on account of” phrase entirely from subsection (b)(2)(B)(ii). On this assumption, reading the provision as a blanket prohibition would leave “on account of” as a redundancy, contrary to the interpretive obligation to try to give meaning to all the statutory language. One would also have to ask why Congress would have desired to exclude prior equity categorically from the class of potential owners following a cramdown. Although we have some doubt about the Court of Appeals’s assumption that prior equity is often the only source of significant capital for reorganizations, old equity may well be in the best position to make a go of the reorganized enterprise and so may be the party most likely to work out an equity-for-value reorganization.

Id. at 452–53 (citations omitted).

58. *Id.* at 453.

59. *Id.* at 453–54.

60. *Id.* at 454.

61. *Id.*

an opportunity to anyone else either to compete for that equity or to propose a competing reorganization plan.”⁶² The Court emphasized that

the exclusiveness of the opportunity, with its protection against the market’s scrutiny of the purchase price by means of competing bids or even competing plan proposals, renders the partners’ right a property interest extended “on account of” the old equity position and therefore subject to an unpaid senior creditor class’s objection.⁶³

The Court observed that although it could be argued that the opportunity has no market value, it stated that “the law is settled that any otherwise cognizable property interest must be treated as sufficiently valuable to be recognized under the Bankruptcy Code.”⁶⁴

The critical issue in the opinion seems to be the Court’s statement that it would be “necessary for old equity to demonstrate its payment of top dollar”⁶⁵ to ensure that it did not receive its interest in the reorganized debtor on account of its former equity interest. And, “the best way to determine value is exposure to a market,”⁶⁶ not by judicial valuation.⁶⁷ However, the Court declined to give detailed guidance regarding the means to accomplish this. It concluded:

Whether a market test would require an opportunity to offer competing plans or would be satisfied by a right to bid for the same interest sought by old equity, is a question we do not decide here. It is enough to say, assuming a new value corollary, that plans providing junior interest holders with exclusive opportunities free from competition and without benefit of market valuation fall within the prohibition of § 1129(b)(2)(B)(ii).⁶⁸

Justice Thomas, joined by Justice Scalia, concurred. The concurrence argued that neither of the two options for confirming non-consensual plans had been met.⁶⁹ The Bank did not get property equal to the allowed amount of its claim, nor was the absolute priority rule satisfied. In addition, the concurrence contended that old equity received at least two forms of property under the plan: First, it received the exclusive opportunity to obtain equity, and second, it retained an equity interest in the reorganized entity. Since this was sufficient to determine the outcome, the majority’s “speculations about the desirability of a

62. *203 N. LaSalle*, 526 U.S. at 454.

63. *Id.* at 456.

64. *Id.* at 455.

65. *Id.* at 457.

66. *Id.* at 457.

67. *Id.*

68. *Id.* at 458.

69. *Id.* at 459 (Thomas, J., concurring).

'market test'. . . are dicta binding neither this Court nor the lower federal courts."⁷⁰ As for relying on prior practice, the concurrence stated that the "Code's overall scheme often reflects substantial departures from various pre-Code practices. . . . Hence it makes little sense to graft onto the Code concepts that were developed during a quite different era of bankruptcy practice."⁷¹

Justice Stevens dissented. In his dissent, he stated "that a holder of a junior claim or interest does not receive property 'on account of' such a claim when its participation in the plan is based on adequate new value."⁷² As long as the interest is not at a bargain price, it does so "on account of" its prior claim.⁷³ As for the exclusive option to purchase, "[w]hat the Court refuses to recognize, however, is that this 'exclusive opportunity' is the function of the procedural features of this case: the statutory exclusivity period, the Bankruptcy Judge's refusal to allow the bank to file a competing plan, and the inescapable fact that the judge could confirm only one plan."⁷⁴

IV. POLICY AND STRATEGY RELATED TO 203 N. LASALLE

A. Policy

An initial policy analysis of 203 N. LaSalle begins with one central question—namely, why might we desire that new value plans be possible under the Code. There are a number of possible rationales.⁷⁵ The first relates to the basic proposition that more

70. 203 N. LaSalle, 526 U.S. at 459–60 (Thomas, J., concurring).

71. *Id.* at 461-62 (Thomas, J., concurring).

72. *Id.* at 464 (Stevens, J., dissenting).

73. *Id.* at 465 (Stevens, J., dissenting).

74. *Id.* at 471 (Stevens, J., dissenting).

75. In practice, the new value exception is overwhelmingly employed in single-asset real estate cases. See David Gray Carlson & Jack F. Williams, *The Truth About the New Value Exception to Bankruptcy's Absolute Priority Rule*, 21 CARDOZO L. REV. 1303, 1305 n.10 (2000) (noting that an empirical survey of post-*Ahlers* cases shows ninety-two percent of new value cases involve real estate); Lynn M. LoPucki & William C. Whitford, *Preemptive Cram Down*, 65 AM. BANKR. L.J. 625, 645 n.91 (1991) ("The new value exception appears to play a negligible role in the reorganization of large, publicly held companies."). It is thus worth noting that there has been some significant discussion about whether single-asset real estate cases should be allowed to reorganize at all. The argument against allowing reorganization in single-asset cases is that single-asset real estate cases are essentially two-party disputes better handled by state foreclosure law. For a detailed discussion, see Kenneth Klee, *One Size Fits Some: Single Asset Real Estate Bankruptcy Cases*, 87 CORNELL L. REV. 1285, 1301 (2002). See also Douglas G. Baird & Edward R. Morrison, *Bankruptcy Decision Making*, 17 J.L. ECON. & ORG. 356, 371 (2001) (arguing that Chapter 11 is inefficient compared to the alternative of mandatory auction); Alex M. Johnson, Jr., *Critiquing the*

bidders in general results in better auctions. The more interested bidders, the greater the price the auction is likely to return,⁷⁶ which in turn means more funds available for distribution to creditors.⁷⁷ Further, a rational equity holder may bid more than a rational third-party creditor or a third-party buyer. This is the case for a number of reasons. First, as illustrated by *203 N. LaSalle*, in many cases (particularly single-asset real estate partnerships), the old equity holders benefit from preserving tax attributes of ownership. Second, equity holders are already familiar with the business and are thus less likely to discount their bids for unknown risks. Other motivations may include family name and identity associated with the business or embarrassment over failure to pay creditors. Finally, the equity holders may also have personal liability, such as guaranties, linked to the continuation of the business, or personal income opportunities, such as employment compensation or management fees.⁷⁸

An additional justification for desiring the availability of new value plans may be to increase the likelihood that the business may successfully reorganize rather than be liquidated.⁷⁹ The

Foreclosure Process: An Economic Approach Based on the Paradigmatic Norms of Bankruptcy, 79 VA. L. REV. 959, 989 (1993) (stating that expeditious and inexpensive foreclosure is a key part of the ex ante bargain that allows lenders to keep down interest rates). See generally THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* (1986) (arguing bankruptcy should interfere with state law created rights primarily to solve common pool problems).

76. For a discussion, see Paul Klemperer, *Auction Theory: A Guide to the Literature*, 13 J. ECON. SURVS. 227, 239 (1999).

77. However, with respect to the single-asset case, the practical value of an auction of the debtor's equity may be questioned. Some courts have noted that the market for equity participation for failing businesses (particularly small failing businesses) is thin. See, e.g., *In re SM 104 Ltd.*, 160 B.R. 202, 227 (Bankr. S.D. Fla. 1993). The typical disclosure statement does not in all likelihood permit a fully informed investing public to participate. Thus, as a practical matter, bidding may well be limited to one or two major creditors and the insiders. See, e.g., Warren, *supra* note 2, at 9; Judith Greenstone Miller & John C. Murray, *The "New Value" Exception: Myth or Reality After Bank of America National Trust & Savings Association v. 203 N. LaSalle Street Partnership?*, 104 COM. L.J. 147 (1999).

