When Can the Owners Participate in the Reorganized Debtor?: Cram Down as a "Shield" for Creditors

JAMES M. CARR*

I. INTRODUCTION

The goal in most cases under Chapter 11 of the Bankruptcy Code[1] is confirmation by the Bankruptcy Court of a reorganization plan that will provide for the distribution of the going concern value of the debtor business to creditors and owners.[2] A confirmed plan represents resolution of the inherent conflict between the interests of the business' owners and creditors. The owners typically want the company to stay in business and they wish to continue to own the business after confirmation. The creditors want to be paid as fully and as quickly as possible. Usually, creditors either want to sell the assets of the debtor business immediately in order to reduce or satisfy their claims, or they want to own the business so that all profits will be used for payment of their claims.

The goal of a confirmed plan of reoganization can usually be achieved only if the conflict between the interests of the owners of the business and the claims of creditors can be amicably resolved. Sometimes the conflict is resolved by litigation to determine the value of the company on a going concern basis and how that value is to be distributed. More frequently, the owner/creditor conflict is resolved by bargaining.

An owner can retain an ownership interest under a confirmed plan if (1) there is equity in the company in the sense that the deb-

---

*Member of the firm of Baker & Daniels; A.B., Indiana University, 1972; J.D., Indiana University—Bloomington, 1975.

[1]11 U.S.C. §§ 1101-1174 (Supp. IV 1980). Chapter 11 of the Code consolidates former Chapters X, XI, and XII of the Bankruptcy Act into a single business reorganization chapter.

[2]This Article will discuss only Chapter 11 cases in which a reorganization plan is based upon an on-going business; however, the Code also allows for liquidation of a debtor under Chapter 11 ("a liquidating 11"). 11 U.S.C. § 1123(b)(4) (Supp. IV 1980). *See, e.g., In re* L.N. Scott Co., 13 Bankr. 387 (E.D. Pa. 1981) (all tangible assets sold at public sale); *In re* Tele/Resources, Inc., 6 Bankr. 628 (S.D.N.Y. 1980) (debtor and secured creditor were permitted to sell a depreciable asset over the objection of an unsecured creditor who wanted to convert the case into a Chapter 7 liquidation).

A debtor in possession may also effect a liquidation by converting a voluntary Chapter 11 into a Chapter 7 liquidation. 11 U.S.C. § 1112(a) (Supp. IV 1980). A party in interest, however, may only effect a conversion for cause and after notice and hearing. *Id.* § 1112(b). *See, e.g., In re* Commercial Finance Corp. of Nev., 3 BANKR. L. REP. (CCH) ¶ 68,480 (D.D.C. Dec. 16, 1981) (U.S. trustee may move to convert a Chapter 11 when the debtor is unable to pay the administrative expenses of the bankruptcy proceeding).

tor's going concern value exceeds its debts;[3] or (2) all *classes* of creditors who will not be paid in full under the plan agree that the owners can retain an ownership interest, and all *creditors* who do not consent to the proposed plan will receive at least as much under the plan as they would receive if the debtor were liquidated under Chapter 7 of the Bankruptcy Code;[4] or (3) the owner contributes "money or money's worth" to the reorganized debtor and receives an ownership interest equal in value to that contribution.[5] This Article will discuss the above circumstances under which the owners of a debtor enterprise can retain an ownership interest following confirmation, and those instances in which creditors might consent to the owner's retention of an ownership interest.

II. Financial Standards Required for Confirmation

In a liquidation case under Chapter 7 of the Code,[6] the trustee either sells or appraises the assets of the business debtor,[7] and then distributes the sale proceeds or the assets at their market or appraised value to satisfy the claims of creditors and interests of owners in accordance with the priorities of their claims.[8] Although there is often argument in Chapter 7 cases about the valuation of assets, most such arguments can be resolved by simply offering the assets for sale and realizing their liquidation value.[9] The problem of determining and distributing the value of the debtor's assets in a Chapter 11 case is more complex because the method of valuation, and therefore the value to be distributed, is determined by "the purpose of the valuation and of the proposed disposition or use of such property."[10] That analysis[11] will determine whether a liquidation value or a "going concern value," that is, the future business earnings of the company discounted by an appropriate capitalization rate,[12] will be the appropriate method of valuation. If the Chapter 11

---

[3]*See* notes 44-46 *infra* and accompanying text.

[4]*See* notes 19-22, 47-48 *infra* and accompanying text.

[5]Case v. Los Angeles Lumber Co., 308 U.S. 106, 121 (1939). *See* notes 49-62 *infra* and accompanying text.

[6]11 U.S.C. §§ 701-766 (Supp. IV 1980).

[7]*Id.* §§ 327(a), 363.

[8]*Id.* §§ 501-510, 726.

[9]At a sale of a debtor's assets, secured creditors may bid ("credit bid") their claims and, if successful, may offset the amount of the secured claim against the purchase price and pay the trustee the balance remaining. *Id.* § 363(k).

