Indiana Law Review

Volume 24 1991 Number 2

NOTES

Redefining the New Value Exception to the Absolute Priority Rule in Light of the Creditors' Bargain Model

I. Introduction

In Chapter 11[1] bankruptcy reorganizations, the debtor's equityholders frequently seek to retain ownership of the firm. When the reorganization plan fails to provide for full payment of all the creditors' claims, one issue often arises — under what circumstances should the equityholders be permitted to retain an ownership interest in the reorganized firm? The answer to this question depends upon the weight given to the rules that attempt to accommodate Chapter 11's two potentially antagonistic objectives: the protection of creditors' rights and the promotion of successful reorganizations.[2]

The absolute priority rule protects creditors' "bargained for rights." It demands that creditors receive full payment of their claims in their established order of priority before lesser interests, such as those of equityholders, may share in the assets of the reorganized firm.[3] Section A of Part II of this Note will examine both the historical development and the current state of the absolute priority rule.

Commentators and the judiciary suggest that the new value exception to the absolute priority rule operates to promote successful reorganizations, but at the expense of creditors' rights.[4] Originally established in 1939, the new value exception provides that equityholders who infuse new capital into the firm may retain an interest in the reorganized firm if

1. Bankruptcy Code of 1978, 11 U.S.C.A. §§ 101-1330 (West 1979 & Supp. 1989) [hereinafter Bankruptcy Code].

2. Skeel, *The Uncertain State of an Unstated Rule: Bankruptcy's Contribution Rule Doctrine After* Ahlers, 63 Am. Bankr. L.J. 221, 223 (1989).

3. Powlen & Wuhrman, *The New Value Exception to the Absolute Priority Rule: Is* Ahlers *the Beginning of the End?*, 93 Com. L.J. 303, 303 (1988).

4. *See, e.g., In re* Potter Material Service, Inc., 781 F.2d 99 (7th Cir. 1986); Levin, *Retention of Ownership Interest Over Creditor Objection - How Intangible and Unsubstantial May the Substantial Contribution Be?*, 92 Com. L.J. 101 (1987).

certain conditions are satisfied.[5] If these conditions are met, the bankruptcy court may confirm the reorganization plan over the objections of creditors, notwithstanding the plan's non-compliance with the absolute priority rule.[6] Section B of Part II will discuss the development of the new value exception.

Two significant events have occurred since 1939 that arguably signal the abrogation of the new value exception. First, the enactment of the Bankruptcy Code of 1978 significantly altered the Bankruptcy Act of 1898.[7] Second, the United States Supreme Court's decision in *Norwest Bank Worthington v. Ahlers*,[8] involving the Court's first foray into this area since 1978, failed to confirm the viability of the new value exception.[9] Part III analyzes these two events' effect upon the present vitality of the new value exception.

Part IV provides a conceptual model to aid in this Note's attempt to diffuse the tension between the absolute priority rule and the new value exception. It focuses upon Dean Thomas Jackson's "creditors' bargain" model of bankruptcy.[10] The creditors' bargain model seeks to vindicate the creditors' bargained-for rights of priority in the bankruptcy process.[11]

Section A of Part V offers a critique of the new value exception in light of the creditors' bargain model, and concludes that the two are irreconcilable. In an attempt to preserve the new value exception's ability to promote successful reorganizations under certain circumstances, Section B of Part V proposes a restructuring of the new value exception to better accommodate the creditors' bargain model.

II. Conflicting Roles: The Absolute Priority Rule and the New Value Exception

A. *The Absolute Priority Rule*

The absolute priority rule requires that a dissenting class of creditors be provided for fully before any junior class may receive or retain any interest in the reorganized firm.[12] The rule originated at the end of the

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5. *See* Case v. Los Angeles Lumber Products Co., 308 U.S. 106 (1939).
6. *Id.*
7. Bankruptcy Code, *supra* note 1.
8. 485 U.S. 197 (1988).
9. *Id.* at 203-04 n.3.
10. *See* Jackson, *Bankruptcy, Non-Bankruptcy Entitlement and the Creditors' Bargain*, 91 Yale L.J. 857 (1982).
11. *Id.*
12. *See In re* Future Energy Corp., 83 Bankr. 470, 497 (Bankr. S.D. Ohio 1988).

nineteenth century under the law of equity receiverships when many of the railroads' capital structures were reorganized.[13] In equity receivership reorganizations, senior creditors frequently found the value of their interests reduced, while the equityholders, who were often a part of the railroad's management, usually retained an interest in the railroad.[14] This result occurred not as a function of the existing law, but rather as a result of the reorganization negotiations between the senior creditors and the equityholders.[15] The general creditors were often "frozen out," or given only a small amount for their interests.[16] In order to combat possible collusion by the senior creditors and equityholders, courts developed the absolute priority rule.[17] Thus, the rule prevented senior creditors and equityholders from recombining their interests and finding themselves with ownership interests in the same firm free of the claims of the general creditors.[18]

Drawing upon these experiences, Congress codified the absolute priority rule.[19] Section 77B of the Bankruptcy Act of 1898 required that, as a prerequisite to confirmation, a reorganization plan be "fair and equitable."[20] Fair and equitable was a term of art that had acquired fixed meanings through judicial interpretations in the area of equity receivership reorganizations.[21] One definition of "fair and equitable" was that a junior interest could not receive any property or interest in the reorganized company unless the senior claims or interests were paid in full.[22] Accordingly, the courts considered the absolute priority rule "firmly imbedded in Section 77B."[23]

Under section 77B, the absolute priority requirement was mandatory and could not be waived by the creditors' consent.[24] Similarly, Chapter

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13. *See* Baird & Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. Chi. L. Rev. 738, 739 (1988).

14. *Id.* at 739-40.

15. *Id.*

16. *Id.*

17. *Id. See, e.g.*, Northern Pac. R.R. v. Boyd, 228 U.S. 482 (1913).

18. *See* Baird & Jackson, *supra* note 13, at 739-40.