78. See, e.g., Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 STAN. L. REV. 69 (1991) [hereinafter Markell, *Owners, Auctions, and Absolute Priority*]; Douglas G. Baird, *Revisiting Auctions in Chapter 11*, 36 J.L. & ECON. 633, 647-52 (1993).

79. There is no doubt that reorganization has traditionally been seen as generally preferable to liquidation. See, e.g., *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 203 (1983) ("By permitting reorganization, Congress anticipated that the business would continue to provide jobs, to satisfy creditors' claims, and to produce a return for its owners. Congress presumed that the assets of the debtor would be more valuable if used in a rehabilitated business than if 'sold for scrap.'") (citations omitted) (quoting H.R. REP. NO.

reorganization process may be viewed as more than a collective proceeding for the enforcement of rights held by creditors under state law. Rather, liquidations may have a negative impact on jobs, suppliers to businesses, and the economy as a whole. The ability of shareholders to remain in control and rehabilitate the business encourages reorganization instead of liquidation.⁸⁰

Is there policy that goes against the desirability of new value plans? The answer depends on whom one believes should be given ultimate discretion to determine the future of insolvent firms. New value plans remove the ultimate decision of a firm's future from creditors, who effectively own insolvent firms,⁸¹ and largely give that power to the equity holders, who do not share the same risk-reward incentives that creditors do when dealing with insolvent firms. As a result, creditors lose their "right" to block confirmation of plans that would otherwise violate the absolute priority rule.

Removing this power from creditors cuts against certain basic concepts. The notion of keeping ultimate decision making power with those who bear the risk of loss—creditors—is consistent with the notion that when a firm becomes insolvent outside of

95-595, at 220 (1977)).

80. However, as noted, the vast majority of new value cases have historically involved single-asset real estate cases, not operating businesses. In such cases, with a relatively small pool of unsecured debt and no employees, the only competing interests appear to be the secured creditor and the equity, who are likely concerned about tax ramifications of a sale. In such cases, failure to confirm a new value plan and subsequent foreclosure on the property does not effect the cessation of business. It merely causes title to change hands. See Zinman, *supra* note 2, at 498-500.

81. See *Kham & Nate's Shoes No. 2*, 908 F.2d at 1360 ("Creditors effectively own bankrupt firms."). In fact, the fiduciary duty of a firm's directors shifts upon insolvency from the firm's shareholders to its creditors. See *Am. Nat'l Bank of Austin v. Mortgageamerica Corp. (In re Mortgageamerica)*, 714 F.2d 1266, 1269 (5th Cir. 1983) ("Becoming insolvent, the equitable interest of the stockholders in the property, together with their conditional liability to the creditors, places the property in a condition of trust, first for the creditors, and then for the stockholders.") (quoting *Hollins v. Brierfield Coal & Iron Co.*, 150 U.S. 371, 383 (1893)). See also *Clarkson Co. v. Shaheen*, 660 F.2d 506, 512 (2d Cir. 1981) (stating that "[i]f the corporation was insolvent at that time it is clear that defendants, as officers and directors thereof, were to be considered as though trustees of the property for the corporate creditor-beneficiaries.") (quoting *N.Y. Credit Men's Adjustment Bureau, Inc. v. Weiss*, 110 N.E.2d 397, 398 (N.Y. 1953)); *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, No. 12510, No. CIV.A.12150, 1991 WL 277613, at *34 (Del. Ch. Dec. 30, 1991) ("At least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise."); *FDIC v. Sea Pines Co.*, 692 F.2d 973, 976-77 (4th Cir. 1982) ("[W]hen the corporation becomes insolvent, the fiduciary duty of the directors shifts from the stockholders to the creditors.").

bankruptcy, the fiduciary duty of the firm's directors and officers shifts from shareholders⁸² to creditors.⁸³ The rationale for this is

82. A solvent corporation does not owe creditors the same fiduciary obligations. *See, e.g.*, *Steinberg v. Kendig (In re Ben Franklin Retail Stores, Inc.)*, 225 B.R. 646, 652-53 (Bankr., N.D. Ill. 1998).

The shareholders, after all, own the corporation and management of the corporate assets is vested in the directors. The directors are therefore entrusted with the control and management of the property of others. As frequently happens when a person is so entrusted with the property of others, the law imposes fiduciary obligations on that person. Creditors, on the other hand, deal with corporations by entering into contracts. Satisfaction of their claims against the corporate assets requires only compliance with their contracts. So long as the corporation is solvent, they require no additional protection; by definition, a solvent corporation, no matter how badly managed otherwise, is able to satisfy its contractual obligations.

Id. *See also* *Lorenz v. CSX Corp.*, 1 F.3d 1406, 1417 (3d Cir. 1993) (discussing that under New York law, it is a "well-established" principle that "a corporation does not have a fiduciary relationship with its debt security holders").

83. Many courts have supported this proposition. *See, e.g.*, *Credit Lyonnais Bank Nederland*, 1991 WL 277613, at *34 ("At least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise."). In such instances, "circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act." *Id.* at *36 n.55. *See also* *Sea Pines Co.*, 692 F.2d at 976-77 ("[W]hen a corporation becomes insolvent, the fiduciary duty of the directors shifts from the stockholders to the creditors."); *In re Kingston Square Assocs.*, 214 B.R. 713, 735 (Bankr. S.D.N.Y. 1997) ("[I]t is universally agreed that when a corporation approaches insolvency or actually becomes insolvent, directors' fiduciary duties expand to include general creditors."); *Geyer v. Ingersoll Publ'ns Co.*, 621 A.2d 784, 787 (Del. Ch. 1992) ("[W]hen the insolvency exception does arise, it creates fiduciary duties for directors for the benefit of creditors."). *See also* Christopher W. Frost, *The Theory, Reality and Pragmatism of Corporate Governance in Bankruptcy Reorganizations*, 72 AM. BANKR. L.J. 103, 108 (1998).

In a growing number of cases, courts hold that managerial allegiance must shift to the creditors when the corporation approaches insolvency. Upon insolvency, the residual claims of the shareholders become economically worthless. Creditors who go unpaid in the event of complete financial failure now occupy the position of residual owners. Thus, it is not surprising that managerial allegiance should depend upon the fortunes of the business.

Id. *See generally* Michael D. Sabbath, *Liability of Officers and Directors for Pre-Petition Management of the Financially Troubled Company*, (Mercer University School of Law) (on file with author and the John Marshall Law Review). A number of courts have held that while a fiduciary duty extends to the creditors upon insolvency, it also remains with the shareholders as well. *See, e.g.*, *Sanford Fork & Tool Co. v. Howe Brown & Co.*, 157 U.S. 312, 317-19 (1895) (holding that the directors of an insolvent corporation, which was still a going concern intending to continue its business, stood in a fiduciary

straightforward. As the court in *Steinberg v. Kendig (In re Ben Franklin Retail Stores, Inc.)*⁸⁴ explained,

The economic rationale for the "insolvency exception" is that the value of creditors' contract claims against an insolvent corporation may be affected by the business decisions of managers. At the same time, the claims of the shareholders are (at least temporarily) worthless. As a result, it is the creditors who "now occupy the position of residual owners."⁸⁵

Thus, equity bears essentially no risk once a firm is insolvent. And those who bear no risk have every incentive to engage in behavior which maximizes their own prospects of recovery while threatening the value held by the secured creditors.⁸⁶ Secured

relationship to both the stockholders and the creditors); *In re Mortgageamerica Corp.*, 714 F.2d at 1277 (holding that officers and directors of insolvent corporations "are fiduciaries to the corporations' stockholders and creditors") (quoting *Hassett v. McColley (In re O.P.M. Leasing Servs.)*, 28 B.R. 740, 759 (Bankr. S.D.N.Y. 1983)); *Geyer*, 621 A.2d at 789 ("[E]xistence of the fiduciary duties at the moment of insolvency may cause directors to choose a course of action that best serves the entire corporate enterprise rather than any single group interested in the corporation at a point in time when shareholders' wishes should not be the directors only concern.").

