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# The New Value Exception to the Absolute Priority Rule in Chapter 11 Reorganizations: What Should the Rule Be?

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# The New Value Exception to the Absolute Priority Rule in Chapter 11 Reorganizations: What Should the Rule Be?

Linda J. Rusch*

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## I. INTRODUCTION

Reorganizations under Chapter 11[1] of the 1978 Bankruptcy Code[2] involve a process by which the owner and creditors of a debtor-enterprise negotiate a restructuring of the financially distressed business.[3]

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1. 11 U.S.C. §§ 1101-1174 (1988).
2. 11 U.S.C.A. §§ 101-1330 (1979 & West Supp. 1992) (hereinafter "the Code").
3. *See* Donald R. Korobkin, *Rehabilitating Values: A Jurisprudence of Bankruptcy*, 91 COLUM. L. REV. 717, 762-80 (1991) (bankruptcy reorganization provides a

Sometimes the negotiating process fails and the owner attempts to "cram down," or force, a reorganization plan on dissenting classes of creditors.[4] Currently, courts are divided over an issue that is critical both to the parties' ability to negotiate a consensual plan and to the owner's ability to cram down a plan on dissenting creditors: whether the new value exception to the absolute priority rule survived enactment of the 1978 Code.[5]

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process for the interested parties to debate and to decide about the debtor's future potential).

4. 11 U.S.C. § 1129(b) (1988). *See generally* Charles D. Booth, *The Cramdown on Secured Creditors: An Impetus Toward Settlement*, 60 AM. BANKR. L.J. 69 (1986) (the risks of valuation make it more advantageous to negotiate than cram down a plan); Kenneth N. Klee, *All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code*, 53 AM. BANKR. L.J. 133 (1979) (explaining "cramdown" as a means of confirming a reorganization plan over the protests of a dissenting class); Linda J. Rusch, *Gerrymandering the Classification Issue in Chapter Eleven Reorganizations*, 63 U. COLO. L. REV. 163, 167-75 (1992) (debtor cannot cram down a plan unless it is fair and equitable to all dissenting impaired classes and does not unfairly discriminate against dissenting classes of impaired claims).

5. *See, e.g., In re* Snyder, 967 F.2d 1126, 1128-31 (7th Cir. 1992) (deferring decision on whether "new value" survives in this Code, dictum that it probably survived); *In re* Bryson Properties XVII, 961 F.2d 496, 503-05 (4th Cir. 1992) (held even if new value survives Code, criteria not met in this case), *cert. filed*, 61 U.S.L.W. 3061 (July 16, 1992); Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting, 908 F. 2d 1351, 1359-63 (7th Cir. 1990) (refusing to rule on the new value exception because it was not properly preserved in the court below); *In re* A.V.B.I., 1992 WL 201264 (Bankr. L.D. Cal. July 29, 1992) (new value exception does not exist); *In re* Bonner Mall Partnership, 1992 WL 171900 (D. Idaho July 15, 1992) (new value exception still viable); *In re* Sovereign Group 1985-27, Ltd., 1992 WL 172641 (E.D. Pa. June 30, 1992) (same); *In re* Ba-Hen, 1992 WL 143812 (Bankr. W.D. L.a June 10, 1992) (same); *In re* Montgomery Court Apartment of Ingham County Ltd., 141 B.R. 324, 342-44 (Bankr. S.D. Ohio 1992) (same); *In re* Ribs Auto Sales, Inc., 140 B.R. 390, 395-96 (Bankr. E.D. Va. 1992) (dicta that no new value exception permitted); *In re* SLC Limited V, 137 B.R. 847, 850-55 (Bankr. D. Utah 1992) (new value exception exists); *In re* James, 1992 WL 21365 (Bankr. M.D. Fla. 1992) (new value exception did not survive passage of the Code); *In re* Bjolmes Realty Trust, 134 B.R. 1000, 1003-08 (Bankr. D. Mass. 1991) (concluding that the "fresh contribution" is viable); *In re* Woodscape Ltd. Partnership, 134 B.R. 165, 168-76 (Bankr. D. Md. 1991) (refusing to decide the question whether the new value exception survives passage of the Code); *In re* Triple R Holdings, L.P., 134 B.R. 382, 384-92 (Bankr. N.D. Cal. 1991), *rev'd* 1992 WL 237328 (N.D. Cal. Sept. 15, 1992) (holding that the new value exception survived passage of the Code); *In re* Professional Dev. Corp., 133 B.R. 425 (Bankr. W.D. Tenn. 1991) (new value exception remains viable); *In re* Tallahassee Assocs., L.P., 132 B.R. 712, 715-17 (Bankr. W.D. Pa. 1991) (holding that new value exception remains viable); Piedemont Assocs. v. CIGNA Property & Casualty Ins., 132 B.R. 75, 79 (N.D. Ga. 1991) (the new value exception did not survive passage of the Code); *In re* Outlook/Century Ltd., 127 B.R. 650, 654-58 (Bankr. N.D. Cal. 1991) (same); *In re* Lumber Exchange Ltd. Partnership, 125 B.R. 1000, 1006-08 (Bankr. D. Minn.) (same) *aff'd*, 134 B.R. 454 (D. Minn. 1991), *aff'd on other grounds*, 1992 WL 143303 (8th Cir. June 29, 1992); *In re* 222 Liberty Assocs., 108 B.R. 971, 983-85 (Bankr. E.D. Pa. 1990) (new capital exception survived passage of the Code); *In re* Drimmel, 108 B.R. 284, 288-90 (Bankr. D. Kan. 1989), *aff'd*, 135 B.R. 410 (Bankr. D. Kan. 1991) (new value exception did not survive passage of the the Code); *In re* Pullman Constr. Indus. Inc., 107 B.R. 909, 943-48 (Bankr. N.D. Ill. 1989) (new capital exception retains its vitality); *In re* Winters, 99 B.R. 658, 660-63 (Bankr. W.D. Pa. 1989) (new capital exception did not survive passage of the Code). The Fifth Circuit Court of Appeals originally decided that the new value exception did not survive the

The absolute priority rule requires full payment to each class of senior claimants before any member of a junior class can receive a monetary distribution under the plan on account of its junior claim or interest.[6] Thus, absolute priority requires full payment to secured claim holders before any payment to unsecured claim holders, and full payment to unsecured claim holders before any payment to holders of equity interests. The new value exception allows the debtor's owner, the equity holder, to receive or to retain an equity interest in the reorganized business through a contribution of new value, even if all senior claimants are not paid in full.[7] The essence of the debate over the existence of the new value exception is whether the current owner of a bankrupt business should be able to buy her way into ownership of the reorganized business over the objections of unsecured creditors who have not been paid in full through the reorganization process.

The new value issue is especially important in the context of a non-publicly held company if the owner of that company participates in the management or daily business operations. Ownership and management of a publicly held business does not usually rest with the same group of persons. When ownership and management are divided, the same management team can continue working, despite a change in ownership, without a significant impact on continuous business operations. In contrast, the non-publicly held business is more likely to have ownership and management residing in the same person or group of persons. When management and ownership are not divided, changing ownership usually requires new management unless the former owner agrees to continue running the business as an employee of the new owners. The new value issue is most important to a non-publicly held business because the new value exception significantly impacts the distribution of management control and the business' financial value.[8] Therefore, this article focuses on the new

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enactment of the 1978 Code. *In re* Greystone III Joint Venture, 948 F.2d 134, 142 (5th Cir. 1991). That opinion was withdrawn and the new value portion of the opinion vacated on February 27, 1992. A petition for certiorari has been filed. 61 USLW 3060 (June 26, 1992).