[10]*Id.* § 506(a). *See* Pachulski, *The Cram Down and Valuation under Chapter 11 of the Bankruptcy Code*, 58 N.C.L. Rev. 925, 951-53 (1980).

[11]*See* notes 17-26 *infra* and accompanying text.

[12]The two basic components of a capitalization rate are the time value of money and risk. Pachulski, *supra* note 10, at 939-41. To establish an appropriate capitalization

case is based upon continuation of the business, then the projected going concern value is the appropriate method of valuation.[13]

As anyone who has even dabbled in the stock market can attest, it is extremely difficult to predict with any precision how a business with a history of success will perform in the future. It is certainly much more difficult to value the future performance of a business that requires relief under the Bankruptcy Code because of past financial or managerial ills.[14]

Largely because of the intrinsic difficulty of precisely establishing this value, confirmation of a plan is usually achieved because the interested parties bargain and reach a compromise of their conflicting claims based upon their "gut" feelings concerning the likelihood that the reorganized debtor will or will not be successful in the future. If not all interested parties can agree upon a method for distributing the value of the debtor business, then a proposed plan cannot be confirmed unless the Bankruptcy Court determines that the objecting class or party is being adequately treated under the plan in accordance with certain financial standards or tests contained in section 1129 of the Code.[15] The Bankruptcy Court can make such a determination only as part of valuation litigation that may be time-consuming and expensive.[16] The bargaining that leads to confirmation should take place against the backdrop of these section 1129 tests. Attorneys representing creditors should understand these tests in order to secure the best possible result for their clients.

The two tests set out in section 1129 are referred to as "the

---

rate, two questions must be answered. First, what would a relevant market establish as the risk-free time value of the anticipated earnings stream of the business? Second, how likely is it that the company will actually produce the projected earnings? *Id.*

[13]*See, e.g.*, Consolidated Rock Prods. Co. v. Du Bois, 312 U.S. 510, 525 (1941). *In re* Duplan Corp., 9 Bankr. 921, 924-29 (S.D.N.Y. 1980) (decided under the Act).

[14]The determination of the debtor's going concern value has been characterized as a " 'guess compounded by an estimate.' " H.R. REP. NO. 595, 95th Cong., 1st Sess. 225 (1977), *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5963, 6184 [hereinafter cited as HOUSE REPORT]. *See, e.g.*, Consolidated Rock Prods. Co. v. Du Bois, 312 U.S. 510, 526 (1941) ("Since its application requires a prediction as to what will occur in the future, an estimate, as distinguished from mathematical certitude, is all that can be made.").

[15]11 U.S.C. § 1129 (Supp. IV 1980).

[16]The bargaining leverage provided shareholders of the debtor corporation by the threat of an unwanted valuation hearing is a strategic device intended by the law's drafters and noted by commentators. *See* Labovitz, *Outline of "Cram Down" Provisions Under Chapter 11 of the Bankruptcy Reform Act of 1978*, 86 COM. L.J. 51, 52-53 (1981).

best interests" test,[17] and the fair and equitable test.[18] Assuming that all other requirements[19] for confirmation have been satisfied, the best interests test is applied when a creditor rejects the plan but is a member of a *class* of "impaired"[20] creditors that has otherwise accepted the plan by the requisite majorities.[21] The best interest test requires that a dissenting *creditor* receive at least as much under the proposed plan as that creditor would receive if the debtor company were liquidated under Chapter 7 of the Code.[22] If a

---

[17]11 U.S.C. § 1129(a)(7)(A)(ii) (Supp. IV 1980) (former version at 11 U.S.C. §§ 366(2), 472(2) (1976) (repealed 1978)). *See* United Properties, Inc. v. Emporium Dep't Stores, Inc., 379 F.2d 55 (8th Cir. 1967); Technical Color & Chem. Works, Inc. v. Two Guys from Massapequa, Inc., 327 F.2d 737 (2d Cir. 1964) as examples of courts applying the best interests test under Chapter XI of the former Bankruptcy Act.

[18]11 U.S.C. § 1129(b)(1) (Supp. IV 1980) (former version at 11 U.S.C. § 221(2) (1976) (repealed 1978)). The Code also states that a plan shall not "discriminate unfairly" with regard to each impaired class of creditors that does not accept the plan. 11 U.S.C. § 1129(b)(1) (Supp. IV 1980). *See* Pachulski, *supra* note 10, at 936-38.

[19]11 U.S.C. § 1129(a)(1)-(6), (8)-(11) (Supp. IV 1980). Subsections (a)(1) and (a)(2) require that the plan and its proponent also comply with other requirements of Chapter 11 such as sections 1123 (contents of a plan) and 1125 (disclosure).

[20]Section 1124 of the Code lists three ways in which a class of claims or interests is left unimpaired. *Id.* § 1124.