19. *See* Case v. Los Angeles Lumber Co., 308 U.S. 106 (1939). *See generally* Bonbright and Bergerman, *Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization*, 28 Colum. L. Rev. 125 (1928); Foster, *Conflicting Ideals for Reorganization*, 45 Yale L.J. 923 (1935); Gerdes, *General Principles of Plans for Corporate Reorganization*, 89 U. Pa. L. Rev. 39 (1940).

20. Section 77B(f) stated that "[a]fter hearing such objections as may be made to the plan, the judge shall confirm the plan if satisfied that (1) it is fair and equitable and does not discriminate unfairly in favor of any class of creditors or stockholders, and is feasible . . ." *Case*, 308 U.S. at 114 n.6.

21. *Case*, 308 U.S. at 115.

22. *Id.* at 115-16.

23. *Id.* at 119.

24. In *Case*, the Court explained, "It is clear from a reading of Section 77B(f)

X of the Bankruptcy Act, which succeeded section 77B in 1939, required full compliance with the absolute priority rule.[25]

In 1978, Congress passed the Bankruptcy Code, which superceded the 1898 Bankruptcy Act. Although much precedent was expressly applicable to the new code, controversy developed concerning the applicability of old precedent in several areas. Section 1129(b)(2)[26] is an example. It states in part:

> (2) For purposes of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements:
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> (B) With respect to a class of unsecured claims-
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> (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
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> (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.[27]

Unlike Section 77B of the Bankruptcy Act, Section 1129(b)(2) provides statutory definitions of "fair and equitable." The second definition, section 1129(b)(2)(B)(ii), is a modification of the earlier version of the absolute priority rule.[28] Rather than applying mandatorily to all reorganization plans as required under the Bankruptcy Act, the absolute priority rule now applies only when a dissenting impaired class of creditors receives less than the full amount of its claims under the proposed reorganization plan.[29] This situation arises under section 1129(b)(1) when, in order to further the purpose of reorganizing the firm, the bankruptcy court may confirm a reorganization plan over the objections of an

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that the Congress has required both the required percentages of each class of security holders approve the plan and that the plan be found to be 'fair and equitable'. The former is not a substitute for the latter." *Id.* at 114.

25. *See* Marine Harbor Properties Inc. v. Manufacturers Trust Co., 317 U.S. 78, 85, *reh'g denied*, 317 U.S. 710 (1942).

26. 11 U.S.C.A. §§ 1129(b)(2)(i)-(ii) (West 1979 & Supp. 1989).

27. *Id.*

28. *See In re* Marston Enter. Inc., 13 Bankr. 514, 517 (Bankr. E.D.N.Y. 1981).

29. 11 U.S.C.A. § 1129 (West 1979 & Supp. 1989). *See In re Marston Enter. Inc.*, 13 Bankr. at 517. A class of creditors dissents when less than two-third in amount or one-half in number of the holders of claims in the class vote for the reorganization plan. 11 U.S.C.A. § 1126(c) (West 1979). A class of creditors is "impaired" when its members receive less than full payment of their claims under the reorganization plan.

impaired class of creditors.[30] Section 1129(b)(1) is referred to as the "cram-down" provision of section 1129.[31]

B. The New Value Exception

The United States Supreme Court carved out an exception to the absolute priority rule in 1939. In *Case v. Los Angeles Lumber Products Co.*,[32] the debtor's equityholders sought to retain an ownership interest in the reorganized firm despite the reorganization plan's failure to provide for full payment of each claim.[33] The equityholders attempted to justify this result, arguing that their "financial standing and influence in the community," familiarity with the operation of the business, and the "continuity of management" they could provide the reorganized firm were essential to the success of the reorganization plan.[34]

Writing for a unanimous Court, Justice Douglas explained that equityholders could justify their continued participation in the ownership of a reorganized firm by contributing new resources to the firm.[35] However, to prevent the dilution of creditors' rights resulting from the equityholders' inadequate contributions, the Court mandated that several conditions be satisfied before the Court would confirm a plan that violated the absolute priority rule.[36] The Court required that the contribution be (1) necessary to the success of the reorganization plan; (2) "fresh"; and (3) "reasonably equivalent" in value to the value of the equityholders' continued participation in the reorganized firm.[37] In addition, the equityholders' par-

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30. 11 U.S.C. § 1129(b)(1) (West 1979). The "cram-down" provision reflects a congressional policy of achieving reorganization values over the objections of recalcitrant creditors whose property rights are satisfactorily addressed in the "adequate protection scheme" of § 1129. *In re* Greystone III Joint Venture, 102 Bankr. 560, 563-64 n.3 (Bankr. W.D. Tex. 1989).

31. *See, e.g., In re* U.S. Truck Co., Inc., 800 F.2d 581, 583 (6th Cir. 1986); *In re* Future Energy Corp., 83 Bankr. 470, 490 (Bankr. S.D. Ohio 1988). In addition to complying with either § 1129(b)(2)(B)(i) or (ii), a reorganization plan must also satisfy the "best interests of creditors test." Located in § 1129(b)(1), the test requires each class receive or retain under the plan on account of its claims at least equal the amount that would be received or retained if the debtor were liquidated under Chapter 7 rather than reorganized.

32. 308 U.S. 106 (1939).

33. *Id.* at 111.

34. *Id.* at 122.

35. *Id.* at 121. The Court explained, " 'Generally, additional funds will be essential to the success of the undertaking, and it may be impossible to obtain them unless stockholders are permitted to contribute and retain an interest sufficiently valuable to move them.' " *Id.* at 117 (quoting Kansas City Terminal Ry. v. Central Union Trust, 271 U.S. 445, 455 (1926)).

36. *Id.* at 122.