6. *See infra* notes 21-26 and accompanying text.

7. *See infra* notes 27-31 and accompanying text.

8. *See infra* note 63 and accompanying text. *See* Ralph A. Peeples, *Staying in: Chapter 11, Close Corporations and the Absolute Priority Rule*, 63 AM. BANKR. L.J. 65, 76 (1989) (arguing for a separate set of rules for reorganization in closely-held corporations). As one study demonstrates, in reorganizations of large publicly held companies, the absolute priority rule and the new value exception do not heavily influence the bargaining over the distribution of the going concern value. Lynn M. LoPucki & Wil-

value issue as it applies to non-publicly held businesses where the owner participates in the business' management.

The division among courts that have addressed the new value issue reflects the extreme difficulty of discerning whether Congress intended to abrogate the new value exception. Scholars are also divided over the issue.[9] Until Congress acts to clarify its intent,

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liam C. Whitford, *Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125, 143-64 (1990) (discussing survey results on how the reorganizing enterprise was divided among competing claims and interests). In addition, resolving the question of control of the reorganized business differs between publicly held and privately held businesses. Raymond T. Nimmer, *Negotiated Bankruptcy Reorganization Plans: Absolute Priority and New Value Contributions*, 36 EMORY L.J. 1009, 1054-84 (1987) (owners of privately held businesses deserve greater protection under the Code due to their greater liability).

Congress, recognizing the difficulty of reorganizing one type of closely held business, the family farm, created a special chapter, Chapter 12, for reorganizing that type of small business. 11 U.S.C. §§ 1201-1231 (1988). Chapter 12 is modeled after Chapter 13, 11 U.S.C. §§ 1301-1330 (1988 & Supp. II 1990), which authorizes repayment plans for individuals with secured and unsecured debts under specified limits. 11 U.S.C. § 109(e) (1988). In both Chapters 12 and 13, the debtor may cram down a plan on dissenting, unsecured creditors with impaired claims and retain ownership of her business as long as the plan requires the debtor to apply all of her projected disposable income to reorganization plan payments. 11 U.S.C. §§ 1225(b)(1), 1325(b)(1) (1988). Further recognition of the fact that the absolute priority rule may be inappropriate for small businesses is the introduction of a bill in Congress for a small business reorganization process similar to that found in Chapters 12 and 13. S. 1985, 102nd Cong., 1st Sess. § 205(c) (1991), *reprinted in* 137 CONG. REC. S17048-53 (daily ed. Nov. 19, 1991). The sponsors of the bill seek Congressional approval for an eight-district pilot project to test this type of reorganization. 137 CONG. REC. S17057 (daily ed. Nov. 19, 1991) (statement by Sen. Grassley). The bill contains the same cramdown provision as in Chapters 12 and 13. S. 1985, 102nd Cong., 1st Sess. § 205(c) (1991) (proposed 11 U.S.C. § 1026(b)(2)). For a description and evaluation of this bill, see Phillip J. Hendel, *An Enlightened Approach to Small Business Reorganization: Proposed Finetuning of Chapter 10*, 7 Comm. L. Bulletin 11 (Jan./Feb. 1992). The Senate Judiciary Committee revised the bill and sent a substitute bill to the Senate. S. Rep. 279, 102nd Cong., 1st Sess. (1992). On June 17, 1992, the Senate passed the bill as amended on the Senate floor. 138 Cong. Rec. 58359 (June 17, 1992). The bill as passed is printed at 138 Cong. Rev. S 8359-71 (June 17, 1992). The House of Representatives referred to the bill to the House Judiciary Committee. 138 Cong. Rec. H4981 (June 18, 1992).

9. *See, e.g.*, John D. Ayer, *Rethinking Absolute Priority After Ahlers*, 87 MICH. L. REV. 963, 1011-16 (1989) (observing that *Ahlers*, 485 U.S. 197 (1988), at least sharply restricted the use of the new value exception); Daren R. Brinkman, *The New Value Exception to the Absolute Priority Rule After Ahlers*, 106 BANKING L.J. 351, 358-62 (1989) (arguing that Congress did not attempt to fully codify the absolute priority rule); Kenneth N. Klee, *Cram Down II*, 64 AM. BANKR. L.J. 229, 240-44 (1990) (in favor of retaining the new value exception to protect against low valuations); Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 STAN. L. REV. 69, 74-95 (1991) (the new value "exception" is better understood as an "extension" of absolute priority principles); David M. Powlen & Arnold H. Wuhrman, *The New Value Exception to the Absolute Priority Rule: Is Ahlers the Beginning of the End?*, 93 COM. L.J. 303, 316-19 (1988) (courts might take different approaches to the new value question); Jeffery M. Sharp, *Bankruptcy Reorganizations, Section 1129, and the New Capital Quagmire: A Call for Congressional Response*, 28 AM. BUS. L.J. 525, 543-52 (1991) (Congress must clarify its intent behind section 1129 to restore order to the bankruptcy system); Clifford S. Harris, Note, *A Rule Unvanquished: The New Value Exception to the Absolute Priority Rule*, 89 MICH. L. REV. 2301, 2316-22 (1991) (the new

continued attempts to ascertain that intent will probably not be productive. Accordingly, instead of trying to determine congressional intent regarding the new value exception, this article discusses what the rule ought to be regarding owner participation over creditor dissent. The view proposed herein is based upon a functional analysis of business reorganization law. A functional analysis identifies the functions of the law and evaluates the doctrines at issue in light of those functions. Deciding the extent to which a particular doctrine will promote the various functions of the law requires a resolution of conflicts between competing value choices.

Section II will review the current Chapter 11 reorganization process, including the application of the absolute priority rule and the new value exception. Section III will describe the functional approach to resolving bankruptcy issues. Section IV will review the two dominant theories of business reorganization law, namely credi-

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value exception protects creditors by continuing the business as a going concern, instead of merely liquidating it).

Professor Sharp makes a convincing argument that the method of statutory interpretation substantially determines the answer to whether Congress intended the new value exception to exist. Using the plain language approach to statutory interpretation, new value is not part of the Code because Congress did not mention new value in the statutory language. Sharp, *supra*, at 544-47. A more integrated approach to statutory interpretation includes the legislative history and a presumption that if Congress had wanted to change prior law, it would have said so. Commentators favoring this approach contend that Congress meant to only partially codify the standards for cramdown; the new value exception was part of the prior standards, and Congress did not disclaim new value. Therefore, they maintain, new value is part of the Code. Sharp, *supra*, at 548-52. Both approaches use legitimate methods of statutory interpretation and both methods have been used by the courts to resolve the new value issue. *Compare In re* Ribs Auto Sales, Inc., 140 B.R. 390, 393-94 (Bankr. E.D. Va 1992) *with In re* Triple R Holdings, L.P., 134 B.R. 382, 384-92 (Bankr. N.D. Cal. 1991), *rev'd*, 1992 WL 237328 (N.D. Cal. Sept. 15, 1992), and In re Snyder, 967, F.2d 1126, 1128-31 (7th Cir. 1992). The justices of the Supreme Court cannot agree on the standards of statutory interpretation that should be used in interpreting Code provisions. *See* Rusch, *supra* note 4, at 180-81 & nn. 88-93; Charles Jordan Tabb and Robert M. Lawless, *Of Commas, Gerunds, and Conjunctions: The Bankruptcy Jurisprudence of the Rehnquist Court*, 42 SYRACUSE L. REV. 823 (1991) (authors analyze Supreme Court bankruptcy decisions and conclude the Court has not developed a consistent bankruptcy jurisprudence). In any event, allowing the statutory interpretation methodology to determine the answer is unsatisfactory.