84. 225 B.R. 646.

85. *Id.* at 653 (quoting *Geyer*, 621 A.2d at 787). This shift in fiduciary duty is often described in terms of the creation of a trust fund to be utilized for the benefit of corporate creditors. See, e.g., *Bovay v. H.M. Byllesby & Co.*, 38 A.2d 808, 813 (Del. 1944) ("An insolvent corporation is civilly dead in the sense that its property may be administered in equity as a trust fund for the benefit of creditors.") (citations omitted); *Clarkson Co.*, 660 F.2d at 512 ("If the corporation was insolvent at that time it is clear that defendants, as officers and directors thereof, were to be considered as though trustees of the property for the corporate-beneficiaries [creditors].") (quoting *N.Y. Credit Men's Adjustment Bureau*, 110 N.E.2d at 398). See also D. BLOCK, ET AL., *THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS* 597 (5th ed. 1998). *But see* *St. James Capital Corp. v. Pallet Recycling Assocs. of N. Am., Inc.*, 589 N.W.2d 511, 516 (Minn. Ct. App. 1999).

Creditors are not owed a duty by an insolvent corporation's directors and officers to minimize any loss that may occur as a result of the corporation's insolvency. To hold otherwise would allow creditors of a corporation, solvent or insolvent, to interfere unduly and interject themselves in the day-to-day management of the corporation. While it is axiomatic that creditors have the right to be repaid, it is equally true that they do not have the right, absent an agreement to the contrary, to dictate what course of action the directors and officers of a corporation shall take in managing the company, or . . . to direct how the assets of the corporation shall be disposed of to satisfy the debts of the corporation.

Id.

86. See, e.g., Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97, 107 (1984) ("Members of any group of investors that would be

creditors, by contrast, have a fixed upside, but bear the risk of loss.⁸⁷ By placing the ultimate decision-making power in the hands of the equity by allowing new value plans, two results follow. First, as noted, the decision-making process is placed in the hands of an inappropriate party. And second, the heightened risk to creditors may lead to a rise in the cost of credit⁸⁸ and a limit on its availability.⁸⁹

203 N. LaSalle provides additional financial protection for undersecured and unsecured creditors in Chapter 11. As noted, the Supreme Court determined that to be consistent with the goal of maximizing creditor return, old equity needs to pay at least as much as any third party would pay for a bankruptcy court to conclude that their interest in the reorganized entity is not “on account of” their prior interests.⁹⁰ The Court also made noises suggesting that ultimate decisions should be creditor-driven by reflecting a general preference for economic self-determination,⁹¹

eliminated by a present liquidation or sale of assets have nothing to lose by seeking a solution that avoids a final distribution today.”)

87. See, e.g., Christopher W. Frost, *Asset Securitization and Corporate Risk Allocation*, 72 TUL. L. REV. 101, 123 (1997) (“Because such claimants have fixed claims, they will not benefit from any potential increase in value resulting from the reorganization. In the event of catastrophe, however, such creditors may bear some of the losses.”).

88. See, e.g., Robert J. Rosenberg, *Beyond Yale Express: Corporate Reorganization and the Secured Creditor’s Rights of Reclamation*, 123 U. PA. L. REV. 509, 515–16 (1975).

The institution of secured credit, which makes capital available to high risk enterprises which could not otherwise obtain it, is making a vital, and perhaps an irreplaceable, contribution toward economic expansion While the contingency of nonenforcement will not affect all potential borrowers equally, since the stronger would just have to pay more for their credit, while the weaker would be denied credit altogether, its effect on the cost of credit, and thereby upon economic growth, is undeniable.

89. As the Australian Law Reform Commission noted in contemplating major changes to the Australian business reorganization laws: “[A]s a matter of economics, it would be undesirable to impede the flow of credit by devaluing the security or other rights which a creditor may require as a condition of giving credit.” AUSTRALIAN LAW REFORM COMM’N, 1 REPORT NO. 45: GENERAL INSOLVENCY INQUIRY 49 (1988), available at <http://www.austlii.edu.au/au/other/alrc/publications/reports/45/>.

90. “A truly full value transaction, on the other hand, would pose no threat to the bankruptcy estate not posed by any reorganization, provided of course that the contribution be in cash or be realizable money’s worth” *203 N. LaSalle*, 526 U.S. at 453–54.

91. Congress enacted Chapter 11 with the “view that creditors and equity security holders are very often better judges of the debtor’s economic viability and their own economic self-interest than courts, trustees, or [governmental agencies such as] the SEC.” *203 N. LaSalle*, 526 U.S. at 458 n.28 (quoting G. Eric Brunstad, et al., *Review of the Proposals of the National Bankruptcy Review Commission Pertaining to Business Bankruptcies: Part One*, 53 BUS.

rather than a view that Chapter 11 should be a “court-driven, debtor-protective regime.”⁹² But *203 N. LaSalle* failed to normalize investment incentives by returning them to a scenario where bankruptcy investment incentives remain economically comparable to those that exist under non-bankruptcy law.⁹³ To do this, investment incentives must reflect both potential gain and potential loss. Outside of bankruptcy, equity has both something to gain and something to lose. They thus have appropriate incentives to make economically rational decisions. Inside of bankruptcy, the appropriate risk-reward incentives rest with the creditors, not the equity, and the equity in turn has economic incentives to undertake unduly risky action.⁹⁴ This is antithetical to the primary goals of bankruptcy.⁹⁵

So while *203 N. LaSalle* guaranteed unsecured creditors the maximum value which the market would bear in return for their being forced to accept a plan they opposed, it did not return control to the creditors themselves to determine the firm’s future. This lack of creditor control may well lead to undesirable results. As Professors Baird and Jackson have written:

Bankruptcy law makes a grave mistake if it assumes that a junior (or another class) will make the correct decision about the deployment of the assets without a legal rule that forces it to take account of investors as a group [T]he best way of ensuring the correct decision — by which we mean that the decision that is not distorted by the self-interest of individuals at the expense of the group — is to create a legal rule that imposes upon the person who makes the decision all the benefits if he decides correctly and all the

LAW. 1381, 1406 n.136 (1998)).

92. See G. Eric Brunstad, Jr. & Mike Sigal, *Competitive Choice Theory and the Broader Implications of the Supreme Court’s Analysis in Bank of America v. 203 N. LaSalle Street Partnership*, 54 BUS. LAW. 1475, 1479-80 (1999).

93. *Id.* at 1480 (arguing for competitive choice theory in the bankruptcy context, meaning that “the best decisions regarding what is to be done with bankrupt debtors, their obligations, and their assets are more likely to be realized if decision-making in the bankruptcy context is made to approximate decision-making in the context of financially healthy firms outside the bankruptcy arena”).

94. There are insolvency systems which afford secured creditors these powers. For example, the Australian approach to insolvency, known as Voluntary Administration, allows secured creditors with a lien on substantially all of the debtor’s assets to in effect opt out of the bankruptcy proceeding and foreclose on its security, and the prospect of cramdown on both secured and unsecured creditors is far more limited in Australia than it is in the United States. Paul B. Lewis, *Trouble Down Under: Some Thoughts on the Australian-American Corporate Bankruptcy Divide*, 2001 UTAH L. REV. 189, 194-95.