[21]*See id.* § 1126(c)-(d) (voting majorities necessary for acceptance of a plan by a class of creditors or other interests).

If a class of creditors is not impaired, then it will be deemed to have accepted the plan as a matter of law. 11 U.S.C. § 1126(f) (Supp. IV 1980). If deemed acceptance satisfies the requirement of *id.* § 1129(a)(10) that one class of claims must accept the plan, a plan might be confirmed even if "not [actually] accepted by *any* impaired class." Pachulski, *supra* note 10, at 927 (emphasis in original). *See, e.g.*, *In re* Landau Boat Co., 13 Bankr. 788 (W.D. Mo. 1981); *In re* Bel Air Assocs., 4 Bankr. 168 (W.D. Okla. 1980). *But see In re* Barrington Oaks Gen. Partnership, 15 Bankr. 952, 967-970 (W.D. Mo. 1981) (legislative history mandates that one class must affirmatively accept the plan); Buffalo Sav. Bank v. Marston Enters., Inc. (*In re* Marston Enters., Inc.), 13 Bankr. 514, 518-21 (E.D.N.Y. 1981) (section 1126(f) only raises a rebuttable presumption).

Courts have likewise construed section 1125(b), which requires a disclosure statement to creditors, as not applicable to a creditor who has been deemed to have accepted the plan under section 1126(f), because the debtor will not need to solicit the vote of that creditor. *See In re* Union County Wholesale Tobacco & Candy Co., 8 Bankr. 442 (D.N.J. 1981); *In re* Bel Air Assocs. Ltd., 4 Bankr. at 174-75 (dicta) (plan itself functioned as a disclosure statement). *But see In re* Northwest Recreational Activities, 4 Bankr. 43, 45 (N.D. Ga. 1980) (written disclosure statement mandatory in all instances).

[22]11 U.S.C. § 1129(a)(7)(A)(ii) (Supp. IV 1980). *See, e.g., In re* Martin's Point Ltd., 12 Bankr. 721 (N.D. Ga. 1981).

The best interests standard does not apply to those partially-secured creditors who have elected under section 1111(b)(2) to have their claims treated as fully secured for purposes of Chapter 11. 11 U.S.C. § 1129(a)(7)(B) (Supp. IV 1980). *See generally* 5 COLLIER ON BANKRUPTCY ¶ 1129.03[4][b] (15th ed. L. King 1981) [hereinafter cited as COLLIER] for an explanation of the relationship between section 1129(b) and section 1111(b)(2).

whole *class* of impaired creditors rejects a proposed plan,[23] the Bankruptcy Court upon the request of the plan's proponent[24] may confirm the plan notwithstanding nonacceptance if, with respect to each dissenting class, the plan does not discriminate unfairly[25] and the fair and equitable test is satisfied based on an analysis of the debtor's going concern value rather than its liquidation value.[26]

The fair and equitable test can be both a "shield" for creditors and a "sword" for debtors.[27] As a shield, it establishes, among other things, the minimum recovery that a creditor must receive if the owners of the debtor business will retain an ownership interest under the plan solely because they owned the business prior to the bankruptcy filing. When utilized as a sword to obtain confirmation of a plan over the objection of creditors, the fair and equitable doctrine is referred to as "cram down."[28]

The concept of fair and equitable has been part of bankruptcy law for many years, and has become a term of art that has been amplified by earlier court decisions, including those of the Supreme Court.[29] As will be discussed below, there are questions about the fair and equitable doctrine, however, that are not answered by the Code itself. A lawyer may have to look at case law decided both

---

[23]Under section 1129(a)(8), each class must either accept a plan or not be impaired. 11 U.S.C. § 1129(a)(8) (Supp. IV 1980).

[24]The court will not confirm a section 1129(b) plan unless requested, nor will the court rewrite a plan. HOUSE REPORT, *supra* note 14, at 413. *See, e.g., In re* K.C. Marsh Co., 12 Bankr. 401 (D. Mass. 1981). If multiple plans are submitted to the court, the court must decide which one should be confirmed after considering the preferences of creditors and equity security holders. 11 U.S.C. § 1129(c) (Supp. IV 1980).

[25]"The criterion of unfair discrimination . . . preserves just treatment of a dissenting class from the class's own perspective." HOUSE REPORT, *supra* note 14, at 417-18. See generally 5 COLLIER, *supra* note 22, at ¶ 1129.03[3][b]; Pachulski, *supra* note 10, at 936-38 for an explanation and application of this requirement.

[26]This valuation method was judicially developed as part of the fair and equitable test which was previously part of Chapter 10 of the Bankruptcy Act. 11 U.S.C. § 621(2) (1976) (repealed 1978). *See* notes 11-13 *supra* and accompanying text.

[27]Note, *From Debtor's Shield to Creditor's Sword: Cram Down Under the Chandler Act and the Bankruptcy Reform Act*, 55 CHI.-KENT L. REV. 713 (1979).