Professor Markell argues that the new value concept is not an exception to the absolute priority rule; rather, new value is part of the concept of absolute priority. Markell, *supra*, at 96. He argues that if the reasonably equivalent criterion is properly applied, requiring a distribution of the going concern value to the creditors, absolute priority is preserved. Markell, *supra*, at 97-98. *See infra* note 91 and accompanying text. *See also In re* Woodscape Ltd. Partnership, 134 B.R. 165, 173-74 (Bankr. D. Md. 1991) (holding that new contribution of money or money's worth in return for future participation does not violate the absolute priority rule).

tor's bargain and loss allocation, and their approaches to the new value issue. Section V will contrast the functional approach to the new value issue with the approaches of the creditor's bargain and loss allocation theories. This article then concludes in Section VI that the new value concept should be part of the Chapter 11 reorganization process because new value is an essential tool for the parties and judges. The parties need to use new value to negotiate consensual plans, and judges need to use new value to evaluate whether owner participation in the reorganization is desirable.

## II. REORGANIZATION, ABSOLUTE PRIORITY, AND NEW VALUE

Congress formulated the Chapter 11 reorganization process for financially distressed businesses[10] based upon two fundamental premises. The first premise is that reorganizing a business instead of liquidating its assets at a forced sale will often generate more value than the liquidation of the assets.[11] That extra value is called the going concern value. The second premise is that a successfully reorganized business, as opposed to a liquidated business, benefits the entire society through production of goods and services, employment, taxes and other contributions.[12] These two premises, however, will not necessarily hold true for every financially distressed business. One of the first questions in every attempted reorganization is whether the reorganization of this particular financially distressed business will generate any going concern value and offer any additional benefit to society. If the answer to that question is positive, then the next question is how to distribute the going concern value and management control among the creditors and the equity owners.

Instead of mandating the same answer to these two questions for every business reorganization, Congress created a bargaining framework for the owner and the creditors.[13] If the parties fail to reach an

10. Congress designed Chapter 11 primarily for business reorganization. *See* S. REP. NO. 989, 95th Cong., 2d Sess. 3, 9 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5789, 5795; H.R. REP. NO. 595, 95th Cong., 2d Sess. 6 (1978) *reprinted in* 1978 U.S.C.C.A.N. 5963, 5968. However, individuals not engaged in business may also seek relief under Chapter 11. *See* Toibb v. Radloff, 111 S. Ct. 2197 (1991).

11. *See* H.R. REP. NO. 595, *supra* note 10, at 220, *reprinted in* 1978 U.S.C.C.A.N. at 6179-80. This premise is used to support the creditor's bargain theory of reorganizations. *See infra* notes 51-54 and accompanying text.

12. *See* H.R. REP. NO. 595, *supra* note 10, at 220, *reprinted in* 1978 U.S.C.C.A.N. at 6179-80. This premise is used to support Professor Korobkin's view that reorganization is a process for deciding the debtor's future potential. *See supra* note 3.

13. *See, e.g.*, H.R. REP. NO. 595, *supra* note 10, at 224, *reprinted in* 1978 U.S.C.C.A.N. at 6183-84; Theodore Eisenberg, *Commentary on "On the Nature of Bankruptcy": Bankruptcy and Bargaining*, 75 VA. L. REV. 205, 205-11 (1989) (discussing provisions of the Code that either encourage or coerce parties to negotiate); Nimmer, *supra* note 8, at 1035-84; Rusch, *supra* note 4, at 196-200. *See also* J. Bradley Johnston, *The Bankruptcy Bargain*, 65 AM. BANKR. L.J. 213 (1991) (recommending improvements to the negotiation process which is at the heart of Chapter 11).

agreement, then congressional guidelines mandate whether the reorganization should take place and how to distribute the value and control of the going concern. These guidelines, contained in the cramdown provision of the Code,[14] permit confirmation over a dissenting class of creditors only if the reorganization plan satisfies several requirements. The cramdown requirements most relevant to the new value issue[15] are that (i) at least one class of creditors with impaired[16] claims accept the plan,[17] (ii) each dissenting creditor with an impaired claim receive at least the liquidation value of her claim,[18] (iii) liquidation or further financial reorganization of the debtor-enterprise be unlikely after confirmation unless provided for in the plan,[19] and (iv) the plan be fair and equitable as to each dissenting class of impaired claims.[20]

The Code contains only a partial codification[21] of the fair and equi-

14. 11 U.S.C. § 1129(b)(1) (1988). Section 1129(b)(1) requires that the proponent prove that the plan (i) meets all of the Section 1129(a) requirements except the requirement that all classes of impaired claims accept the plan; (ii) does not unfairly discriminate against impaired, dissenting classes of claims or interests; and (iii) is fair and equitable to all impaired, dissenting classes of claims or interests. *See* Rusch, *supra* note 4, at 168-75.

15. The requirements of Section 1129(a) that do not directly affect the new value issue are contained in § 1129(a)(1) (plan conforms to all Title 11 requirements), § 1129(a)(2) (plan proponent complies with Title 11 requirements), § 1129(a)(3) (plan proposed in good faith and is not illegal), § 1129(a)(4) (court approval for payment for services rendered in connection with the case), § 1129(a)(5) (disclosure of affiliations), § 1129(a)(6) (applicable regulatory approval), § 1129(a)(9) (provision for certain priority claims under § 507), § 1129(a)(12) (payment of fees), § 1129(a)(13) (provision for certain retirement benefits). 11 U.S.C. § 1129(a) (1988). The requirement in Section 1129(b)(1) that the plan cannot unfairly discriminate against impaired, dissenting classes of claims or interests is also not directly relevant to the new value issue. 11 U.S.C. § 1129(b)(1) (1988).

16. A claim is impaired when the proposed plan alters the debtor's contractual, legal or equitable obligations on the claim. 11 U.S.C. § 1124 (1988). The usual way in which a claim is impaired is if the claim is not paid in full. For a discussion of the impairment concept see 5 LAWRENCE P. KING, COLLIER ON BANKRUPTCY ¶ 1124.03 (15th ed. 1991) and Joseph M. Gaynor, Jr., Comment, *Impairment*, 3 BANKR. DEV. J. 579, 581 (1986).

17. 11 U.S.C. § 1129(a)(10) (1988). See Rusch, *supra* note 4, at 180-205, regarding the ability of the plan proponent to classify unsecured claims in order to create one accepting class of impaired claims for cramdown purposes.

18. 11 U.S.C. § 1129(a)(7) (1988).

19. 11 U.S.C. § 1129(a)(11) (1988). This feasibility test requires a judicial determination that the debtor can fulfill the plan requirements and that the plan has a realistic possibility of success. *See* Rusch, *supra* note 4, at 170-71 & n. 36.

20. 11 U.S.C. § 1129(b)(1) (1988).