37. *Id.* at 121.

ticipation was required to be based on a contribution "in money or in money's worth."[38]

Despite creating an exception to the absolute priority rule, the Court in *Case* rejected the debtor's reorganization plan.[39] The equityholders' consideration fell "far short" of satisfying the requirements of the new value exception.[40] In addition, the Court explained that the equityholders' offering of expertise, influence, and reputation could not "possibly be translated into money's worth reasonably equivalent to the participation accorded to 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."[41]

III. The Current Viability of the New Value Exception Under the Bankruptcy Code of 1978

A. *The Uncertainty Begins*

The new value exception was originally developed under the Bankruptcy Act of 1898. Until recently, the courts have preserved the existence of the exception under the Bankruptcy Code of 1978.[42] However, in 1988 the Supreme Court cast doubt upon the existence of the new value exception.

In *In re Ahlers*,[43] the Ahlerses, operators of a family farm, attempted to have a reorganization plan confirmed that allowed them to retain an equity interest in their farm over the objection of an impaired class of creditors.[44] An Eighth Circuit panel did not reject the reorganization plan and found that the Ahlerses' future contributions of labor, experience, and expertise were contributions "measurable in money or money's worth."[45] On the basis of this determination, the court remanded the matter to the district court with directions to determine whether the value of the Ahlerses' yearly contributions of labor, experience, and expertise

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38. *Id.* at 122.
39. *Id.*
40. *Id.*
41. *Id.* at 122-23.
42. *See, e.g., In re* Marston Enter, Inc., 13 Bankr. 514, 518 (Bankr. E.D.N.Y. 1981) ("There is no statutory prohibition against original shareholders making a substantial necessary capital contribution in consideration for which they received shares of stock in the reorganized corporation.").
43. 794 F.2d 388 (8th Cir. 1986), *rev'd*, Norwest Bank Worthington v. Ahlers, 485 U.S. 197 (1988).
44. *Id.* at 392-93.
45. *Id.* at 402.

over the life of the plan would equal or exceed the value of the retained ownership interest at maturity.[46]

The Supreme Court reversed the decision of the circuit court.[47] The Court viewed the promises of future services as "intangible, inalienable, and, in all likelihood, unenforceable [promises which could not] be exchanged in any market for something of value to the creditors *today*."[48]

The Court noted in a footnote that the Solicitor General, as *amicus curiae*, urged the Court to hold that the codification of the absolute priority rule in section 1129 eliminated any "exception" to that rule.[49] The Court responded:

> We need not reach this question to resolve the instant dispute. . . . [W]e think it clear that even if the *Los Angeles Lumber* exception to the absolute priority rule has survived enactment of the Bankruptcy Code, this exception does not encompass respondents' promise to contribute their "labor, experience, and expertise" to the reorganized enterprise.[50]

Although the Court circumvented the issue raised by the Solicitor General, the Solicitor General's arguments merit consideration. The first prong of the arguments focused on statutory interpretation and legislative intent. The Solicitor General first noted that unlike Chapter X of the old Bankruptcy Act which provided that a plan had to be "fair and equitable," but did not define the term, the Bankruptcy Code of 1978 supplies two statutory definitions of the term in section 1129(b)(2)(B)(i) and (ii).[51] Accordingly, the Solicitor General argued that by stating the two definitions, the Bankruptcy Code excluded all other definitions.[52]

The Solicitor General contended that even allowing equityholders to make new capital contributions as part of a reorganization plan violates the terms of section 1129(b)(2)(B) unless section 1129(b)(2)(B)(i) is satisfied.[53] Otherwise, the "interest that they receive or retain under the plan is received or retained on account of their pre-petition claim or interest" in the property of the debtor.[54] In other words, the exclusive right of prior equityholders to purchase equity results in a "preemptive

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46. *Id.* at 403.
47. Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 202 (1988).
48. *Id.* at 203 n.3 (emphasis in original).
49. *Id.*
50. *Id.*
51. Brief for the United States as *Amicus Curiae* Supporting Petitioners at 20-21, Norwest Bank Worthington v. Ahlers, 485 U.S. 197 (1988) (No. 86-958) [hereinafter Brief].
52. *Id.*
53. *Id.*
54. *Id.*

retention" of equity purchase rights by the equityholders, which the absolute priority rule forbids.[55]

The Solicitor General also noted that the Bankruptcy Code permits a creditor class, by a class vote, to assent to a plan that is not "fair and equitable" as defined in section 1129(b)(2) over the objections of minority members, provided two-thirds of the total dollar amount of the claims within that class and one-half of the actual number of creditors within that class vote to affirm the plan.[56] The Solicitor General argued that this provision of the Code, which restricts the ability of creditors to block confirmation of a reorganization plan, coupled with the codification of two definitions of "fair and equitable," "leave[s] no room to allow an equityholder to buy his way into the reorganized company over the objections of an impaired class of creditors."[57]

The Solicitor General also argued that the legislative history of section 1129(b) is devoid of congressional intent to maintain the new value exception. In support of this contention, the Solicitor General quoted a House Report that described the then proposed section 1129(b): "The general principle of the subsection permits confirmation notwithstanding non-acceptance by an impaired class if that class and all below it in priority are treated according to the absolute priority rule. The dissenting class must be paid in full before any junior class may share under the plan."[58] Furthermore, according to the Solicitor General, even if the legislative history was silent on the new value exception's vitality, the language of section 1129(b) would be a sufficient indication that the exception no longer existed because "[i]t would be extraordinary to require the legislative history to *confirm* the plain meaning of [section 1129(b)(2)(B)]."[59]

The second prong of the Solicitor General's argument focused on the policy reasons supporting the new value exception's abrogation due to the enactment of the Bankrupty Code. The Solicitor General argued that unlike in 1939, when the Court believed that the old equityholders might be the only source of new capital to fund the reorganization plan, today's capital markets make this an unrealistic concern.[60] Their structures make it easier for "worthwhile ventures" to obtain financing.[61] According to the Solicitor General, the inability of a reorganizing firm to convince

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55. *See In re* Snyder, 99 Bankr. 885, 888 n.18 (Bankr. C.D. Ill. 1989); Powlen & Wuhrman, *supra* note 3, at 317.

56. Brief, *supra* note 51, at 10 n.6, 20 (citing 11 U.S.C.A. § 1126(c) (1979)).

57. *Id.* at 20.