[28]*See generally* Blum, *The "Fair and Equitable" Standard For Confirming Reorganizations Under the New Bankruptcy Code*, 54 AM. BANKR. L.J. 165 (1980); Klee, *All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code*, 53 AM. BANKR. L.J. 133 (1979) for a detailed analysis of section 1129(b) and specific examples illustrating the application of cram down.

[29]*See, e.g.*, Protective Comm. v. Anderson, 390 U.S. 414, 441 (1968); Marine Harbor Properties, Inc. v. Manufacturers Trust Co., 317 U.S. 78, 85 (1942); Consolidated Rock Co. v. Du Bois, 312 U.S. 510, 527 (1941); SEC v. United States Realty & Improvement Co., 310 U.S. 434, 452 (1940); Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106, 115-17 (1939); Northern Pac. Ry. v. Boyd, 228 U.S. 482, 508 (1913); *see also* Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416, 435-38 (1972) (Douglas, J., dissenting).

under the Code and prior bankruptcy statutes to determine whether a certain plan is fair and equitable.

There are two additional preliminary matters that should be noted about the fair and equitable rule. First, section 1129 requires *only* that a plan be fair and equitable as to any *class* that has not accepted the plan.[30] Therefore, the fair and equitable test is called into effect only with respect to those classes of creditors who have rejected the plan. This represents a modification of the "absolute priority rule" which was an interpretation of the fair and equitable requirement under Chapter X of the Bankruptcy Act.[31] Second, the Code does not specify *all* conditions under which a plan can be considered fair and equitable with respect to an objecting class. Section 1129(b) contains both an overriding general requirement that a plan be fair and equitable, and certain specific tests that are included within the general requirement but which do not exhaust all possible situations.[32]

A proposed plan of arrangement places creditors and owners in various classes.[33] The fair and equitable requirement specifically ap-

---

[30]11 U.S.C. § 1129(b)(1) (Supp. IV 1980).

[31]Earlier decisions construing Chapter 10 of the Act established that the fair and equitable test included the "absolute priority" rule. Under this interpretation, no class could receive anything of value until senior classes received full compensation for the value of their claims. Only if the debtor was solvent after all creditors had been paid, could provision be made for stockholders. *See* cases cited note 29 *supra.*

The absolute priority rule under the Bankruptcy Act was criticized because "the rigidity of the rule frequently resulted in the destruction rather than the protection of interests of public investors." COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, REPORT, pt. 1, H.R. DOC. NO. 137, 93d Cong., 1st Sess. 256 (1973) [hereinafter cited as COMMISSION REPORT]. *See* Note, *The Proposed Bankruptcy Act: Changes in the Absolute Priority Rule for Corporate Reorganizations*, 87 HARV. L. REV. 1786, 1787 n.7 (1974) (collecting commentary). The absolute priority rule, as embodied in the Bankruptcy Code, was modified to partially alleviate this result. Under this modified version:

> [T]he fair and equitable requirement applies only with respect to dissenting classes. Therefore, unlike the fair and equitable rule contained in chapter X and section 77 of the Bankruptcy Act under section 1129(b)(2), senior accepting classes are permitted to give up value to junior classes as long as no dissenting intervening class receives less than the amount of its claims in full.

124 CONG. REC. 32,407 (1978) (remarks of Rep. Don Edwards).

[32]11 U.S.C. § 1129(b)(2) (Supp. IV 1980). Additional factors which are essential to an analysis of fair and equitable, and which were included in the House report, HOUSE REPORT, *supra* note 14, at 413-18, were left out of section 1129(b) to avoid "statutory complexity and because they would undoubtedly be found by a court to be fundamental to 'fair and equitable treatment' of a dissenting class." 124 CONG. REC. 32,407 (1978) (remarks of Rep. Don Edwards).

[33]*Id.* § 1123(a)(1); *see id.* § 1122 (classification of claims or interests). *See, e.g., In re* Martin's Point, Ltd., 12 Bankr. 721 (N.D. Ga. 1981); Julis, *Classifying Rights and Interests*, 55 AM. BANKR. L.J. 223 (1981).

plies to each class of secured creditors,[34] unsecured creditors[35] or interest holders[36] provided for under the plan. This Article will deal only with the fair and equitable doctrine as it aplies to the retention of some ownership interest under a reorganization plan by the pre-filing owners of a debtor business.

III. Participation in a Plan By Pre-filing Owners

If the debtor files a voluntary Chapter 11 petition, the owners of the debtor company most likely intend to retain an ownership interest after confirmation. However, this is not true in every case. For example, the owners of a debtor business may file a Chapter 11 petition because they guaranteed or are otherwise personally liable for some of the business debts, and want to avoid a forced sale of the business assets, in order to avoid or minimize a deficiency for which they might be liable. In that case, the owners may elect to file a Chapter 11 petition solely to take advantage of the repose afforded by the automatic stay provided by section 362 while they arrange an orderly sale of assets.[37] The owners of the debtor business may also want to use the leverage of the bankruptcy stay to prolong their jobs and salaries, or they may believe that a bankruptcy case will facilitate their purchase of the assets of the business.