21. The language of section 1129(b)(2) indicates the statutory definition is incomplete: "fair and equitable . . . includes the following requirements." 11 U.S.C. § 1129(b)(2) (1988). *See generally* Klee, *supra* note 9 (discussing the uncodified aspects of the fair and equitable rule).

table requirement,[22] which applies differently to secured and unsecured claims.[23] As to secured claims, the plan satisfies the fair and equitable requirement if the dissenting secured creditor retains her property lien and the plan provides for a stream of payments equal to the total amount of the secured claim with a present value equal to the value of the creditor's lien.[24] The absolute priority rule comes into play in a cramdown through the fair and equitable requirement that applies to unsecured claims. "Absolute priority" means that if a dissenting class[25] of unsecured claims is not paid in full, then no claimant junior to that dissenting class can receive or retain any property of the reorganized debtor on account of that junior claim or

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22. Section 1129(b)(2) provides, in pertinent part:

> For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements:
>
> (A) With respect to a class of secured claims, the plan provides—
>
> (i)(I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and
>
> (II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property;
>
> (ii) for the sale, subject to section 363(k) of this title, of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens on proceeds under clause (i) or (iii) of this subparagraph; or
>
> (iii) for the realization by such holders of the indubitable equivalent of such claims.
>
> (B) With respect to a class of unsecured claims—
>
> (i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or
>
> (ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property.

11 U.S.C. § 1129(b)(2) (1988).

23. The value of a secured claim is equal to the value of the collateral. 11 U.S.C. § 506(a) (1988); United Sav. Ass'n v. Timbers of Inwood Forest Assocs., 484 U.S. 365, 372 (1988) ("The phrase 'value of such creditor's interest in § 506(a)' means 'the value of the collateral.' "). *See* Rusch, *supra* note 4, at 166 & n. 14.

24. 11 U.S.C. § 1129(b)(2)(A) (1988). *See supra* note 22 for statutory text. The Code also provides two other means for satisfying the fair and equitable requirement for secured claims: sale of the property with the secured creditor's interest attaching to the proceeds or providing the indubitable equivalent of the secured claim. The method stated in the text is the most common method used in reorganization plans. *See also* Rusch, *supra* note 4, at 173 & n. 47.

25. A class of impaired claims accepts the plan when at least half of the voting creditors that hold at least two-thirds of the dollar amount of claims in that class vote in favor of the plan. 11 U.S.C. § 1126(c) (1988). A dissenting class is any class of impaired claims that does not meet this numerical threshold statutorily required to accept the plan.

interest.[26] The new value exception, recognized by courts prior to the revision of the 1978 Code, provides that if a junior claimant, usually the debtor's owner, contributes fresh capital, then she can retain or receive an interest in the reorganized business even though a class of senior unsecured dissenting claims has not been paid in full.[27] This contribution must consist of fresh money or money's worth, and be substantial, necessary, and reasonably equivalent to the interest in the reorganized debtor-enterprise that the junior claimant receives or retains.[28] In the 1988 case of *Norwest Bank Worthington v. Ahlers*,[29] the Supreme Court held that a sole proprietor's proposed labor contribution to a farm operation was not a sufficient contribution to meet the money or money's worth criterion of the new value exception.[30] The Court stated in a footnote that it was not deciding whether the new value exception survived enactment of the 1978 Code.[31]

The new value issue arises at a confirmation hearing when the owners of the debtor-enterprise have been unable to persuade all classes of creditors with impaired claims to accept the proposed plan.[32] Even though all classes with impaired claims did not accept the plan, before the owner can attempt a cramdown, at least one

26. 11 U.S.C. § 1129(b)(2)(B) (1988). *See supra* note 22 for statutory text. Courts developed the absolute priority rule to prevent bondholders and stockholders from using the equity receivership to sell the business to themselves while squeezing out intermediate unsecured creditors. *See* Northern Pac. Ry. Co. v. Boyd, 228 U.S. 482, 502-08 (1913). Subsequent statutory codifications required full satisfaction of creditors' claims in order of priority before distribution to equity holders. Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106, 115-19 (1939) (Bankruptcy Act of 1898, § 77B); Marine Harbor Properties, Inc. v. Manufacturer's Trust Co., 317 U.S. 78, 85-86 (1942) (Bankruptcy Act of 1898, Chapter X); Sharp, *supra* note 9, at 526-30 & n. 24. Those methods of reorganization applied the absolute priority rule even if all classes of creditors accepted the plan. 6A JAMES W. MOORE & LAWRENCE P. KING, COLLIER ON BANKRUPTCY ¶ 11.06, at 232-34 (14th ed. 1978).

27. *See, e.g.*, Peeples, *supra* note 8, at 75-77. The United States Supreme Court created the new value exception to the absolute priority rule in *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. at 121-22. However, in *Case*, the Court did not allow equity participation because the proposed contribution of "management expertise" was an insufficient contribution, incapable of valuation and, thus, not "money's worth." *Id.* at 122-23. *See* Sharp, *supra* note 9, at 534-36.

28. *See, e.g.*, Peeples, *supra* note 8, at 78-96; *In re* Creekside Landing, Ltd., 140 B.R. 713, 717-18 (Bankr. M.D. Tenn. 1992); *In re* 222 Liberty Associates, 108 B.R. 971, 983-84 (Bankr. E.D. Pa. 1990); *but see* Markell, *supra* note 9, at 95 & n. 166 (substantial is not a criterion mentioned in *Case*).

29. 485 U.S. 197 (1988).

30. *Id.* at 204-06.

31. *Id.* at 203 n.3.

32. *See supra* note 14 and accompanying text. Creditors with unimpaired claims are conclusively presumed to have accepted the plan. 11 U.S.C. § 1126(f) (Supp. 1988).

class of impaired claimants must have voted to accept the plan.[33] Thus, cramdown and the possibility of owner participation will not occur when all classes of creditors with impaired claims reject the plan.

Even if one class of impaired claims has accepted the plan, the owner still cannot cram down a plan on creditors unless each dissenting creditor receives at least the liquidation value of her claim,[34] unless each dissenting secured creditor retains her lien and receives the present value of its collateral,[35] and unless the plan is feasible.[36] These creditor protections balance the owner's ability to cram down a plan on dissenting creditors.[37] Thus, given the cramdown protections for the dissenting classes, when a class of creditors with unpaid, unsecured claims opposes the proposed new value contribution, the creditors and equity owners are using the absolute priority rule and new value exception as tools to fight over the distribution of the going concern value and the control of the reorganized business.[38]

## III. A Functional Approach to Bankruptcy Issues

A functional approach to legal issues acknowledges that law serves several functions in our society and evaluates legal issues with those functions in mind. Using this approach, legal issues should not be resolved in a way that would defeat the functions of a particular law. A functional analysis of a legal issue involves four major steps.

The first step is to identify the functions of the law. Most laws serve several functions at the same time.[39] Professor Steve Smith has identified at least three functions of law: (i) dispute resolution, (ii) coordination of human behavior, and (iii) shaping a better society.[40]

Each of these three functions is reflected to some degree in bankruptcy law.[41] For example, the Code structure provides a forum for the financially distressed business and all of its creditors to resolve

33. *See supra* notes 16-17 and accompanying text.

34. *See supra* note 18 and accompanying text.

35. *See supra* note 24 and accompanying text.

36. *See supra* note 19 and accompanying text.

37. *See* Rusch, *supra* note 4, at 196-98 (Code provisions balance the power between creditors and the owners).

38. *See infra* note 63 and accompanying text.