58. *Id.* at 21 (quoting H.R. Rep. No. 595, 95th Cong., 1st Sess. 413 (1977)).

59. *Id.* at 21-22 n.20 (quoting Bourjaily v. United States, 483 U.S. 171, 178 (1987) (emphasis in original)).

60. *Id.* at 22.

61. *Id.*

anyone other than the old equityholders to contribute capital suggests that the reorganization is unlikely to succeed rather than that the capital markets have failed.[62]

Implicit in the Solicitor General's argument is the assumption that only "worthwhile ventures" are able to raise capital and all other ventures are unable to do so; that is, that the capital markets are perfectly capable of weeding out ventures with little chance of success. This contention, especially in the bankruptcy arena, is based on erroneous conceptions of the capital markets' role in financing failing ventures.

For example, for the capital markets to function as envisioned by the Solicitor General, all the players in the capital market must possess equal amounts of relevant information concerning the firm to assess whether the firm has the potential to supply the desired return to investors or the ability to make future payments on any debt. In the close corporation and sole proprietorship context, this contention is inaccurate. The former equityholders/managers will undoubtedly possess greater knowledge about the firm and its prospects for success in the future. What may appear a probable failure to those not privy to the inner workings of the firm could actually be a viable opportunity. Furthermore, this informational asymmetry provides the equityholders/managers with a bargaining chip in reorganization negotiations because it enhances both the need for and the value of their skills. They will not relinquish this bargaining chip for the sole purpose of increasing the efficiency of the capital markets.

In addition to the informational asymmetries that prevent the operation of a "perfect" capital market, the broad statement that the failure to raise capital denotes a wasteful enterprise fails to consider the firm-specific skills and knowledge of the former equityholders/managers. The failure to raise capital could be construed as a "statement" by the players of the capital market that they are unwilling to provide capital because they lack or do not have access to the necessary skills or knowledge required to provide the enterprise with its greatest chance for success. On the other hand, if the former equityholders do possess these attributes, they will offer to supply new capital if they are sufficiently compensated.

In conclusion, speculating about why the former equityholders are the only offerors of new capital to fund a reorganization is unreasonable. Linking the new value exception to the functioning of the capital markets is not the solution.

B. The Search for an Answer

In *Ahlers*, the Supreme Court left the new value exception issue unresolved, thus notifying debtors and creditors alike that the current

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62. *Id.*

vitality of the new value exception to the absolute priority rule may be subject to dispute.[63] The Supreme Court's unwillingness to resolve the issue has led to a number of irreconcilable decisions by the bankruptcy and federal courts.

For example, one court has carried the possible interpretations of *Ahlers* to an incorrect extreme. In *In re Rudy Debruycker Ranch, Inc.*,[64] the court stated:

> [T]he Debtor's [sic] further argue that they have made substantial cash contributions to their reorganization plan in the form of inheritance from Mr. Debruycker's father of $50,000.00. Further, they state they will operate the farm without a salary, taking only funds necessary for support. . . . The total unsecured claims equal about $1,257,000.00. The cash contributions, while allowing the [debtors] to retain their equity, pales into the "de minimis" category, even if one were to accept that the exceptions [sic] of *Case* is allowable under the absolute priority rule. In other words, the capital contribution must certainly result in a 100% pay out of unsecured creditors, which is not proposed under the Plan. Finally, the easy answer is that inferred by the *Ahlers* case, namely, there are no exceptions to the absolute priority rule as codified by the 1978 Code. Thus, the only way the rule is satisfied is by payment in full of the senior class.[65]

The above interpretation of *Ahlers* is erroneous because the Supreme Court in *Ahlers* stated that its "decision today should not be taken as any comment on the continuing vitality of the *Los Angeles Lumber* exception . . . ."[66]

Many courts simply have avoided acknowledging that the new value exception rests upon a fragile foundation and instead have conducted business as usual.[67] Other courts have approached the issue with a two-

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63. Powlen & Wuhrman, *supra* note 3, at 314.

64. 84 Bankr. 187 (Bankr. D. Mont. 1988).

65. *Id.* at 189-90.

66. Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 203-04 n.3 (1988).

67. *See, e.g.*, *In re* Green, 98 Bankr. 981 (Bankr. 9th Cir. 1989) (mere promise of future services is alone insufficient to satisfy the recognized exception to the absolute priority rule); *In re* Johnson, 101 Bankr. 307, 309-10 (Bankr. M.D. Fla. 1989) (The court explained that "even prior to the enactment of the Bankruptcy Code, the courts recognized an exception to the 'absolute priority rule'. . . . [The new value] exception has been recognized by several courts and is supported by a strong policy consideration which as stated was to permit the infusion of new capital in a reorganized entity in order to assure that the entity is kept alive."); *In re* 47th and Belleview Partners, 95 Bankr. 117 (Bankr. W.D. Mo. 1988).

step analysis.[68] The first step consisted of the courts' recognizing the uncertainty surrounding the new value exception before determining that the exception was still available.[69] In the second step, the courts determined if the exception applied in the cases at hand.[70]

The court in *In re Snyder*[71] summarized two opposing arguments addressing the existence of the new value exception. The court first focused upon section 1129(b) and how the codification of the absolute priority rule may have abrogated the new value exception. The court quoted heavily from the *amicus curiae* brief filed by the United States in *Ahlers*.[72]

In support of the continued viability of the exception, the court noted the "technical argument" that although equityholders cannot retain or receive any property "on account" of their prior interests unless creditors receive full value, in a new capital case the source of their interest in the reorganized firm is their new contribution.[73] Under this view, the equityholders' new interest is not retained "on account" of their prior status, thus avoiding a violation of the absolute priority rule.[74]

The court adopted a moderate position, determining that "[t]he fresh capital exception is viable until eliminated by a higher court. . . . [I]t is better judicial policy for [a] [c]ourt to apply the long standing concept . . . until the United States Supreme Court or the Circuit Court of Appeals for the Seventh Circuit rules the exception no longer exists."[75]

In finding that the new value exception remains available to debtors, the court in *In re Henke* made a clever statutory argument in order to

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68. *See, e.g.*, *In re* Greystone III Joint Venture, 102 Bankr. 560 (Bankr. W.D. Tex. 1989); *In re* Snyder, 99 Bankr. 885 (Bankr. C.D. Ill. 1989); *In re* Maropa Marine Sales Serv. & Storage, Inc., 90 Bankr. 544 (Bankr. S.D. Fla. 1988) (Chief Judge Britton expressed doubt that the new value exception survived the enactment of the Code and then determined that, regardless, the exception did not apply); *In re* Henke, 90 Bankr. 451 (Bankr. D. Mont. 1988).