Notwithstanding these alternative considerations, one would expect in the typical Chapter 11 case that the owners intend to retain an ownership interest in the business following reorganization. The general goal of creditors, on the other hand, is to maximize their recovery from the business by recovering everything of value from the business until they are paid in full. If a quick sale is not feasible, then creditors want to control the business to prevent further loss and to insure that payment will be received as quickly as possible. As noted above,[38] these conflicting goals are usually resolved by bargaining which is conducted against the statutory backdrop of the fair and equitable rule.

The fair and equitable rule states that a plan must provide either that an impaired non-accepting class of creditors be paid in full with respect to their claims, or that no interest junior to that class of creditors receive any distribution under the plan *with respect to* the junior claimants' pre-filing interest.[39] That means that

---

[34]11 U.S.C. § 1129(b)(2)(A) (Supp. IV 1980).

[35]*Id.* § 1129(b)(2)(B).

[36]*Id.* § 1129(b)(2)(C).

[37]*Id.* § 362. See generally Kennedy, *The Automatic Stay in Bankruptcy*, 11 U. Mich. J.L. Ref. 177 (1978) for a discussion of the uses of the stay under the Bankruptcy Act, and the factors considered by a court in granting relief from the stay. *See also* Kennedy, *Automatic Stays Under the New Bankruptcy Law*, 12 U. Mich. J.L. Ref. 1 (1978).

[38]*See* notes 29-30 *supra* and accompanying text.

[39]11 U.S.C. § 1129(b)(2)(B) (Supp. IV 1980).

if a class of creditors rejects a proposed plan under which the owners of the company are to retain an ownership interest, the Bankruptcy Court cannot confirm the plan unless it finds that the creditors will be paid *in full* under the plan.[40] Therefore, owners can only retain their ownership interest solely because of their pre-filing status if (1) there is sufficient going concern value to pay all objecting creditors and the plan provides for full payment (either by payment in full upon confirmation or by distributions over time from the future earnings in a manner that satisfies the Court that the objecting creditors will in fact receive payments whose present value at the date of confirmation is equal to their claims, or (2) every class of creditors that will receive less than full payment accepts the plan.

Before elaborating upon the circumstances under which owners of a debtor business may retain their ownership interest under a confirmed plan, it is necessary to describe what a reorganization plan should accomplish. A debtor business has a certain going concern value. As described above,[41] that value is the result of an informed estimate of the earnings stream of the business over its projected business life discounted to a present value. A reorganization plan provides for the distribution of that going concern value to the various creditor and ownership interests. This is easiest to describe and to understand by using a model.

As a model, one might think of the going concern value as sand and the various creditor and ownership interests as boxes aligned according to their order of priority. The alignment depends upon a mixture of state law, the Code's provisions granting priority to certain claims, and the equitable principles of bankruptcy law.[42] A Bankruptcy Court, however, should be guided in applying section 1129 by the overriding concept that an insolvent business is a trust fund for payment of creditors and that equality of distribution is equity.[43] When a creditor or owner is entitled to payment before another, he is said to have a "senior" right to payment. Under the fair and equitable rule a plan must provide that the going concern value, that is, the sand in our model, is poured into the boxes in their order of priority and no box junior to a senior box may receive any sand unless the prior box is filled or its owner has agreed to accept less than full payment.

---

[40]*See* notes 15-16 *supra* and accompanying text.

[41]*See* notes 12-14 *supra* and accompanying text.

[42]See generally COLLIER, *supra* note 22, at ¶ 1122.03; 6 COLLIER ON BANKRUPTCY, pt. 2, ¶ 9.13[1] (14th ed. J. Moore 1978) for a discussion of classification of claims under both the Code and the Act.

[43]*See, e.g.*, Northern Pac. Ry. Co. v. Boyd, 228 U.S. 482, 504 (1913); Merrill v. National Bank of Jacksonville, 173 U.S. 131, 136 (1899).

A. *Creditor Acceptance of a Plan*

It is usually difficult and expensive to establish a going concern value to the satisfaction of all parties; thus, the fair and equitable rule promotes bargaining because it is applied only if a class of creditors rejects the plan.[44] One of the first questions that a creditor must answer in determining whether he should reject a plan that would allow the owners to retain their ownership interest is whether the business is solvent. A company is solvent if there is sufficient going concern value to "trickle down" to the owners after paying in full all creditors who demand full payment. If there is clearly equity in the business because there is more than sufficient going concern value to pay all creditors, then there is no need for the owners of the debtor business to obtain the consent of creditors.[45] However, it is rarely certain that there is sufficient going concern value to provide for full payment of all creditors and allow the owners to retain their ownership interest. If there is clearly equity in the company, then the only real issue that will be the subject of bargaining or litigation is that of *when* the creditors will be paid.[46]