39. Steve Smith, *Reductionism in Legal Thought*, 91 COLUM. L. REV. 68, 69-74 (1991).

40. *Id.*

41. Professor Smith believes that focusing on one function of the law, to the exclusion of the other functions, results in a reductionist approach to legal thinking that is overly simplistic and that distorts understanding and practice. *Id.* at 77-81. "A reductionist depicture of law, regardless of which form the particular reductionism takes, will distort legal understanding by presenting one perspective as if it were the whole picture." *Id.* at 84. Professor Smith cites the law and economics movement as

their disputes.[42] By encouraging parties to negotiate reorganization plans, Chapter 11 creates an opportunity for the debtor's owners and creditors to coordinate their actions in reorganizing the company.[43] Finally, establishing reorganization as an alternative to liquidation under Chapter 7[44] indicates Congress' view that allowing reorganizations as an option is better for society than requiring all financially distressed businesses to liquidate.[45]

Although the bankruptcy reorganization concept reflects each of the three functions of law, the functional analysis requires further refinement. The functions described above are too general to be very useful in specific cases. For example, with regard to the third function, advancing a desirable social order, even though Congress generally considers business reorganization to be better for society than liquidation, Congress does not allow every business to reorganize under Chapter 11. Congress does not allow a Chapter 11 reorganization when each dissenting creditor with an impaired claim would receive less than the liquidation value of her claim.[46]

This example demonstrates that the social order function is limited by certain conditions. Generally, reorganization is better for society only when it gives each creditor with an impaired claim at least the liquidation value of the claim. In other words, reorganization is better for society, but only if the confirmation requirements,[47] which represent congressionally imposed conditions to reorganization, are met. The confirmation requirements represent value choices. The liquidation value requirement represents such a value choice based on the concept that the reorganization process should not inflict upon a dissenting creditor more harm than that already caused by the debtor's financial distress.[48] Each legal requirement or doctrine may implicate different societal values.

The second step of the functional approach, therefore, is to identify the societal values that are relevant to the legal doctrine at issue. Those values may be embodied in statutes, cases, legislative history

an example of a reductionist approach that emphasizes the third function of the law, creating a desirable social order, to the exclusion of the other two. *Id.* at 74.

42. *See* Korobkin, *supra* note 3.

43. *See supra* note 13 and accompanying text.

44. 11 U.S.C. §§ 701-766 (1988).

45. *See supra* notes 11-12 and accompanying text.

46. 11 U.S.C. § 1129(a)(7) (1988).

47. *See supra* notes 14-31 and accompanying text.

48. *See* Rusch, *supra* note 4, at 170.

or other non-legal sources. The values are then used to add further definition to the general functions of the law.

The third step is to determine whether any conflict between the functions, as defined, exists. If conflict exists, the functions must be examined to determine if the conflicts can be minimized. In the event the functions cannot be reconciled, then a decision must be made as to which function will be paramount.[49] Finally, the fourth step is to determine how the legal doctrine at issue can be structured to promote the paramount function and lead to the desired results in individual cases.

The new value issue has an impact on all three functions of bankruptcy law: dispute resolution, coordination, and defining a desirable social order. Functional analysis helps determine the impact that a particular resolution of the new value issue will have on the three functions of bankruptcy reorganization law. Functional analysis also helps to determine what societal values embodied in these functions are relevant to the new value issue. Finally, functional analysis provides a method for resolving conflicts between inconsistent functions and values. The societal values chosen to further define the social order function of reorganization law revolve around the two questions raised earlier: (i) should this particular business reorganize and, if so, (ii) how should the going concern value and control of the reorganized debtor be distributed?[50]

## IV. EXISTING THEORIES APPLIED TO THE NEW VALUE ISSUE

Before using the functional approach to evaluate the new value issue, it is helpful to identify the functions and values that current reorganization theories promote. The two dominant theories of bankruptcy reorganization are the creditor's bargain theory and the loss allocation theory. Each theory focuses on different functions. The creditor's bargain school emphasizes the social order function, whereas the loss allocation school emphasizes the dispute resolution and coordination functions.

### *A. Creditor's Bargain*

The premise of the creditor's bargain theory is that the reorganization of a financially distressed enterprise should result in a going concern value greater than the value realized in piecemeal sales of assets through state law collection remedies. The reorganization process then preserves this going concern value for the benefit of all creditors. In exchange for not being allowed to dismantle the debtor-en-

49. *See* Smith, *supra* note 39, at 86-109.
50. *See supra* notes 12-13 and accompanying text.

terprise, the creditors are entitled to control the creation and distribution of the going concern value.[51] Thus, the paramount societal values promoted in the creditor's bargain theory are enhanced collective creditor recovery and creditor control of the reorganization process. These values represent the desirable social order under the creditor's bargain theory.

The twin values of greater recovery for creditors as a whole and creditor-controlled reorganization are also part of the creditor's bargain approach to the new value exception.[52] Two proponents of the creditor's bargain theory, Professors Baird and Jackson, have proposed valuing the debtor-enterprise on a going concern basis. Using that going concern valuation, the claims against the debtor would be ordered into the appropriate hierarchy of priority.[53] The going concern value would then be allocated to each class of claims in order of priority. The class of claims that remains unpaid after that allocation would be the residual owner of the debtor-enterprise. That residual owner would decide whether the previous owner of the bankrupt debtor could participate in the reorganization and would dictate the terms of any such participation. The previous owner would not be allowed to participate over the objection of the residual owner. The residual owner's decision to allow or to disallow owner participation

51. *See, e.g.*, THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW (1986); Douglas G. Baird, *The Uneasy Case for Corporate Reorganization*, 15 J. LEGAL STUD. 127 (1986); Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditor's Bargain*, 75 VA. L. REV. 155 (1989); Thomas H. Jackson, *Of Liquidation, Continuation, and Delay: An Analysis of Bankruptcy Policy and Non-Bankruptcy Rules*, 60 AM. BANKR. L.J. 399 (1986); Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857 (1982).

52. Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738 (1988); Douglas G. Baird & Randal C. Picker, *A Simple Noncooperative Bargaining Model of Corporate Reorganizations*, 20 J. LEGAL STUDIES 311, 325-28, 344-47 (1991); David A. Skeel, *The Uncertain State of an Unstated Rule: Bankruptcy's Contribution Rule Doctrine After Ahlers*, 63 AM. BANKR. L.J. 221, 236-39 (1989); James J. White, *Absolute Priority and New Value*, 8 COOLEY L. REV. 1, 20-31 (1991); Derek J. Meyer, Note, *Redefining the New Value Exception to the Absolute Priority Rule in Light of the Creditor's Bargain Model*, 24 IND. L. REV. 417 (1991).

53. The creditor's bargain theorists maintain that this distribution among the ranks of creditors should respect state law entitlements. *See, e.g.*, Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97 (1984); Thomas H. Jackson, *Translating Assets and Liabilities to the Bankruptcy Forum*, 14 J. LEGAL STUD. 73 (1985); Lawrence Ponoroff & F. Stephen Knippenberg, *The Implied Good Faith Filing Requirement: Sentinel of an Evolving Bankruptcy Policy*, 85 NW. U. L. REV. 919, 955 (1991).

is presumed to be the best decision to enhance collective creditor recovery.[54]

The creditor's bargain theorists would allocate to the residual owner all decision-making authority to determine whether the business reorganization should take place, who should control the reorganized debtor, and how the going concern value of the reorganized debtor should be distributed. The creditor's bargain theory leads to the conclusion that a new value exception would undermine the values of creditor control and enhanced collective creditor recovery because the new value exception would remove absolute control from the residual owner.