95. Brunstad & Sigal, *supra* note 92, at 1482-83.

costs if he guesses wrong.⁹⁶

B. Strategy

The *203 N. LaSalle* opinion created a different framework for creditor and debtor attorneys in thinking about possible confirmation of new value plans with *203 N. LaSalle*-type facts. Among the strategies for creditor lawyers to consider post-*203 N. LaSalle* are the following:

- Purchase other unsecured claims by making an offer to all unsecured creditors for close to full payment. In single-asset cases, this amount is likely to be low.
- Object to the separate classification of the unsecured deficiency claim from the other non-insider general unsecured claims.
- Object to the favorable treatment of general unsecured claims (other than the deficiency claim), on the grounds that it constitutes “artificial impairment” and on the grounds of unfair discrimination.
- Contest a low valuation of the collateral.
- Contest the interest rate and terms of repayment proposed by the debtor for the treatment of the secured claim in the plan.
- Move to terminate or to shorten the debtor’s exclusive period to file a plan.
- Propose a competing plan, possibly a liquidating plan, under which the collateral is sold shortly after confirmation.
- Object to confirmation of the debtor’s new value plan unless it is subject to a true auction that allows other creditors and third parties to bid and acquire post-confirmation equity.

Possible strategies for debtors’ lawyers to consider post-*203 N. LaSalle* to increase the likelihood of confirmation include:

- Purchase the small non-insider unsecured claims and aggregate them in a class that will vote to accept the plan.
- Separately classify the non-insider unsecured claims and treat them well in order to obtain their vote, while continuing to impair them so that their vote counts as an accepting class.
- Protect the initial 120-day exclusivity period by providing frequent reports to the court and creditors about progress toward a restructuring plan.
- File a plan of reorganization within the 120 days; do

96. Baird & Jackson, *supra* note 86, at 124–25.

not assume the debtor will obtain an extension beyond that date.

- Do not rely on continuing exclusivity once a new value plan is filed.
- Insure that the new value contribution is significant in relation to the non-insider general unsecured claims.
- Give careful thought to whether the new contribution should be used to pay pre-petition unsecured claims, for post-confirmation working capital or improvements in the property, or for both.
- Give careful thought to the auction provided for by the plan. Consider whether the auction should invite participation by creditors only or also by outsider investors. Also, consider potential difficulties that could accompany auctions, such as having overly restrictive bidding rules, unnecessarily high entrance fees, minimum bids, non-refundable deposits, and the like.
- Consider whether to engage a broker or investment advisor to actively search for alternative financing or purchasers.

V. THE "OPEN ISSUES" FOLLOWING *203 N. LASALLE*

Shortly after the release of the *203 N. LaSalle* opinion, commentators began to note two significant omissions in the Supreme Court's opinion. The first deals with the issue of causation.⁹⁷ The Court held that the debtor's plan was doomed since it vested "equity in the reorganized business in the Debtor's partners without extending an opportunity to anyone else either to compete for the equity or to propose a competing reorganization plan."⁹⁸ That is, there was a direct causal relationship between the status of old equity and its right to participate in the reorganized debtor. Thus, under the Court's ruling, old equity is not per se barred from participating in the reorganized entity, but its participation cannot be wholly on account of its prior status. However, the Court specifically declined to decide what level of causation was required to bar a new value plan from being

97. See, e.g., Robert J. Keach, *LaSalle, the "Market Test" and Competing Plans: Still in the Fog*, 21 AM. BANKR. INST. J. 18 (2002) (discussing the debate over whether competing bids or competing plans are appropriate); Hieu T. Hoang, Comment, *The New Value Exception to the Absolute Priority Rule After In re 203 N. LaSalle Street Partnership: What Should Bankruptcy Courts Do, and How Can Congress Help?*, 149 U. PA. L. REV. 581, 596-98 (2000).

98. *203 N. LaSalle*, 526 U.S. at 454.

confirmed.⁹⁹

The second omission dealt with the question of the market test.¹⁰⁰ The critical element of the Court's opinion appears to be the concept that old equity must demonstrate its payment of top dollar.¹⁰¹ The best way to determine value is exposure to the market. However, the Court declined to give direct guidance on how this demonstration of "top dollar" should be accomplished. Following the Court's opinion, it remained unclear whether a market test requires an opportunity to offer competing plans, or whether it can be satisfied by a provision in the debtor's plan under which creditors and other third parties are afforded the right to bid for the interest sought by old equity.¹⁰²

A number of other omissions have subsequently become clear as well. Five years after the ruling in *203 N. LaSalle*, as a general matter, lower courts have been reluctant to provide much guidance in terms of exploring the ramifications of *203 N. LaSalle*. Not only does there appear to be a shortage of cases which involve fact-specific determinations, but courts also appear reluctant to take the reasoning behind *203 N. LaSalle* and expand it to its logical limits. I now examine some of the key "open questions" and discuss what, if any, treatment these questions have received by lower courts post-*203 N. LaSalle*.

A. *Does the New Value Exception Continue to Exist?*

This appears to be the easiest of the "open issues." Courts¹⁰³ and commentators¹⁰⁴ have interpreted the Supreme Court's

99. *Id.*

100. See Keach, *supra* note 97, at 18 (noting that the Supreme Court failed to define "market test"); Bruce A. Markell, *LaSalle and the Little Guy: Some Initial Musings on the Ultimate Impact of Bank of America, NT & SA v. 203 N. LaSalle Street Partnership*, 16 BANKR. DEV. J. 345, 353-55 (2000) [hereinafter Markell, *LaSalle and the Little Guy*].

101. *203 N. LaSalle*, 526 U.S. at 453-54.

102. See Markell, *LaSalle and the Little Guy*, *supra* note 100, at 354-55 (contemplating the effects of the *203 N. LaSalle* decision upon the bankruptcy legal community).

103. See, e.g., *In re Davis*, 262 B.R. 791, 799 n.9 (Bankr. D. Ariz. 2001) (noting that the Ninth Circuit recognizes the validity of the new value exception); Bank of Am. Commercial Fin. Corp. v. CGE Shattuck, LLC (*In re CGE Shattuck, LLC*), Nos. 99-12287-JMD, CM-99-747, 1999 WL 33457789, at *5-6 (Bankr. D. N.H. Dec. 20, 1999) (noting approvingly the previous decisions that recognized the new value exception).

104. See Margaret A. Mahoney, *Commercial Real Estate Defaults, Workouts, and Reorganizations: Confirmation of Chapter 11 Plans*, SJ076 A.L.I.-A.B.A. Course of Study Materials 555, 559 (2004); Nicholas L. Georgakopoulos, *New Value, After LaSalle*, 20 BANKR. DEV. J. 1, 2 (2003) (noting that the outcome of the Supreme Court's *203 N. LaSalle* decision reaffirmed the existence of the new value exception); Carlson & Williams, *supra* note 75, at 1303-04 (2000) (expressing alternative views on the Supreme Court's vindication of the new

opinion as an implicit recognition of the ongoing viability of the new value exception. This conclusion is buttressed in a number of ways. First, it is supported by the Court's conclusion that the legislative history does not eliminate the possibility "that the absolute priority rule now on the books as subsection (b)(2)(B)(ii) may carry a new value corollary."¹⁰⁵ Second, it follows from the Court's rejection of the Government's "starchy" argument that former equity holders categorically should be barred from participating in the reorganized debtor.¹⁰⁶ And finally, it follows from the Court's careful discussion of the specific flaws in the *203 N. LaSalle* plan. If the exception does not exist, why would the Court bother to hold the debtor's plan to such scrutiny?¹⁰⁷ Thus, it appears that under appropriate conditions, new value plans are confirmable.

B. *Must Exclusivity Be Terminated?*

There is no doubt that following *203 N. LaSalle*, former equity holders may not have the exclusive opportunity to participate in the reorganized entity. But this does not settle the question completely about what precisely *203 N. LaSalle* means in regard to the exclusivity period. Does *203 N. LaSalle* require termination of exclusivity for any proposed new value plan? Or rather, does *203 N. LaSalle* merely hold that no new value plan filed during the debtor's exclusivity period be confirmable unless it provides for a true market test? If the latter, must competing bids by creditors and other third parties be allowed to contest for the equity in the reorganized debtor, or is it sufficient to allow some other determination, such as expert testimony, that old equity is in fact paying the highest price that the market will bear for the new equity shares?