In most cases, it will either be doubtful whether there is sufficient going concern value to pay all creditors in full and still provide an equity for the owners, or relatively clear that there is no equity. In either of these instances, the owners will need to obtain the consent of creditors if the owners are to retain an ownership interest. There are several reasons, however, why creditors might give their consent, even though there is no equity in the business. They might do so if creditors cannot propose a better plan, that is, a plan that would generate a larger recovery without the agreement and cooperation of the owners, or a commitment that the owners will participate in the business following confirmation.[47] Creditors might not be able to propose a better plan without the participation of the owners if the owners possess management, sales, or other skills that

---

[44]*See* note 16 *supra.*

[45]A plan will be unfair and inequitable as to stockholders if senior creditors are to be paid in excess of their claims while stockholder interests remain impaired. Klee, *supra* note 28, at 148-50.

[46]*See, e.g., In re* Hollanger, 15 Bankr. 35 (W.D. La. 1981).

[47]If the owners and shareholders of a business are completely eliminated from participation in a proposed plan, that class of interests is deemed to have rejected the plan, 11 U.S.C. § 1126(g) (Supp. IV 1980), resulting in an expensive and time-consuming going concern valuation to ensure that senior classes will not receive more than full payment, or a "bonus." *See* 5 COLLIER, *supra* note 22, at ¶ 1129.03[4][g]. This clearly increases the bargaining power of owners and shareholders. *See* Labovitz, *supra* note 16, at 53-54.

are essential to the business, or if litigation with the owners over an alternative creditor plan might harm the going concern value of the business. In either case, creditors must then decide whether they would recover more by liquidation of the business assets than they would under the debtor's plan.[48]

In connection with that decision, a creditor should take into consideration whether it is advantageous to maintain the debtor as a going business entity to serve as either a buyer of the creditors' goods or services, or as a supplier. If an individual principal of the debtor guaranteed a debt to a creditor, the creditor must also consider whether a liquidation of the debtor business may be followed by bankruptcy of the guarantor with a reduced likelihood of recovery. The creditor in that case must decide whether the combination of his share of the projected profits from the business, plus anticipated payment of all or some of the deficiency by the guarantor-principal funded by the principal's income from the business, will be greater than the creditor's dividend if the company is liquidated and the guarantor-principal is forced to seek relief under the Bankruptcy Code. After taking these factors into consideration, if creditors agree to the reorganization plan, even though there is no equity in the business, a plan may be confirmed which allows the owners to retain their ownership interest.

B. *Owner Participation in an Insolvent Company Despite Creditor Dissent*

If there is clearly insufficient going concern value to fully satisfy the obligations of creditors, and creditors do not agree to a plan which allows the owners to retain an ownership interest, then the owners may not retain their ownership interest *with respect to their pre-filing interest in the business.* There may be circumstances, however, under which the owners can be granted an ownership interest and in effect continue as owners after confirmation of the plan even though the company is insolvent and creditors do not agree to the owners retaining ownership. In that case, their continuing ownership must arise from some new contribution to the reorganized debtor. For example, if the business would be materially aided by an injection of new capital, then the owners of the business may make a new capital contribution and receive an ownership interest in the reorganized company with respect to that new

[48]The fact that a creditor would receive less under liquidation than by accepting the debtor's plan, is not a factor in determining whether that plan is fair and equitable. Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106, 123 (1939), *quoted in In re* Landau Boat Co., 8 Bankr. 436, 438 (W.D. Mo. 1981).

contribution in the same manner as any other investor.

In *Case v. Los Angeles Lumber Products Co.*,[49] the Supreme Court set forth the conditions that must be met before the fair and equitable doctrine will allow the owners of a debtor business to receive an ownership interest in the reorganized company because of a new contribution to the business. The Court held that there must first be a need by the company for the contribution, and second, that the ownership interest received by the owners must be the fair equivalent of the contribution they made.[50] The Court required that the contribution of shareholders or other owners must be in "money or money's worth,"[51] raising the question of what types of contributions other than an injection of cash would satisfy the fair and equitable rule and allow an owner to receive an ownership interest.

Los Angeles Lumber held under the particular facts of the case that the stockholders' " 'financial standing and influence in the community' " and their ability to provide a " 'continuity of management' constitute[d] no legal justification for issuance of new stock to them."[52] The Court said that:

> Such items are illustrative of a host of intangibles which, if recognized as adequate consideration for issuance of stock to valueless junior interests would serve as easy evasions of the principle of full or absolute priority of *Northern Pacific Ry. Co. v. Boyd* . . . and related cases. Such items, on facts present here, are not adequate consideration for issuance of the stock in question. *On the facts of this case* they cannot possibly translate it into money's worth reasonably equivalent to the participation accorded the old stockholders. They have no place in the asset column of the balance sheet of the new company. They reflect merely vague hopes or possibilities.[53]

Accordingly, the Court held that the plan did not satisfy the absolute priority interpretation of the fair and equitable requirement under Chapter X, because the stockholders retained an ownership interest although the debtor's bondholders had not been paid in full.[54]

---

[49]308 U.S. 106 (1939).