69. *See* cases cited *supra* note 68.

70. *See* cases cited *supra* note 68.

71. 99 Bankr. 885 (Bankr. C.D. Ill. 1989).

72. *Id.* at 888. *See generally* Brief, *supra* note 51, at 17-23.

73. *See* Levin, *Retention of Ownership Interest Over Creditor Objection - How Intangible and Unsubstantial may the Substantial Contribution Be?*, 92 Com. L.J. 101, 104 (1987); Nimmer, *Negotiated Bankruptcy Reorganization Plans: Absolute Priority and New Value Contributions*, 36 Emory L.J. 1009 (1987). This view is defective because it fails to acknowledge that the only reason the equityholders have the opportunity to make this contribution is because of their prior status as equityholders of the debtor.

74. *See In re Snyder*, 99 Bankr. at 888.

75. *Id.* at 888-89. The court also noted that the new value exception is a "deeply engraved concept" and that nothing in the legislative history of § 1129 indicates Congress intended to eliminate the exception. *Id.* at 888.

escape the confining language of section 1129(b)(2)(B)(ii).[76] First, the court noted that the section 1129(b)(2) definition of "fair and equitable" only "includes" the requirements found in subsections 1129(b)(2)(B)(i) and (ii).[77] Because the Code contains a rule of construction that "includes" is not limiting,[78] the court explained that "Congress clearly intended that the examples set forth [in sections 1129(b)(2)(B)(i) and (ii)] are not limiting but rather invite an open-ended approach, such as the exception set forth in *Los Angeles Lumber*."[79] The court wrote that its holding that the definitions of "fair and equitable" found in sections 1129(b)(2)(B)(i) and (ii) are not exclusive was consistent with legislative intent and history, and constituted a practical, desirable, and compatible approach to a Chapter 11 reorganization effort.[80]

In *In re Greystone III Joint Venture*,[81] the largest creditor noted that the availability of the new value exception was questioned in *Ahlers*, and urged the court to rule that the exception was unavailable to permit debtors "to 'buy' their way back into their own cases."[82] The court rejected the creditor's invitation. Otherwise, the court explained, "a perfectly sensible reorganization might founder [sic] for lack of capital infusion from the equity holders, who could hardly be expected to pump new money into a venture if they could not in the process retain an interest in the venture."[83]

The court also determined that, contrary to the Solicitor General's argument in *Ahlers*, the definitions of "fair and equitable" found in

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76. *In re* Henke, 90 Bankr. 451 (Bankr. D. Mont. 1988). Interestingly, Judge Peterson, the author of the *In re* Rudy Debruycker Ranch, Inc., 84 Bankr. 187 (Bankr. D. Mont. 1988) opinion, reversed his prior view that the *Ahlers* decision eliminated the new value exception, as he wrote the *In re Henke* opinion as well.

77. *In re Henke*, 90 Bankr. at 455. 11 U.S.C. § 1129(b)(2) (West 1979) states: "For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements."

78. *In re Henke*, 90 Bankr. at 455 (citing 11 U.S.C.A. § 102(3) (West 1979)).

79. *Id.*

80. *Id.* Concerning legislative intent and history, the court quoted identical House and Senate reports that stated:

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

Id. at 455 n.3. (citing 124 Cong. Rec. H11,103 at 11,104 (daily ed. Sept. 28, 1978); 124 Cong. Rec. S17420 at 17420 (daily ed. Oct. 6, 1978)).

81. 102 Bankr. 560 (Bankr. W.D. Tex. 1989).

82. *Id.* at 572.

83. *Id.* at 573.

sections 1129(b)(2)(B)(i) and (ii) were not exclusive.[84] In a footnote, the court reasoned:

> It is fair to assume that Congress was aware of *Case* when it passed the Bankruptcy Code. That Congress did not expressly codify *Case*'s holding should be of no moment, as the term of art carried with it the judicial glosses that had been placed upon it. What does matter is that the bankruptcy Code did not expressly repudiate *Case*. It is a time-honored principle of statutory construction that legislators are presumed to be aware of judicial glosses placed on prior statutory enactments, and that subsequent amendments and codifications are presumed to have been carried into the new statute unless expressly repudiated. The Bankruptcy Code did not repudiate *Case*, so the [new value exception to] the absolute priority rule should be presumed to still be good law.[85]

Given the courts' numerous approaches to reach a conclusion as to whether the new value exception survived the enactment of the Bankruptcy Code, clearly no "majority" position has evolved. Possibly, lower courts have been forced to creatively breathe new life into the new value exception because they are reluctant to contradict the United States Supreme Court. On the other hand, the lower courts may be basing their decisions on the often-discussed rationale that the practicalities of a successful reorganization dictate such a result. Regardless of why the courts have kept the new value exception available to a debtor or debtors, a colorable argument can be made to support either the elimination or continuation of the new value exception. However, the statutory arguments of the Solicitor General in *Ahlers* are the most consistent with the language of section 1129(b)(2). Yet, to date, the arguments have not carried the day. The next two sections of this Note will, in part, attempt to determine which of the two possible results concerning the availability of the new value exception best comports with the overall framework of the Bankruptcy Code.