### B. *Loss Allocation*

Loss allocation theorists view bankruptcy as a process that Congress created to allocate losses among all interested parties when a debtor encounters financial distress.[55] The allocation of these losses is necessarily based upon a balancing of competing values.[56] Congress reconciles these conflicting values in whatever way Congress sees fit, subject only to constitutional limitations.[57]

Reorganization, as opposed to liquidation, is just one process that allows the creditors and the owner to negotiate the allocation of the greater going concern value.[58] The loss allocation theorists consider the new value exception as a source of leverage that the business owner can use to force recalcitrant creditors to the bargaining table.[59]

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54. Baird & Jackson, *supra* note 52.

55. Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 789-93 (1987); Nimmer, *supra* note 8, at 1013-34.

56. Warren, *supra* note 55, at 789-93; *see* Ponoroff & Knippenberg, *supra* note 53, at 959-62. *But see* Richard E. Flint, *Bankruptcy Policy: Toward a Moral Justification for Financial Rehabilitation of the Consumer Debtor*, 48 WASH. & LEE L. REV. 515 (1991) (advancing a natural law moral justification for discharging consumer debtors). Other scholars have made the connection between principles of bankruptcy and principles of morality and value conflict. *See, e.g.*, Philip Shuchman, *An Attempt at a "Philosophy of Bankruptcy,"* 21 UCLA L. REV. 403 (1973) (describing bankruptcy as a reflection of cultural values regarding obligations); Robert Weisberg, *Commercial Morality, the Merchant Character, and the History of the Voidable Preference*, 39 STAN. L. REV. 3 (1986). *See generally* Paul G. Haskell, *Teaching Moral Analysis in Law School*, 66 NOTRE DAME L. REV. 1025, 1029 (1991) (law has moral content). In addition, individual moral convictions have an impact on how people utilize existing laws. *See* TERESA A. SULLIVAN, ELIZABETH WARREN & JAY L. WESTBROOK, AS WE FORGIVE OUR DEBTORS 336-38 (1989) (moral convictions influence the decisions of consumer debtors in bankruptcy).

57. For a discussion of the limitations on Congress' bankruptcy power, U.S. CONST. art. I, § 8, cl. 4, see James Steven Rogers, *The Impairment of Secured Creditors' Rights in Reorganization: A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Clause*, 96 HARV. L. REV. 973 (1983).

58. *See* Korobkin, *supra* note 3.

59. *See* Elizabeth Warren, *Absolute Priority, New Value and Theories of Bankruptcy*, 11-25, 11-33 (Bankruptcy Update 1990, 64th Annual Meeting of the National Conference of Bankruptcy Judges, Nov. 7-10 1990) [hereinafter Warren, Bankruptcy

In addition, the new value exception is a tool that allows the bankruptcy judge to decide whether to permit reorganization and how to distribute the value and control of this reorganized debtor-enterprise.[60] However, the loss allocation theorists have not specified the societal values that should guide the judge's evaluation of these two essential questions.[61] Under the loss allocation theory, the primary functions of reorganization are the coordination of the parties' behavior and the resolution of disputes. Because the new value exception aids these functions, it should be a part of the Chapter 11 reorganization process.

### *C. Comparison*

The creditor's bargain and loss allocation theories each promote different functions and values. The creditor's bargain school promotes the social order function of reorganization law, with creditor control and enhanced collective creditor recovery as the primary societal values. The creditor's bargain theory ignores the dispute resolution and coordination functions. Loss allocation, however, promotes both coordination and dispute resolution through negotiation. But if coordination fails, the loss allocation method offers no guidance as to the values to be promoted as part of the desirable social order in deciding whether the particular reorganization should take place or how the going concern value and control should be distributed between the debtor's owners and the creditors.

## V. APPLYING THE FUNCTIONAL APPROACH TO THE NEW VALUE ISSUE

This section examines the new value issue using the functional approach, identifies the major societal values that the new value issue implicates, and compares the functional approach with the creditor's bargain and loss allocation theories.

The absolute priority rule and the new value exception directly relate to all three functions: dispute resolution, coordination, and promotion of the desired social order for owner participation over creditor dissent. In reorganization law, a strong connection exists be-

Update]; Elizabeth Warren, *A Theory of Absolute Priority*, 1991 Ann. Surv. of Am. Law 9, 29-33 [hereinafter Warren, Absolute Priority]; *but see* LoPucki & Whitford, *supra*, note 8, at 143-64.

60. *See* Warren, Bankruptcy Update, *supra* note 59, at 11-32 (new value exception allows judge to evaluate fairness of the plan).

61. *See infra* note 84 and accompanying text.

tween the coordination and dispute resolution functions because the more the creditors and the owner of the debtor-enterprise negotiate, the more likely the parties will reach a global settlement as part of the plan. Thus, to the extent a reorganization doctrine encourages coordination, it is also likely to encourage dispute resolution through negotiation. Because of the close connection between the coordination and dispute resolution functions, this article will refer to both as the coordination function.

Coordination between creditors and the owner of the debtor-enterprise ideally results in a consensual reorganization plan. To encourage coordination, the Code gives both sides a set of bargaining tools.[62] The absolute priority rule and the new value exception are two of the tools that the creditors and the debtor's owner use to bargain about the two practical questions[63] present in every reorganization: should this business reorganize and how should its going concern value and control be distributed between its owner and creditors?

The absolute priority rule and the new value exception are also relevant to the social order function of bankruptcy law. When the coordination function fails to produce a consensual reorganization plan, the absolute priority rule and the new value exception provide default rules for distributing the going concern value and control of the reorganized business between creditors and the owner. These default rules, which involve value choices, represent the desired social order when coordination fails.

Congressional emphasis on negotiated consensual plans[64] makes the coordination function paramount. Only if coordination fails does

62. *See* Rusch, *supra* note 4, at 196-200. *See supra* notes 13-38 and accompanying text.

63. A consideration of the parties' motivations illustrates their respective bargaining positions. The owner wants to make the new value contribution and continue to participate in the business as the owner because otherwise the business will liquidate and cease to exist. The unsecured creditors resist the cash contribution and the planned cramdown because they would rather take the liquidation value of their claims now than receive payments over time under the plan, even if the present value of the payments is the same as the liquidation value. This is the essence of the parties' dispute over whether to liquidate or reorganize this particular business.

In the struggle for control of the business, the owner wants to participate in the reorganization effort as the owner, rather than as an employee, while the unsecured creditors want someone else to own and operate the reorganized business. In the fight over distribution of value, the owner wants to reap the future profits of the business if the reorganization effort is successful while the unsecured creditors want to receive a larger percentage of money than proposed in the plan. If the new value exception does not exist, the view of the unsecured creditors as to the "correct" resolution of control and distribution will always prevail. If the new value exception does exist and the plan is confirmed, the owner's view of the "correct" resolution of those questions will prevail. *See infra* notes 65-76 and accompanying text.

64. *See supra* note 13 and accompanying text.

the social order function become relevant. Thus, the new value exception's impact on the coordination function will be explored first.

*A. New Value and the Coordination Function*

To determine whether the new value exception is a critical tool for the coordination function, the first question is whether the new value exception is a necessary tool to arrive at consensual plans. To promote the parties' coordination so that they can arrive at a consensual plan, each side needs bargaining tools to strengthen its position.[65] For a non-publicly held business where the owner participates in management, if the new value exception does not exist, the absolute priority rule gives the dissenting class with unsecured claims a means to stop any attempt to reorganize the business. Therefore, to determine whether the new value exception is a necessary tool for the coordination function, the next question is whether the owner needs the new value exception in order to bring creditors to the bargaining table.