[50]*Id.* at 121.

[51]*Id.* at 122.

[52]*Id.*

[53]*Id.* at 122-23 (emphasis added).

[54]*Id.* at 123. *Los Angeles Lumber* represents a classic application of the absolute priority rule as it existed prior to the present Bankruptcy Code. *See* note 31 *supra*.

The opinion of the Supreme Court in *Los Angeles Lumber* leaves open the possibility that shareholders or other owners of a debtor business could in fact prove that intangible contributions such as management or other skills that the owners agree to provide after confirmation, have a measurable value to the reorganized company and could therefore be the basis for the receipt by the old owners of an ownership interest in the reorganized company. Supreme Court cases decided after *Los Angeles Lumber*, however, have cast very little light upon the question.[55] That possibility once again raises the very important question of valuation and highlights the need for bargaining prior to submission of a plan for confirmation.

The application of these principles by the progeny of *Los Angeles Lumber* in the lower federal courts has done little to flesh out the conditions of shareholder participation in a reorganized debtor. These decisions, reached under Chapter X of the Bankruptcy Act and its predecessors, consistently held that when there was a demonstrable need to finance a reorganization plan,[56] the shareholders could retain an interest in the reorganized company if they contributed money or money's worth,[57] and their participation

---

Even though all classes in *Los Angeles Lumber* had agreed to the debtor's plan, the court nevertheless rejected the plan because senior classes were not paid in full. The plan would have been accepted under the present modified version of the absolute priority rule. *See id.* and accompanying text. The requirements for stockholder participation as stated in *Los Angeles Lumber* have survived, however. *See* note 62 *infra.*

[55]*See* cases cited *supra* note 29. *But cf.* Horowitz v. Kaplan (*In re* Waltham Watch Co.), 193 F.2d 64 (1st Cir. 1951), *cert. denied*, 342 U.S. 9046 (1952), which suggests that the absolute priority rule will not bar participation if the management skills are essential to the success of the business. The court of appeals in *Horowitz* distinguished *Los Angeles Lumber* because in *Horowitz*, participation was limited to only those stockholders who were part of management and there was a binding contract by management to remain in that capacity. 193 F.2d at 73-75.

The Commission on the Bankruptcy Laws of the United States also believed that this aspect of the absolute priority rule should be altered. Relying on the district court decision in *In re* Los Angeles Lumber Prods. Co., 24 F. Supp. 501 (S.D. Cal. 1938), *aff'd sub nom.* Case v. Los Angeles Lumber Prods. Co., 100 F.2d 963 (9th Cir.), *rev'd*, 308 U.S. 106 (1939), the Commission recommended that a revised bankruptcy law should permit participation based on management skills. COMMISSION REPORT, pt. 2, *supra* note 30, at 254. The legislative history of the Bankruptcy Code, however, was silent on this issue. *See* note 61 *infra.*

[56]*See, e.g.*, First Nat'l Bank of Herkimer v. Poland Union, 109 F.2d 54 (2d Cir. 1940); *In re* Associated Owners, Inc., 32 F. Supp. 828 (E.D. Wis. 1940). *See also In re* Dutch Woodcraft Shops, 14 F. Supp. 467, 471 (W.D. Mich. 1935) for an application of this condition prior to its recognition by the Supreme Court.

[57]*See, e.g.*, Muskegon Motor Stockholders Protective Comm. v. Davis (*In re* Muskegon Motor Specialties), 366 F.2d 522, 525, 530 (6th Cir. 1966); SEC v. Canandaigua Enterprises Corp., 339 F.2d 14, 21 (2d Cir. 1964); *In re* Universal Lubricating

was equivalent to their contribution.[58] Courts generally rejected all attempts, however, to expand the conditions of participation beyond those laid out in *Los Angeles Lumber*, and treated such challenges as a threat to the "absolute priority rule."[59]

The Bankruptcy Code adopted a "partial codification of the absolute priority rule"[60] to respond to earlier criticism by commentators. However, the legislative history indicates that little attention was paid to the effect of this rule upon shareholder participation in reorganized debtors.[61] The Code, however, does not prohibit stockholder participation under the conditions set out in *Los Angeles Lumber*. As a result, several bankruptcy courts[62] have ap-

---

Systems, 71 F. Supp. 775, 785-88 (W.D. Pa. 1947); *see also* Swanson v. Barclay Park Corp. (*In re* Barclay Park Corp.), 90 F.2d 595, 598 (2d Cir. 1937), *quoted in* Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106, 123 n.16 (1939); *cf.* Spitzer v. Stichman (*In re* Hudson & Manhattan R.R. Co.), 278 F.2d 402, 405 (2d Cir. 1960) (contingent particpation rejected when creditors not fully compensated); *In re* Janson Steel & Iron Co., 47 F. Supp. 652, 655-57 (E.D. Pa. 1942) (capital advances made by stockholders prior to bankruptcy petition did not entitle them to share pari passu with general unsecured creditors).