Post-*203 N. LaSalle* case law on the issue has been mixed.

value exception).

105. *203 N. LaSalle*, 526 U.S. at 449.

106. *Id.* at 451.

107. One interesting interpretation is that the Supreme Court's decision in *203 N. LaSalle* changed the focus of the debate from a linguistic debate over whether the Code is plain or ambiguous to a more useful debate over the issue of valuation and what constitutes fair value. See George H. Singer, *Supreme Court Clarifies "New Value Exception" to Absolute Priority Rule—Or Does It?*, AM. BANKR. INST. J., 1, 33, 47 (July/August 1999) (discussing the implications of the *203 N. LaSalle* decision on new value plans); Mark A. McDermott, *Bankruptcy Reorganizations: Before and After the Supreme Court's Stillborn Decision in 203 North LaSalle*, 46 FED. LAW. 22, 27 (1999). The Court's insistence on a market test of valuation and its expression of distrust of judicial valuations in determining fair value is a consistent theme that has appeared in other recent Supreme Court bankruptcy decisions. See *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 547 (1994); *Assocs. Commercial Corp. v. Rash*, 520 U.S. 953, 965 (1997).

Some courts have opted for the competing bid option within the debtor's plan.¹⁰⁸ Other courts have terminated exclusivity so that competing plans may be proffered,¹⁰⁹ an approach supported by many commentators and the National Bankruptcy Review Commission.¹¹⁰ However, the concern has been expressed that terminating exclusivity to allow competing plans might not create a sufficient market in small and mid-size Chapter 11 cases, which form the bulk of Chapter 11 cases in terms of number of filings.¹¹¹ Some courts have deemed either option sufficient to satisfy the 203

108. See *In re CGE Shattuck*, 1999 WL 33457789, at *7 (ordering the debtor to amend its plan to provide for a competitive market determination). See also *In re Minkoff*, No. 97-22962-11-JAR, 1999 WL 1424987, at *9 (Bankr. D. Kan. Dec. 6, 1999). But see NAT'L BANKR. REVIEW COMM'N, BANKRUPTCY: THE NEXT TWENTY YEARS, FINAL REPORT § 2.4.15, at 562-63 (1997) [hereinafter BANKRUPTCY: THE NEXT TWENTY YEARS] (criticizing the equity auction approach).

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

Id.

109. For example, in *In re Situation Mgmt. Sys., Inc.*, 252 B.R. 859, 860 (Bankr. D. Mass. 2000), the debtor's plan contained a provision for competing bids. The court held that the inclusion of the bid procedure justified terminating exclusivity, finding that the "Debtor's exclusive right to propose and gain acceptance of a plan has effectively been forfeited because any party can bid on the Debtor's equity interest and assume control of the Debtor if the bidder is successful." *Id.* at 865. The Court held that where there is another bidder interested, terminating exclusivity is a better procedural option than an auction. The rationale for this is that the disclosure statement that would accompany any other proposed plan would help bidders make an informed choice. *Id.* at 865. See also *In re Davis*, 262 B.R. at 799.

110. See Markell, Owners, Auctions, and Absolute Priority, *supra* note 78, at 118-19 (1991); BANKRUPTCY: THE NEXT TWENTY YEARS, *supra* note 108, § 2.4.15, at 555 (arguing that the rule about valuation and exclusive bidding should not be too harsh).

[T]he Commission also recommends a significant additional condition: exclusivity should be lifted as of right whenever a debtor seeks to confirm a cramdown plan under section 1129(b)(2)(B)(ii) that uses equity contributions from former equity holders The best way to accomplish this marketplace validation of value is to permit other parties to propose plans of reorganization that may garner creditor support to compete when the debtor moves for confirmation of an unsecured creditor cramdown plan.

Id.

111. That is, the cost to creditors of preparing and confirming a plan might be too high. See Markell, LaSalle and the *Little Guy*, *supra* note 100, at 354.

N. LaSalle market test approach.¹¹²

A related question is if a court allows competing plans to be set forth in order to satisfy the market test, how should a court determine which of a number of confirmable plans to choose? The Code itself provides limited guidance. Section 1129(c) states:

Notwithstanding subsections (a) and (b) of this section and except as provided in section 1127(b) of this title, the court may confirm only one plan, unless the order of confirmation in the case has been revoked under section 1144 of this title. If the requirements of subsections (a) and (b) of this section are met with respect to more than one plan, the court shall consider the preferences of creditors and equity security holders in determining which plan to confirm.¹¹³

Courts faced with multiple confirmable plans have historically looked at a number of factors to balance in determining which plan to confirm. These factors have typically included: “(1) the type of plan;¹¹⁴ (2) the treatment of creditors and equity security holders under each plan; (3) the feasibility of the plan; and (4) the preferences of creditors and equity security holders.”¹¹⁵ The last factor is generally determined by a question on the ballot of a multi-plan confirmation vote asking interested parties to indicate their preference among the plans they vote to confirm.¹¹⁶

Prior to *203 N. LaSalle*, courts facing multiple confirmable plans had to balance all of these factors. No single element—including which plan provided for the highest payout to

112. Consider *In re Union Fin. Servs. Group, Inc.*, 303 B.R. 390, 424 (Bankr. E.D. Mo. 2003), which provides:

To test the price contribution by old equity for the consideration to be secured by old equity, either (i) the exclusive period for a debtor to file a plan of reorganization must be terminated; or (ii) the consideration that the old equity holder will receive must be offered or exposed to a market test to ensure that the old equity holder is providing fair value for that consideration. The Supreme Court did not define precisely how that market test was to be determined.

For one court’s guidance on how to avoid violating the absolute priority rule, see *In re Global Ocean Carriers, Ltd.*, 251 B.R. 31, 49 (Bankr. D. Del. 2000), which states:

[T]he Debtors must subject the “exclusive opportunity” to determine who will own Global Ocean to the market-place test This can be achieved by either terminating exclusivity and allowing others to file a competing plan or allowing others to bid for the equity (or the right to designate who will own the equity) in the context of the Debtor’s Plan.

113. 11 U.S.C. § 1129(c).

114. Reorganizations plans are typically favored over liquidating plans. See *In re Holley Garden Apartments, Ltd.*, 238 B.R. 488, 495 (Bankr. M.D. Fla. 1999); *In re Valley View Shopping Center, L.P.* 260 B.R. 10, 21 (Bankr. D. Kan. 2001).

115. *In re Holley Garden Apartments*, 238 B.R. at 493.

116. *Id.* at 495–96.

creditors¹¹⁷—was universally controlling. *203 N. LaSalle* raises an obvious question—given its emphasis on the market and payment of top dollar for equity in the reorganized debtor, does *203 N. LaSalle* in fact dictate that a court faced with choosing among more than one confirmable plan select the plan which pays the highest price for the new equity? Courts have yet to supply an answer to this question.

C. Auction Questions

The *203 N. LaSalle* opinion stated that new value plans “providing junior interest holders with exclusive opportunities free from competition and without benefit of market valuation fall within the prohibition of § 1129(b)(2)(B)(ii).”¹¹⁸ However, the Supreme Court declined to decide whether a market test would be satisfied by allowing competing plans or competing bids within a single plan. There appear to be several options. First, an auction could be required.¹¹⁹ A second possibility would be that an auction not be required, provided that others are afforded the possibility of filing competing plans, regardless of whether alternative plans are actually filed. And a third possibility is that since the Court declined to hold that an auction is required, perhaps a debtor could obviate the need for an auction by engaging an investment banker to render a decision that the intended capital contribution is the best available.¹²⁰

In addition to the core question of whether an auction is required, there are a number of related questions of more limited scope. For example, if an auction is required, what kind of competing bid process is needed? Again, to the extent that courts have given any guidance, it is that the determination must be fact specific.¹²¹

117. See, e.g., *In re Turner Eng'g, Inc.*, 109 B.R. 956, 962–63 (Bankr. D. Mont. 1989).

118. *203 N. LaSalle*, 526 U.S. at 458.