If the dissenting class with unsecured claims is also the residual owner of the financially distressed business, the creditor's bargain theorists believe that that class should have the absolute authority to stop the reorganization.[66] The assumption is that the residual owner will oppose the prior owner's participation in the reorganized business when that decision maximizes the wealth for all creditors. Because the creditor's bargain theorists consider the residual owner's decision the "best" decision for all creditors, these theorists reason that the former owner needs no leverage to force the residual owner to bargain. If reorganization with the prior owner's participation is wealth-maximizing, the residual owner will bargain with that owner. If such reorganization is not wealth-maximizing, the residual owner will not bargain.

The premise that the residual owner will support owner participation if it maximizes the wealth for all creditors[67] rests on two under-

65. *See supra* notes 13-38, 62 and accompanying text.

66. The residual owners may or may not be the dissenting class of unsecured claims. *See supra* notes 53-54 and accompanying text. For instance, Professors Baird and Jackson posit the situation where the residual owner is the senior undersecured creditor. *See* Baird & Jackson, *supra* note 52, at 750-51. When this occurs, they recommend eliminating the absolute priority rule, which gives final authority to the class of unsecured creditors, and giving that final authority to the senior undersecured creditor.

67. *See infra* notes 80-82 and accompanying text for a discussion of whether monetary wealth maximization is a desirable social order.

lying assumptions. First, the residual owner will act rationally, balancing monetary costs against monetary benefits and choosing the option resulting in the greatest monetary wealth. Second, the choice that maximizes the wealth of the residual owner also maximizes the wealth of all other creditors.

Each of these assumptions is faulty, thus casting doubt on the view, under the creditor's bargain theory, that the owner of the debtor-enterprise does not need the leverage of the new value exception. The first assumption, that the residual owner will make the optimal monetary wealth-maximizing decision, is flawed because the residual owner's decision will not necessarily be based only on monetary values.[68] The residual owner may value the ability to walk away with the liquidation value of her claim, even if reorganization would result in her receiving a larger recovery. If this is the case, a non-pecuniary value, the freedom to walk away, trumps the pecuniary value, the greater recovery. Non-monetary factors often influence decision making.[69] Any time the residual owner makes a decision based upon non-pecuniary factors, that decision will not necessarily maximize monetary wealth.

Second, even if the residual owner decides to maximize her own monetary wealth, that decision will not necessarily maximize the wealth for all other creditors. The residual owner may choose to liquidate the business, rather than reorganize, because of factors external to the reorganization effort, such as that creditor's overall profit and loss picture. If the residual owner is a major lender and is trying to set an example for other borrowers, the residual owner might liquidate one or two debtors, thereby taking a lower repayment in these cases, in order to encourage greater repayment from other borrowers. The residual owner's decision to liquidate the debtor-enterprise will not necessarily maximize the monetary wealth for other creditors, for whom reorganization may represent the only hope of any significant debt repayment. Thus, the premise that the best result for the residual owner is the best result for all the debtor's creditors is not necessarily true.

Because the assumptions underlying the premise that the residual owner will make the optimal wealth-maximizing decision are false, the further premise that the owner does not need the new value ex-

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68. *See, e.g.,* RICHARD A. POSNER, THE PROBLEMS OF JURISPRUDENCE 365-66 (1991); James W. Bowers, *Groping and Coping in the Shadow of Murphy's Law: Bankruptcy Theory and the Elementary Economics of Failure,* 88 MICH. L. REV. 2097, 2143-44 (1990).

69. It is not hard to imagine a creditor belonging to the "once burned, twice shy" school of decision-making. *See* POSNER, *supra* note 68, at 365-66 (people take into account non-monetary values in deciding upon a course of action).

ception as leverage to encourage the creditors to make the wealth-maximizing decision is also false.

The new value exception encourages unsecured creditors to bargain with the owner for a consensual plan because a plan can be confirmed even if an unsecured claims class dissents. The loss allocation theorists endorse the new value exception as a tool to encourage such bargaining.[70] However, in order to fulfill the coordination function of bankruptcy law, the new value exception must not allow the owner of the debtor-enterprise to avoid the bargaining process that leads to consensual plans. The creditor's bargain theorists argue that the new value exception does give the owner the ability to opt out of the bargaining process.[71] This view is premised on the assumption that bankruptcy judges uncritically endorse any and every proposed owner contribution. This perspective of bankruptcy judges is based on a perception of either on pro-debtor judicial bias[72] or judicial incompetence,[73] both of which are unfounded.

The fear of pro-debtor bias is supported at best by anecdotal evidence and at worst by mere presumption. No proof is available that bankruptcy judges, as a whole, neglect their responsibility to make legally correct and fair decisions.[74] In addition, no one has demonstrated that bankruptcy judges do not possess the necessary skill and expertise to determine whether owner participation in the reorganization is desirable.[75] Believing that markets are the best place to de-

70. *See supra* note 59 and accompanying text. At least one court has explicitly recognized this effect on the parties' bargaining. *See In re* Triple R Holdings, L.P., 134 B.R. 382, 386-89 (Bankr. N.D. Cal. 1991), *rev'd.*, 1992 WL 237328 (N.D. Cal. Sept. 15, 1992).

71. Baird & Picker, *supra* note 52, at 328 (new value exception provides an option for the owners of the debtor-enterprise to abandon the bargaining process).

72. James J. White, *Taking from Farm Lenders and Farm Debtors: Chapter 12 of the Bankruptcy Code*, 13 J. CORP. L. 1, 15-16 (1987).

73. Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527, 547-48 (1983).

74. Patrick B. Bauer, *Where You Stand Depends on Where You Sit: A Response to Professor White's Sortie Against Chapter 12*, 13 J. CORP. L. 33, 39-40 & n. 42 (1987).

75. *See In re* Triple R Holdings, L.P., 134 B.R. 382, 391-92 (Bankr. N.D. Cal. 1991), *rev'd*, 1992 WL 237328 (N.D. Cal. Sept. 15, 1992) (no evidence that judges are out of control on this issue). The decisions that judges would have to make if the new value exception exists are no more complex or difficult than the decisions that judges and juries make every day in complex commercial litigation cases that require valuation of harm. Furthermore, instead of unskilled jurors making these decisions, experienced bankruptcy judges, who see the same issues and hear the same types of evidence repeatedly, would evaluate the proposed new value contribution. Repetition gives the bankruptcy judge increased competence in evaluating the credibility of expert testimony on enterprise value and plan feasibility. Moreover, the critical issues in a cramdown are tried in an adversarial manner, with both sides having the opportunity

termine value, the creditor's bargain theorists criticize placing valuation questions in the hands of people not parties to the negotiation, even a judge. Thus, their objection to judges making the valuations that application of the new value exception would require is not based upon particular instances or even a pattern of erroneous valuations, but upon a system-wide belief that judges should not make these decisions because judicial valuations are not market-based. However, the creditor's bargain theorists ignore the fact that in a cramdown situation, the market (negotiation) has failed. When market failure occurs, the legal system has commonly allowed third parties to value the rights at issue.[76]

As demonstrated above, some type of new value concept that would allow existing owners to buy their way back into a business over the dissent of unpaid, unsecured creditors, is a necessary tool to provide each of the parties with enough leverage to negotiate toward a consensual plan. Elimination of the new value concept would give absolute power to the dissenting class of unsecured creditors to liquidate the business. Uncritical approval of any proposed contribution would give the owner absolute power to run roughshod over the dissenting creditors. However, neither the creditors nor the owners have absolute power if a neutral third party, such as a bankruptcy judge, critically evaluates the proposed contribution to ensure that it meets the accepted standards. Thus, a new value concept is needed to balance the rule of absolute priority and to promote the coordination function of Chapter 11 reorganization law.