IV. The Creditors' Bargain Model

The first step in determining whether the new value exception has a niche in the overall framework of the Bankruptcy Code requires selecting a theoretical framework that provides a unifying vision of the seemingly contradictory objectives of Chapter 11. In what one commentator has

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84. *Id.* at 575.
85. *Id.* at 575 n.20.

termed the "first attempt at a unifying theme,"[86] Dean Thomas Jackson has developed a conceptual model of the bankruptcy process to provide an explanation of the process.[87]

The model is based on the belief that creditors' consensually negotiated, non-bankruptcy entitlements should be recognized in bankruptcy.[88] Noting that no normative theory has been developed under which intercreditor bankruptcy rules could be examined, Jackson has developed what he terms a "creditors' bargain" model of bankruptcy.[89] He argues that bankruptcy should be viewed as a system "designed to mirror the agreement one would expect the creditors to form among themselves were they able to negotiate such an agreement from an *ex ante* position."[90]

Jackson first examines what motives both secured and unsecured creditors have to participate in a "government imposed collective asset-distribution system," that is, the bankruptcy process.[91] He suggests the following three benefits accrue to unsecured creditors under such a system: (1) a reduction in strategy costs; (2) an overall increase in the aggregate pool of assets available for distribution; and (3) administrative efficiencies.[92]

A collective system that treats identically all claimants with the same relationship to a debtor has three strategic advantages. First, instead of facing the possibility of recovering an uncertain amount under an "individualistic creditor's remedy system," the creditors receive a sum "certain."[93] Second, when liquidation is inevitable, the strategic costs associated with a race to the courthouse are eliminated.[94] Finally, a collective proceeding reduces variances in recoveries, which is a virtue to risk-averse creditors.[95]

The second benefit of a collective proceeding accruing to unsecured creditors is the increased pool of assets that are available for distribution.[96]

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86. Skeel, *supra* note 2, at 223.
87. *See* Jackson, *supra* note 10.
88. *See id.* at 858.
89. *Id.*
90. *Id.* at 860.
91. *Id.* at 859.
92. *Id.* at 861.
93. *Id.* Jackson emphasizes that the advantage of a collective system is not that it provides, *ex ante*, a fully determinable sum, but that such a system ensures creditors of equal priority will be treated equally.
94. *Id.* For example, C1 and C2 have each loaned D $50,000. D's assets total $60,000. Both creditors know that the first to the courthouse (or to D, to persuade D to pay voluntarily) will collect $50,000, leaving only $10,000 for the "slower" creditor absent a bankruptcy process. *Id.* at 862.
95. *Id.* at 861-62.
96. *Id.* at 864.

The use of individualistic remedies "may lead to a piecemeal dismantling of a debtor's business by untimely removal of necessary operating assets."[97] On the other hand, an organized non-piecemeal bankruptcy process is likely to increase the aggregate pool of assets available for distribution because the structure of the process is coordinated to achieve this objective.[98]

In addition, Jackson explains that a collective proceeding enhances administrative efficiencies.[99] For instance, issues such as the valuation of the debtor's assets and the nature and extent of secured claims arise in virtually every collection proceeding.[100] In a collective proceeding, these costs are pooled, benefiting all involved. Jackson states that at the time of "negotiating" the creditors' bargain, the reduction in expenses "would be viewed as a clear advantage of a collective process."[101]

Jackson contends these benefits make it likely that an unsecured creditor will agree to a collective system as opposed to pursuing individual remedies.[102] He recognizes, however, that no single creditor "would agree to be bound to this collective system unless it were a compulsory system binding all other creditors: to allow the debtor to contract with other creditors on an opt-out basis would destroy the advantages of a collective proceeding."[103]

Although a mandatory collective proceeding would be an expected feature of the "creditors' bargain," it is unrealistic to assume an *ex ante* meeting of the creditors will take place.[104] The creditors could not negotiate such an agreement because a debtor is unlikely to know who its future creditors will be, and the pool of the debtor's creditors will change over time.[105] Jackson reasons that the problem's solution is the federal bankruptcy rules, which make a mandatory collective system available once insolvency has occurred.[106]

The next question is whether secured creditors would agree to be bound by a collective proceeding. Jackson notes that, unlike unsecured

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97. *Id.*
98. *Id.*
99. *Id.* at 866.
100. *Id.*
101. *Id.*
102. *Id.*
103. *Id.*
104. *Id.*
105. *Id.*
106. *Id.* at 867. Jackson emphasizes that the role of a mandatory collective system should not be overstated because the presence of a bankruptcy system does not mandate its use. He states, "The availability of a mandatory collective system in which distributions are governed by a set of statutory rules is . . . important because it stipulates a minimum set of entitlements for claimants that, in turn, provides a framework for implementing a consensual collective proceeding outside of the bankruptcy process. *Id.*

creditors, fully secured creditors would not benefit directly from the increased aggregate pool of assets or the reduction of strategic costs.[107] Furthermore, because some of the administratively difficult issues, such as the availability of assets and the priorities of competing claimants, already have been negotiated away, secured creditors are not likely to view administrative efficiencies as a reason to adopt a mandatory collective system.[108]

Thus, the unsecured creditors must be willing to make some type of concessions to the secured creditors to entice their participation in a collective proceeding.[109] If forced to participate on a *pro rata* basis with unsecured creditors in a bankruptcy proceeding, the advantages of secured credit would be lost.[110] To ensure the secured creditors' participation, the bankruptcy process must respect the secured creditors' expectations to be paid first from the assets constituting the secured creditors' collateral.[111] A secured creditor has no reason to object to inclusion in a mandatory collective system if "left as well off as before."[112]

Jackson concludes that the mandatory inclusion of secured creditors in a collective system would produce the following net benefits: The unsecured creditor could be made better off, even if the secured creditors' preferential entitlements were respected, and the secured creditor would be no worse off than before.[113] Jackson also suggests that if secured creditors' superior rights are not respected in a collective system, these creditors will transfer their increased risk to the debtor, and to others seeking their funds, in the form of higher interest rates. Conceivably, these rates could escalate to the level of the interest rates demanded by unsecured creditors, depriving debtors of a cheaper source of funds.[114] Thus, according to Jackson, bankruptcy rules must preserve the parties' non-bankruptcy entitlements in order to avoid undesirable external costs.[115]