119. For an argument in favor of mandatory auctions in reorganizations, see Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127 (1986).

120. It is worth noting, however, that lack of an auction would effectively leave the court with the ultimate decision on valuation, which the *203 N. LaSalle* majority sought to avoid.

121. See, e.g., *In re CGE Shattuck*, 1999 WL 33457789, at *6 (“The precise means of achieving market competition will be determined on the facts in a given case.”). Consider also the case of *In re Union Financial Services Group, Inc.* In this case, the property was marketed to certain parties and bids were solicited from these parties. However, an open auction was not conducted. *In re Union Fin. Servs. Group*, 303 B.R. at 403–04. The debtor’s marketing process consisted of independent directors who managed the process with the assistance of independent counsel and professional financial advisors. *Id.* at 425. The result was the creation of a competitive bidding environment that

Another related question is whether securities regulations prohibit the type of equity interest sales that the Supreme Court requires. The Bankruptcy Code sheds nominal light on the question. Title 11 U.S.C. § 1145 exempts from registration under the Federal Securities Act of 1933 and state registration laws securities which are offered or given in exchange for a claim against or an interest in the debtor, an affiliate participating in a joint plan, or a successor to the debtor under its plan.¹²² It is possible that securities issued for new value, not in exchange for a claim, are not within the exemption.

One question which does seem to have been answered in regard to auctions is whether credit bidding would be permitted by secured creditors in a competitive bidding situation. The answer to this appears to be no. While in general, a secured creditor may credit bid at auction of an item over which it has a lien,¹²³ this is

was used to test the market, though a traditional auction was not employed. *Id.* at 425. Rather, the opportunity to submit competing bids for the Restructuring Plan as a "whole" as well as the right to bid for parts of the package was offered to

- (i) parties previously expressing interests in acquiring the Debtors, (ii) companies providing financing and capital investments, (iii) existing lenders, and (iv) competitors. The marketing process included (i) establishing a data room, (ii) disseminating sales data, (iii) management presentations and follow-ups regarding specific due diligence concerns and (iv) flexibility in the due diligence process and timing for submission of offers.

Id. at 426. Bids that were received were reviewed by an independent Special Committee. *Id.*

The Court approached the question of whether the *203 N. LaSalle* test was satisfied by looking at the totality of the circumstances. *Id.* at 426. It found, after relying on expert testimony that the marketing process the debtor used was appropriate, that the process used was fair and satisfied the *203 N. LaSalle* requirements. *Id.* at 425. Bids were solicited from most of the country's leading equity, financial services, and investment banking firms. They were given sufficient time to respond. No bids received offered to pay a premium price. The court noted that "[t]he Debtors have complied with the letter and spirit of *203 North LaSalle Street.*" *Id.* at 426. It concluded that "the appropriateness of any 'market test' for the new value exception to the absolute priority rule must be evaluated on a case by case basis. The marketing process utilized by the Debtors . . . were more than sufficient to ensure that a true market test occurred in accordance with the requirements of *203 North LaSalle Street . . .*" *Id.* The market was given a fair opportunity to outbid old equity, the court concluded, and it failed to do so. *Id.*

122. 11 U.S.C. § 1145 (a)(1).

123. 11 U.S.C. § 363(k). ("[U]nless the court for cause orders otherwise[,] the holder of [the secured] claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property."). The rationale for the credit bid provision is to give "the secured creditor protections against attempts to sell the collateral too cheaply; if the secured party thinks the collateral is worth more than the debtor is selling it for, it may effectively bid its debt and take title to the

not the case in a new value transaction, because the creditor's collateral is not what is being auctioned. Rather, what is being auctioned in such a transaction is the equity of the reorganized debtor.¹²⁴ Accordingly, it would be inappropriate for a court to allow credit bidding under this circumstance.¹²⁵

D. Should the Logic of 203 N. LaSalle Be Limited to its Particular Facts?

Courts generally appear reluctant to apply the *203 N. LaSalle* reasoning in slightly different contexts than in relation to the new value exception pursuant under 11 U.S.C. § 1129(B)(2)(b)(ii).¹²⁶ Consider *In re Zenith Electronics Corp.*¹²⁷ In this case, an unofficial committee that represented a class of minority shareholders objected to a plan under which LGE, a creditor and controlling shareholder, would be permitted to purchase new equity in the reorganized debtor in return for a cash infusion and the release of a sizable claim, while old equity would receive no distribution.¹²⁸ The equity committee invoked *203 N. LaSalle* and requested that the court withhold confirmation because the price at which LGE would be permitted to buy its new interest had not been tested by the market.¹²⁹ Arguably, at least, the Court should

property.” 7 COLLIER ON BANKRUPTCY ¶ 1129.05[2][b][ii], at 1129-133 (Henry J. Somer & Alan N. Resnick eds., 15th ed. 1998).

124. See *Beal Bank, S.S.B. v. Waters Edge L.P.*, 248 B.R. 668, 679-80 (D. Mass 2000) (stating that a credit bid by a secured creditor was inappropriate because “the reorganization plan provides for a sale of equity in the limited partnership, not a sale of the collateral. The bankruptcy court found that the transaction was not a sale of property subject to Beal’s lien, and did not improperly frustrate Beal’s credit bid rights”).

125. For a discussion of the issue of credit bidding, see Markell, *LaSalle and the Little Guy*, *supra* note 100, at 357-58 (noting that the issue of credit bidding confused things as whether what is being retained or sold is in fact the creditor’s collateral and who its actual owner is). On the question of credit bidding, the National Bankruptcy Review Commission has stated: “Credit bidding violates the principle of equality of distribution among all legally similar creditors. It also undercuts reorganization efforts because it provides the leverage to a secured creditor, by virtue of its unsecured portion of debt, to seize any business in which it is not paid in full.” BANKRUPTCY: THE NEXT TWENTY YEARS, *supra* note 108, § 2.4.15, at 564.

126. *203 N. LaSalle* dealt with the cramdown procedures of § 1129(b)(2)(b)(ii). If all impaired classes vote for the plan, § 1129(a)(8) is satisfied, and the cramdown provisions in § 1129(b) are not implicated. See, e.g., *In re Annicott Excellence LLC*, 258 B.R. 278, 283 n.6 (Bankr. M.D. Fla. 2001) (“Until such time as an impaired, unsecured class actually rejects the Plan, triggering a cramdown, the rule of [*203 N. LaSalle*] need not be considered.”).

127. 241 B.R. 92 (Bankr. D. Del. 1999).

128. *Id.* at 97-98.

129. *Id.* at 106.

have adopted the Supreme Court's "disfavor for decisions untested by competitive choice,"¹³⁰ especially since this was a new value case.¹³¹ Instead, the Delaware bankruptcy court made a ruling, in effect, on the question of standing. The court held that since the creditor received the right to purchase the equity in its capacity as a creditor rather than as a shareholder, and that since all classes of creditors had voted to accept the plan, the absolute priority rule had no application.¹³² Rather, the case was governed by § 1129(b)(2)(C).¹³³ The court then went on to add the following statement:

It is not appropriate to extend the ruling of the 203 North LaSalle case beyond the facts of that case. To do so would require in all cases that a debtor be placed "on the market" for sale to the highest bidder. Such a requirement would eliminate the concept of exclusivity . . . and the broad powers of the debtor to propose a plan in whatever format it desires The restriction on the debtor's right to propose a plan contained in the 203 North LaSalle case should be limited to the facts of that case—where the absolute priority

130. *203 N. LaSalle*, 526 U.S. at 457–58.

131. For an argument that the bankruptcy court erred in this regard, see Barry E. Adler & George G. Triantis, *Corporate Bankruptcy in the New Millennium: The Aftermath of North LaSalle Street*, 70 U. CIN. L. REV. 1225, 1240–42 (2002).