[58]*See, e.g.*, Highland Towers Co. v. Bondholders' Protective Comm. of Highland Towers, 115 F.2d 58 (6th Cir. 1940); Metropolitan Holding Co. v. Weadock, 113 F.2d 207 (6th Cir. 1940). *See also* Sophian v. Congress Realty Co., 98 F.2d 499, 502 (8th Cir. 1938).

[59]*See, e.g.*, Kelce v. U.S. Financial Inc. (*In re* U.S. Financial Inc.), 648 F.2d 515 (9th Cir. 1980); Jezarian v. Raichle (*In re* Stirling Homex Corp.), 579 F.2d 206 (2d Cir. 1978), *cert. denied*, 439 U.S. 1074 (1979). In both cases, the courts rejected the argument that defrauded shareholders' claims should be accorded parity with unsecured creditors, a conclusion codified in the Bankruptcy Code. 11 U.S.C. § 510(b) (Supp. IV 1980). See generally Huff, *The Defrauded Investor in Chapter X Reorganizations: Absolute Priority v. Rule 10b-5*, 50 AM. BANKR. L.J. 197 (1976) for a comparison of the risks assumed by shareholders and creditors which supports this codification.

[60]*See* note 31 *supra*.

[61]*See* S. REP. NO. 989, 95th Cong., 2d Sess. 126-28 (1978); HOUSE REPORT, *supra* note 14, at 413-18; 124 CONG. REC. 34,007-08 (1978) (statement of Sen. De Concini); 124 CONG. REC. 32,406-08 (1978) (statement of Rep. Don Edwards); *but see* note 55 *supra* describing the Bankruptcy Commission's closer examination of this issue.

[62]*See, e.g.*, *In re* Landau Boat Co., 13 Bankr. 788, 791-94 (W.D. Mo. 1981) (modified plan) (new money contribution and irrevocable commitment to a loan was a "substantial investment in excess of value to be received"); Buffalo Sav. Bank v. Marston Enters., Inc. (*In re* Marston Enters., Inc.), 13 Bankr. 514, 517-18 (E.D.N.Y. 1981) (participation after "a substantial necessary capital contribution"); *In re* Landau Boat Co., 8 Bankr. 436-39 (W.D. Mo. 1981) (first plan) (retention of ownership interest for purposes of "prospective earnings and control" failed fair and equitable test when unsecured creditors were not paid in full); *In re* Antilles Yachting, Inc., 4 Bankr. 470, 473-74 (V.I. 1980) (debtor stockholder barred from participation after he refused to contribute additional money); *see also In re* Liberal Market, Inc., 11 Bankr. 742, 743-44 (S.D. Ohio 1981) (application of absolute priority rule to appointment of trustee). *In re* Tele/Resources, Inc., 6 Bankr. 628, 631-32 (S.D.N.Y. 1980) (absolute priority doctrine precluded debtor stockholders from sharing in the proceeds of the sale of assets); *In re*

plied these principles in reorganization cases arising under Chapter 11. As with cases decided under the Bankruptcy Act, these few early decisions have not elaborated upon the conditions originally established in *Los Angeles Lumber.*

IV. Conclusion

The fair and equitable and best interests tests of section 1129 of the Code offer creditors protection from unwarranted participation by the pre-filing owners in the reorganized debtor. To obtain that protection, a creditor must speak up. To prevent confirmation of a plan under which a creditor will not realize maximum payment, the creditor must object by rejecting a plan that provides for the pre-filing owners to confirm their ownership interest in the reorganized company when (1) the creditor's class will not receive full payment under the plan; or (2) the creditor would fare better if the debtor was liquidated; or (3) the owners' new contribution to the reorganized debtor is not equal to the participation granted to the owners under the reorganization plan. However, before rejecting a proposed plan, a creditor should decide whether a better plan can be proposed that will receive the consent of owners and other interested parties, whether a better plan can be confirmed by the Bankruptcy Court without the consent of the owners, and how the creditor will fare under liquidation. The creditor must also consider the effect that litigation with the owners concerning valuation of the debtor on a going concern basis may have upon the company and the creditor's prospect of recovery. In many cases, this analysis should indicate to creditors, as well as to owners, that the parties will be better served by a negotiated compromise and that they should bargain to strike an equitable arrangement against the backdrop of the section 1129 tests.

Northwest Recreational Activities, Inc., 4 Bankr. 43, 48 (N.D. Ga. 1980) (participation in reorganzied corporation at 20% of original investment after all creditors agreed to plan).