V. The New Value Exception in Light of the Creditors' Bargain Model

A. *The "Traditional" New Value Exception*

One commentator recently examined the new value exception in light of Jackson's creditors' bargain model and concluded that the two are

107. *Id.* at 868.
108. *Id.* at 868-69.
109. *Id.* at 869.
110. *Id.*
111. *Id.* at 869-70.
112. *Id.* at 870.
113. *Id.*
114. *Id.* at 868-69.
115. *Id.* at 871.

irreconcilable.[116] The commentator first focused on the Solicitor General's argument in *Ahlers*.[117] He noted that the new value exception's grant of the exclusive right to the pre-petition equityholders to receive equity in the reorganized firm in return for a fresh capital contribution when all superior classes have not been compensated in full violates the absolute priority rule.[118] This violation of the absolute priority rule is irreconcilable with the creditors' bargain model because it allows lower priority interests to preempt bargained-for superior interests.[119]

The commentator also examined the risk of the contributors receiving an interest in the entity that exceeds their capital contribution.[120] The creditors' bargain is violated if the value of the equity received by an equityholder exceeds the value of the equityholders' contribution.[121] The preservation of the creditors' bargain is directly tied to the courts' ability to accurately value the contribution made and the value of the ownership interest in the reorganized firm granted to the contributor.[122] However, although cash contributions present little challenge, a judge cannot precisely determine the value of the equity granted given the extremely uncertain value of a reorganized company's equity.[123] This inconsistency leads to conflicts with the creditors' bargain model.

Additionally, equityholders' use of the contribution rule violates the creditors' bargain model when reorganization fails.[124] To visit such a result on creditors permits the equityholders, who have little to lose, a gamble at success at the expense of their creditors.[125]

Given these problems, the commentator concluded that Jackson's creditors' bargain model suggests the Supreme Court should have adopted the Solicitor General's position in *Ahlers*, and held that the enactment of the Bankruptcy Code of 1978 abrogated the new value exception.[126]

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116. *See* Skeel, *supra* note 2, at 236-39.

117. *Id. See* Brief, *supra* note 51, at 20-21.

118. *See* Skeel, *supra* note 2, at 236. Essentially, this right is an option that conceivably could have a market value.

119. *Id.*

120. *Id.* Recall that the Court in *Case v. Los Angeles Lumber Products Co.* stated that "participation must be based on a contribution in money or money's worth, reasonably equivalent in view of all the circumstances to the participation of the stockholder." 308 U.S. 106, 122 (1939).

121. Skeel, *supra* note 2, at 237 ("The suggestion is that in purchasing a share of the reorganized company, an equityholder has not really received value on account of his or her former status; the equityholder has merely engaged in a quid pro quo transaction.").

122. *Id.*

123. *Id.* at 238.

124. *Id.*

125. *Id.*

126. *Id.* at 239.

B. A Restructured New Value Exception

The new value exception possesses a positive attribute — it provides fresh capital, thus promoting successful reorganizations under certain conditions. This benefit is derived at the cost of violating the creditors' bargain model. However, the circumstances under which the new value exception is made available to equityholders could be altered to reduce the gravity of this violation of the creditors' bargain model.

First, all senior creditors, for the purpose of one vote, would become members of a "superclass." A creditor qualifies as a "senior creditor" if at the time of extending credit to the debtor, the parties agreed that no other creditor would be given a superior priority position upon dissolution of the firm.[127]

Today, the ultimate decision of whether equityholders may benefit from the new value exception rests with a judge. Under the superclass mechanism, the superclass would have this power. Confirmation of a reorganization plan that permits the equityholders to retain an ownership interest in the reorganized firm, yet fails to provide for payment in full of all creditors' claims, would be conditioned upon the superclass's consent to the plan. However, the superclass's power to make this determination without any input from the intermediate creditors is subject to one important limitation — the aggregate value of the superclass's claims would have to exceed the value of the firm.[128] If the superclass did not meet this condition or rejected the reorganization, the court would apply the existing rules, including the absolute priority rule.

The superclass should be given the power to confirm a reorganization plan over the objection of the intermediate creditors because, like Jackson's creditors' bargain model, the mechanism would mirror the parties'

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127. Practically speaking, secured creditors would constitute the "senior class."

128. *See generally* Baird & Jackson, *supra* note 13, at 745. Baird & Jackson question the application of the absolute priority rule when the firm is worth less than the amount the most senior creditor is owed. They note that the threat of a freeze-out of the intermediate creditors is not a serious problem in this situation because if the firm's assets were liquidated in a state foreclosure action, the intermediate creditors may not be entitled to anything because of their priority position. However, in a Chapter 11 case, the firm is being reorganized, not dismembered. *Id.* Accordingly, Baird & Jackson recognize that a freeze-out of the intermediate creditors could occur here because the possibility that the reorganized company will do much better than expected makes the intermediate creditors' right to reach the assets of the debtor before the equityholders worth something. *Id.* In this sense, the superclass mechanism does not fully respect the rights of the intermediate creditors because it fails to take the full value of their claims in account. However, this result is justified based on the following competing interest of Chapter 11 — the promotion of the successful reorganization of the debtor. At some point, this interest must override the "speculative" claims of the intermediate creditors. Under the superclass mechanism, this point is surpassed when the aggregate value of the superclass's claims exceeds the value of the firm.

nonbankruptcy entitlements and bargaining positions.[129] For example, outside of bankruptcy, if secured creditors were to foreclose on a debtor's property and the assets were worth less than the amount owed, the secured creditors would get only those assets. The secured creditors would control the debtor's assets and would be able to convey an interest in the assets to anyone they deem advantageous.[130] Their decision to share the assets with the old shareholders, instead of the intermediate creditors or a third party, suggests that the secured creditors believe it is in their best interest.[131] The superclass mechanism merely grants the superclass a type of control of the process similar to what the superclass enjoys in state foreclosure actions.