132. The court stated:

[I]n this case, all creditor classes have accepted the Plan and there is no objection to confirmation by any creditor. Thus, the absolute priority rule . . . is not even applicable. Rather, section 1129(b)(2)(C) is the applicable section in this case. Further, in this case, it is not a shareholder who is being given the right to buy equity, it is LGE in its capacity as a substantial secured and unsecured creditor who is being given that right The Supreme Court in 203 North LaSalle did not say that a plan which allowed a senior secured creditor to buy the equity violated the Code.

In re Zenith, 241 B.R. at 106. Despite the court's ruling, it is hard to see why a potential violation of absolute priority on the part of a creditor is any less important than a violation on behalf of a shareholder, if the concern is maximizing the price paid to purchase new equity.

133. Section 1129(b)(2)(C) states:

(C) With respect to a class of interests—

- (i) the plan provides that each holder of an interest of such class receive or retain on account of such interest property of a value, as of the effective date of the plan, equal to the greatest of the allowed amount of any fixed liquidation preference to which such holder is entitled, any fixed redemption price to which such holder is entitled, or the value of such interest; or
- (ii) the holder of any interest that is junior to the interests of such class will not receive or retain under the plan on account of such junior interest any property.

rule . . . is violated.¹³⁴

For another example of a case where the court^{or} failed to apply the underlying rationale of *203 N. LaSalle* to a different fact pattern, consider *In re New Midland Plaza Associates*.¹³⁵ In this case, a secured creditor objected to a plan proposal which would have forced it to accept a new debt claim. The creditor claimed its new claim would be worth less than its prior claim, which was oversecured, yet the plan vested most of the new equity in the old equity investors.¹³⁶ The court declined to expose the proposed plan to a market test to discover the true value of the new debt, holding that the absolute priority rule does not apply to secured creditors.¹³⁷ Rather, the court determined, since all impaired, unsecured classes had accepted the plan, the absolute priority rule and its ramifications, including the dictates of *203 N. LaSalle*, were inapplicable. Instead, the recourse for the secured creditors was to look solely to the protections found in § 1129(b)(2)(A).¹³⁸

A few courts have in fact extended the *203 N. LaSalle* rationale to non-traditional applications. Perhaps most notably, the court in *In re Davis*¹³⁹ employed the underlying reasoning of *203 N. LaSalle* in a case where the debtor was an individual in Chapter 11¹⁴⁰ rather than a business entity. After first

134. *In re Zenith*, 241 B.R. at 106.

135. 247 B.R. 877 (Bankr. S.D. Fla. 2000).

136. *Id.* at 893–895.

137. *Id.* The court went on to state that it would not, “through an over-expansive reading of the ‘fair and equitable’ standard . . . rewrite paragraph (A) of § 1129(b)(2) to include a rule purposefully excluded by Congress.” *Id.* at 894–95.

138. Section 1129(b)(2)(A) states:

(A) With respect to a class of secured claims, the plan provides—

(i) (I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and

(II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder’s interest in the estate’s interest in such property;

(ii) for the sale, subject to section 363(k) of this title, of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens on proceeds under clause (i) or (iii) of this subparagraph; or

(iii) for the realization by such holders of the indubitable equivalent of such claims.

139. 262 B.R. 791.

140. While geared toward business reorganization, individuals may also file in Chapter 11. See *Toibb v. Radloff*, 501 U.S. 157, 161 (1991).

determining that the absolute priority rule applies to individual debtors in Chapter 11,¹⁴¹ the court went on to apply *203 N. LaSalle*, denying confirmation based on the absence of any market type mechanism in the debtor's proposed plan.¹⁴²

E. Can a Mortgage Deficiency Claim Be Classified Separately in Order to Obtain an Accepting Class?

In order to confirm a Chapter 11 plan which impairs a class of claimants, at least one impaired class of non-insiders must vote for the plan.¹⁴³ According to the Code, a plan may place a claim in a particular class only if the claim is substantially similar to other claims in the class.¹⁴⁴ The Code does not expressly indicate whether similar claims must be classified together. As a result, the question of gerrymandering classes for voting purposes has long been an issue in bankruptcy cases.¹⁴⁵

In *203 N. LaSalle*, the debtor's plan placed Bank of America's mortgage deficiency claim in a separate class from other unsecured claims. The purpose of this, presumably, was to create an impaired class of creditors that (without the Bank's deficiency claim voted to the contrary) would vote to accept the plan.¹⁴⁶ The legitimacy of this tactic was neither raised nor addressed by the Supreme Court in *203 N. LaSalle*. The courts that have addressed the issue post-*203 N. LaSalle* have generally allowed this separate classification on the basis that while the claims of a mortgage deficiency holder and of general unsecured creditors enjoy the

141. The court noted the harshness of applying the absolute priority rule to individuals, stating:

The broad sweep of the term "any property" may be felt to be harsher on the individual than on the corporate Chapter 11 debtor . . . Individuals who file Chapter 11 cases must necessarily retain a residual interest in their economic future since there is no effective way to alienate all future accessions to their net worth . . . "In summary, the jurisprudence apparently unanimously holds that if the Debtor retains any property, even control or the potential for future earnings, the cramdown provisions of Section 1129(b)(2)(B)(ii) are not met."

In re Davis, 262 B.R. at 797 (quoting *In re East*, 57 B.R. 14, 17 (Bankr. M.D. La. 1985) (citations omitted).

142. *In re Davis*, 262 B.R. at 798.

143. 11 U.S.C. § 1129(a)(10).

144. 11 U.S.C. § 1122(a).

145. The leading case on the issue perhaps remains *Teamsters Nat'l Freight Indus. Negotiating Comm. v. U.S. Truck Co.* (*In re U.S. Truck Co.*), 800 F.2d 581 (6th Cir. 1986).

146. If classified together, the bank's deficiency claim would in effect have had a veto power over the other unsecured claimants. For a discussion, see David Gray Carlson, *Artificial Impairment and the Single Asset Chapter 11 Case*, 23 CAP. U. L. REV. 339, 347-53 (1994). See also David Gray Carlson, *Chapter 11 Issues: The Classification Veto in Single-Asset Cases Under Bankruptcy Code Section 1129(a)(10)*, 44 S.C. L. REV. 565 (1993).

same legal status (unsecured), the interests of the respective parties in the reorganization and the potential survival of the debtor are unlikely to align.¹⁴⁷

F. What Is the Minimum Acceptable Bid by Old Equity?

The Supreme Court in *203 N. LaSalle* fixed a minimum bid requirement for old equity: Old equity's price is too low when the equity holders obtain or preserve an ownership interest "for less than someone else would have paid."¹⁴⁸ This serves the purpose of providing greatest possible addition to the bankruptcy estate. In addition, it reduces the prospect of an excessively leveraged reorganized company where the creditors would bear much of the risk.¹⁴⁹ But the *203 N. LaSalle* court left open the question of whether old equity must bid higher than the next highest bid, as seemingly was required by the Second Circuit in *Coltex*.¹⁵⁰ Pre-*203 N. LaSalle*, some courts weighed the substance of the contribution compared to the total unsecured claims, rather than compared to the value of the reorganized firm.¹⁵¹ "This . . . , of course, is irrelevant for the viability of the reorganized

147. See *In re Am. HomePatient, Inc.*, 298 B.R. 152, 167–68 (Bankr. M.D. Tenn. 2003) (authorizing separate classification of deficiency and other secured claims, and noting that "[c]lassification of unsecured claims is measured by a flexible standard in the Sixth Circuit. Although abuse of the voting process through 'creative' classification is prohibited, separate classification of unsecured claims with dissimilar attributes or interests is allowed" (citations omitted)); *Beal Bank*, 248 B.R. at 691 (reasoning that separate classification of a nonrecourse claim is allowed, as the deficiency claim holder had different motivations in voting and there was no evidence of an improper business justification for the classification scheme); *In re Grete Bay Hotel & Casino, Inc.*, 251 B.R. 213, 224–25 (Bankr. D.N.J. 2000) (explaining that a separate classification of deficiency allowed a deficiency claim that awarded debt and equity representing the entire equity value of the debtor, whereas the trade claimants received a cash payout). Cf. *In re SunCruz Casinos LLC*, 298 B.R. 833, 838 (Bankr. S.D. Fla. 2003) ("Although the proponent of a plan of reorganization has considerable discretion to classify claims and interests according to the facts and circumstances of the case, this discretion is not unlimited If the plan unfairly creates too many or too few classes, if the classifications are designed to manipulate class voting, or if the classification scheme violates basic priority rights, the plan cannot be confirmed.") (quoting *Olympia & York Fla. Equity Corp. v. Bank of N.Y.*, 913 F.2d 873, 880 (11th Cir. 1990); *Boston Post Rd. L.P. v. FDIC (In re Boston Post Rd. L.P.)*, 21 F.3d 477, 484 (2d Cir. 1994) (refusing to confirm cramdown when the only accepting class was "segregated without any demonstrated legitimate reason from like unsecured creditors . . .").