At first glance, the superclass mechanism may seem harsh on the intermediate creditors. However, the mechanism merely reflects the power, or lack thereof, of the priority position chosen by the intermediate creditors upon extending credit to the debtor in exchange for a higher rate of interest. However, as a practical matter, when negotiating the terms of an acceptable reorganization plan, the superclass and equityholders are forced to consider the bargaining position of the intermediate creditors. For instance, a supplier may refuse to deliver supplies unless treated fairly in the reorganization plan.[132]

The advantages of the superclass mechanism are apparent when analyzed in the context of the controversial aspects of the current new value exception. As previously discussed, the current new value exception is inconsistent with the creditors' bargain model because the equityholders' exclusive right to invest fresh capital in the firm allows the equityholders, due to their prior status, to retain value in the form of an "option" to exercise this right.[133] The value inherent in this right stems from the courts' control of the availability of the new value exception. A court decides whether, over the objection of dissenting creditors, the capital contribution is "fresh," necessary, and substantial enough to justify the pre-petition equityholders' equity interest in the reorganized company.

The value of this exclusive right would be greatly diminished under the superclass mechanism because the superclass would now control the right. The equityholders would have to convince the superclass, which

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129. *See generally*, Jackson, *supra* note 10, at 858.

130. *Id.*

131. *Id.*

132. *See, e.g.*, *In re* Blackwelder Furniture Co., 7 Bankr. 328 (Bankr. W.D.N.C. 1980) (refusal to continue deliveries); *In re* Ike Kempner & Bros., 4 Bankr. 31 (Bankr. E.D. Ark. 1980) (refusal to deliver shoes to supplier); Baird & Jackson, *supra* note 13, at 760 (analyzing the strength of general creditor bargaining positions in reorganization negotiations).

133. *See supra* notes 114-19 and accompanying text.

would seek to enforce its original "bargain" to the greatest degree possible, that the equityholders' contributions justify their participation in the reorganized company.

The superclass mechanism would also reduce the costs of the uncertainty surrounding the current new value exception. For instance, when parties are unsure how a court will apply a rule, they will take excessive precautions that often produce few desirable social benefits in order to protect their interests.[134] The superclass mechanism could reduce these costs because its framework could provide more predictable results. In analyzing a debtor's financial situation, the parties generally could estimate whether the superclass is able to control the availability of the new value exception. Even if this estimate becomes too difficult, at a minimum the parties are assured that either the superclass or all of the creditors, and not an impartial third party, will control the availability of the new value exception.

Also, the creditors could reduce the costs associated with insuring against the failure of their precautions [135] because the superclass mechanism is a clearer legal regime in which to analyze the risk of losses. The clearer legal regime would also allow the superclass to determine whether the reorganized company is worth more with the continued participation of the equityholders without being forced to account for the possibility that a judge will allow the equityholders to retain an interest in the reorganized firm.[136]

The superclass mechanism could also promote successful reorganizations under circumstances that the current new value exception cannot. For example, allowing the superclass to determine what type of capital it is willing to accept as consideration for the equityholders' interest in the reorganized firm could expand the "money or money's worth" genre of capital required under the current new value exception. One of the reasons the courts have strictly interpreted the "money or money's worth" capital requirement is to protect the creditors from equityholders who offered speculative contributions or promises of future services to escape the confines of the absolute priority rule.[137] Under the superclass mechanism, the superclass could decide at its own risk what types of capital it would accept; there would be no reason for a court to protect the superclass in this situation. Consequently, the superclass would be allowed to recognize the value of continuity of management in a small company, in which the primary asset is often the entrepreneurial skills of the owner

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134. *See* Skeel, *supra* note 2, at 230.

135. *Id.*

136. Brief, *supra* note 51, at 22-23. The Solicitor General made this argument in the context of arguing that the new value exception should be abolished.

137. *See* Skeel, *supra* note 2, at 227.

or owners, and in which there may be no remaining wealth to contribute to the company.[138]

Similarly, a court would no longer have to demand that the equityholders' contributions be "reasonably equivalent" in value to the value of the equityholders' retained interest in the reorganized company. The superclass's consent to a reorganization plan would supercede the original creditors' bargain. Hence, the original creditors' bargain is not violated if the value of the equity received by the equityholders exceeded the value of the equityholders' contribution.

VI. Conclusion

Anchored in the creditors' bargain model, the superclass mechanism gives to the equityholders with one hand what it takes with the other. By allowing the superclass to determine the conditions of the equityholders' continued participation in the reorganized firm, the mechanism liberalizes the current new value exception. No longer will courts be required to guard against the dilution of creditors' rights through the use of speculative contributions by strictly interpreting the prerequisites to continued equityholder participation established in *Case v. Los Angeles Lumber Products Co.*[139] Instead, equityholders will have the opportunity, subject to the consent of the superclass, to exchange their skills, labor, and ideas for continued participation in the reorganization.

On the other hand, the superclass mechanism increases the bargaining power of the superclass, a justifiable result given the size of the superclass's claims compared to the firm's value. Yet all is not lost for the equityholders. Under the superclass mechanism, the equityholders must satisfy only the demands of the superclass. Prudential considerations, however, may require both the superclass and the equityholders to respect the claims of the intermediate creditors.

The benefits of the superclass mechanism closely parallel those of the bankruptcy process defined by Jackson's creditors' bargain model. The senior creditors are treated comparably both inside and outside the bankruptcy system. The intermediate creditors gain similar benefits yet face the same risks. Whether in the bankruptcy arena or not, their bargaining position depends upon the value of the firm in relation to the value of the creditors possessing superior priority rights.

The benefits of the superclass mechanism would also trickle down to everyday debtors. Creditors would be assured that their bargained-for rights of priority would be respected. No longer would the "traditional"

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138. *Id.* at 226. Skeel raised this point while examining the value of labor and firm-specific skills.

139. 308 U.S. 106 (1939).

new value exception eviscerate the absolute priority rule, effectively negating any of the exception's upward influence upon the interest rate on borrowed funds demanded by creditors.

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