148. *203 N. LaSalle*, 526 U.S. at 453.

149. See Georgakopoulos, *supra* note 104, at 13.

150. 138 F.3d at 45.

151. See *In re Arc Water Treatment*, No. 96-31144DWS, 1998 WL732875, at *5 (Bankr. E.D. Pa. Oct. 15, 1998); *In re Pocono Springs Co.*, No. 97-13534, 1998 WL 151423 at *4 (Bankr. E.D. Pa. Mar. 25, 1998).

entity . . .,"¹⁵² so it should not affect "the propriety of the plan."¹⁵³ Post-*203 N. LaSalle*, there does not appear yet to be any conclusive statement in the case law on this issue.¹⁵⁴ All that is clear is that the contribution must be reasonably equivalent to the interest being retained.¹⁵⁵

G. New Contributions Must Be Necessary to the Reorganization.

Particularly relevant to the *203 N. LaSalle* decision is the requirement that the new value be "necessary" for the reorganization. In *Case v. Los Angeles Lumber Products Co.*,¹⁵⁶ Justice Douglas posited that there will be "the necessity, at times, of seeking new money 'essential to the success of the undertaking' from the old stockholders."¹⁵⁷ Justice Douglas may have intended that old equity owners should participate only when the market would not supply working capital at (presumably) lower cost. This raises the question of what in fact constitutes "necessity."

In evaluating this, there appear to be two logically distinct, critical questions. The first is what the contribution will be used for. If the new value is desired solely to overcome the absolute priority rule, rather than because it is necessary to repair or alter property owned by the debtor, the new value is not necessary to the reorganization.

The second question goes to the available sources for capital. Prior to *203 N. LaSalle*, the Seventh Circuit had suggested that the debtor must have no alternative source of capital other than fresh contributions by old equity.¹⁵⁸ The Second Circuit in *Coltex* admitted that its strict interpretation of the necessity requirement was another method to ensure that former equity holders do not obtain their new interests "on account of" their old equity.¹⁵⁹ Under their holding, old equity must be the lender of last resort.¹⁶⁰ Post-*203 N. LaSalle*, it remains unclear whether the "necessity" requirement includes that old equity be the sole available source of financing for the new entity.

152. Georgakopoulos, *supra* note 104, at 13.

153. *Id.*

154. For an argument that *203 N. LaSalle* requires equity to do more than match the next best offer, see Harvey R. Miller et al., *Leaving Old Questions Unanswered and Raising New Ones: The Supreme Court Furthers the New Value Controversy in Bank of America National Trust & Savings Ass'n v. 203 North LaSalle Street Partnership*, 30 U. MEM. L. REV. 553, 589 (2000).

155. *203 N. LaSalle*, 526 U.S. at 456-57.

156. 308 U.S. 106.

157. *Id.* at 121.

158. See Official Creditors' Comm. v. Potter Material Serv., Inc. (*In re Potter Material Serv.*), Inc., 781 F.2d 99, 101 (7th Cir. 1986).

159. *Coltex*, 138 F.3d at 42.

160. *Id.* at 45.

H. Must the New Value Contributed Be Used to Pay Creditors or for Working Capital Needs, or Can It Be Used for Both?

The last of the “open questions” relates to how the fresh capital is employed. Most of the cases agree that a capital infusion is “necessary for an effective reorganization” where it is needed to make initial payments under the plan and to pay for maintenance and/or improvements to the debtor’s property, especially the latter.¹⁶¹ While some courts have held that if money is used to pay pre-confirmation expenses or creditors the necessity requirement is not satisfied,¹⁶² *203 N. LaSalle* may suggest otherwise. Since one purpose of the market test is to increase payments to creditors, an argument based on *203 N. LaSalle* appears to exist that using new capital to pay pre-confirmation creditors is an acceptable use of the new cash infusion.¹⁶³ Again, any sort of definitive answer to this question by the lower courts has yet to be forthcoming.

161. See *Baseline-Dobson Ctr. Real Estate L.P.*, 193 B.R. 284, 290 (Bankr. D. Ariz. 1994); *In re HRC Joint Venture*, 187 B.R. 202, 210 (Bankr. S.D. Ohio 1995); *State St. Bank & Trust Co. v. Elmwood, Inc. (In re Elmwood, Inc.)*, 182 B.R. 845, 852–53 (D. Nev. 1995); *In re Dean*, 166 B.R. 949, 956 (Bankr. D.N.M. 1994). But see *In re One Times Square Assocs. L.P.*, 159 B.R. 695, 707–08 (Bankr. S.D.N.Y. 1993) (stating that a contribution used solely for capital improvements which would inure primarily to future benefit of equity holders rather than creditors was not necessary for an effective reorganization); *Oxford Life Ins. Co. v. Tucson Self-Storage, Inc. (In re Tucson Self-Storage, Inc.)*, 166 B.R. 892, 899 (B.A.P. 9th Cir. 1994) (arguing that a capital contribution is not “necessary” when used merely to pay priority and administrative claimants).

162. Rather, it must be for working capital. See Georgakopoulos, *supra* note 104, at 13–17. Professors Carlson and Williams have argued that the text of the Code itself supports such an analysis. See Carlson & Williams, *supra* note 75, at 1318–19. See also Ralph A. Peeples, *Staying In: Chapter 11, Close Corporations and the Absolute Priority Rule*, 63 AM. BANKR. L.J. 65, 98 (1989) (“There is simply no necessary connection between the use of the new contribution exception and benefit to creditors.”).

163. But see Georgakopoulos, *supra* note 104, at 16.

Indeed, the contribution of cash can arguably never be “necessary” for the reorganization of the debtor. If the cash is distributed to the creditors it violates absolute priority. If the cash is used to pay operating expenses, the debtor is not profitable as an independent entity, and is likely to become insolvent again, thus failing the corresponding test of 1129(a)(11).

Id. Section 1129(a)(11) requires that “[c]onfirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan, unless such liquidation or reorganization is proposed in the plan.” See also Carlson & Williams, *supra* note 75, at 1308 (“If unsecured creditors are entitled to receive the proceeds of new value as if the new value were property of the estate, then it becomes impossible for reorganized firms ever to raise new capital.”).

VI. CONCLUSION

The Supreme Court's decision in *203 N. LaSalle* raised as many, if not more, questions than it answered in regard to new value plans in Chapter 11 reorganizations. While the critical question—the ongoing existence of the exception—appears to have been definitively answered, much of the process—which in most instances has major substantive ramifications—necessary to confirm a new value plan remains murky. Five years post-*203 N. LaSalle*, lower courts have done little to definitively define the parameters under which a new value plan should be confirmed. As a result, these “open issues” are likely to continue to be contested pending some more definitive judicial resolutions than have thus far been set forth.