### *B. New Value and the Social Order Function*

To evaluate a proposed owner contribution, judges need criteria. Developing these criteria requires a definition of the desired social order, which, in turn, requires lawmakers to choose among competing societal values.[77] These values define the appropriate circumstances for owner participation in spite of creditor dissent. The ultimate goal is to determine when owner participation in the reorganization will result in a positive contribution to society. Resolution of the new value issue from the social order function perspective, however, should not undermine the paramount coordination function

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to present evidence and cross-examine the opponent's experts. Doubts about the ability of bankruptcy judges to make "correct" decisions after they hear the evidence are really doubts about the adversary process itself.

76. *See, e.g.,* Guido Calabresi and A. Douglas Melamad, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral,* 85 HARV. L. REV. 1089, 1106-10 (1972).

77. *See* POSNER, *supra* note 68, at 119, 141, 233-43; Smith, *supra* note 39, at 73-75. *See generally* John B. Attanasio, *Foreword: The Impoverished States of Law and Morality,* 64 NOTRE DAME L. REV. 773 (1989).

of reorganization law that encourages the creditors and owners to negotiate a consensual plan.

Both the creditor's bargain theory and the loss allocation theory have deficiencies when evaluated in light of the social order function of Chapter 11 reorganization law. The creditor's bargain theory is deficient due to the unsupported value choices present in its definition of the desirable social order for owner participation. The deficiency in the loss allocation theory is its failure to provide a method for making value choices in the event the coordination function fails.

The creditor's bargain theorists promote creditor control of the reorganization process and enhanced collective creditor recovery as the primary values in determining the desirability of owner participation.[78] However, the creditor's bargain theorists have not justified why promotion of these two values will improve society. Even if creditor control and enhanced recovery lead to an efficient result according to economic theory,[79] nothing in economic theory supports the proposition that efficiency is the desirable social order.[80] The creditor's bargain theorists fail to recognize that with their theory, as with any theory, any definition of a desirable social order involves a choice among competing societal values. Values other than economic efficiency or wealth maximization could be equally important, or even more important, to society.[81] For instance, society could legitimately promote the value of debtor rehabilitation over the value of creditor wealth maximization.[82]

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78. *See supra* notes 51-54 and accompanying text.

79. As previously discussed, the assumption that these two values produce a wealth-maximizing, economically efficient result is doubtful. *See supra* notes 67-69 and accompanying text.

80. *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF THE LAW § 1.2, at 13 (3rd ed. 1986) (economic theory may indicate what is efficient, i.e., wealth-maximizing, but nothing in economic theory tells us that efficiency will make society a better place); Robin Paul Malloy, *Is Law and Economics Moral?—Humanistic Economics and a Classical Liberal Critique of Posner's Economic Analysis*, 24 VAL. U. L. REV. 147, 154-57, 160 (1990) (although Posner's economic analysis promotes certain values, nothing in economic theory justifies those values as most important). In his new book, Judge Posner states that wealth maximization should be redefined to include non-monetary values in the maximization equation. POSNER, *supra* note 68, at 356. If that is true, then wealth maximization is simply another term for value balancing.

81. David Gray Carlson, *Philosophy in Bankruptcy*, 85 MICH. L. REV. 1341, 1353 (1987) (reviewing THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW (1986)); Warren, *supra* note 55, at 789-93; *see* Flint, *supra* note 56, at 524 (all normative theory involves value choices); Donald R. Korobkin, Value and Rationality in Bankruptcy Decisionmaking, 33 WM. & MARY L. REV. 333, 337-44 (1992).

82. *See* Flint, *supra* note 56, at 523-26 (discussing debtor rehabilitation in the consumer context). Some scholars, speaking from an economic perspective, question

The loss allocation theorists, on the other hand, recognize that in creating bankruptcy law, Congress has chosen among competing values,[83] but they do not identify the paramount values that should be advanced when an owner participates in reorganization.[84] The loss allocation view relies entirely upon Congress to make the choices and balance the competing values. If Congress' intent is not clear on how

whether bankruptcy law is justified because it changes the debtor and creditor rules embodied in state law. *See, e.g.*, Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815, 822-23 (1987). There are several reasons this change is justified. First, different people, with different views of the ultimate goal, are deciding what values are paramount. The values that are important to a particular legislature will be reflected in that state's laws. However, nothing is sacred about state law that makes those value choices the ultimate right answer. *See* Carlson, *supra* note 81, at 1348. Second, even if state laws are "correct" value choices on a state level, it is equally legitimate for federal lawmakers to decide that different value choices should operate on a federal level. *See generally* Theodore Eisenberg, *Bankruptcy Law in Perspective*, 28 UCLA L. REV. 953 (1981) (criticizing bankruptcy law changes from state law); Steven L. Harris, *A Reply to Theodore Eisenberg's Bankruptcy Law in Perspective*, 30 UCLA L. REV. 327 (1982) (arguing that bankruptcy is one method of balancing competing interests of creditors and debtors). Third, forum shopping, a problem of two systems operating simultaneously, Baird, *supra*, at 824-25, presupposes that one system offers a superior set of choices. That is, those that argue against changes from the state law system, are presupposing that the state law system is superior to the federal bankruptcy system. The opposite conclusion—that the federal bankruptcy system is the superior system and no creditor should ever be allowed to use the state law system—could just as easily be drawn. *See* Lynn M. LoPucki, *A General Theory of the Dynamics of the State Remedies/Bankruptcy System*, 1982 WIS. L. REV. 311, 315-62 (1982). Neither the state system nor the bankruptcy system is inherently superior. Reasonable people could disagree about what value choices are appropriate.

83. *See supra* notes 55-57 and accompanying text. *See also* Korobkin, *supra* note 81, at 353-65 (Congress chose among competing values regarding the rights of parties in bankruptcy to collective bargaining contracts).

84. According to Professor Elizabeth Warren, new value provides a mechanism for evaluating whether the parties' use of bargaining leverage is legitimate or illegitimate. Warren, Bankruptcy Update, *supra* note 59, at 11-33 to 11-34. She classifies as illegitimate, leverage based upon noise-making, leverage used because the party is insulated from the consequences of its actions, or leverage based upon informational deficits. *Id.* at 11-34. This approach has at least two problems. First, judges may not be able to determine whether the parties' use of leverage is legitimate or not. Second, even if the judge can make that determination, this analysis provides no basis for deciding between two legitimate uses of leverage, such as a creditor's desire to receive bigger payments and the owner's desire to rehabilitate the business.

Professor Warren has recently proposed that owner participation should be allowed whenever that option creates the greatest amount of value to the estate. Warren, *Absolute Priority*, *supra* note 59, at 19-28. This premise has at least two drawbacks. First, Warren ignores other criteria, such as the desire to rehabilitate a business, that would be important in determining whether owner participation should be allowed. Harvey R. Miller, *Commentary on Professor Warren's Paper: Absolute Priority*, 1991 Ann. Surv. of Am. Law, at 49-51, 67-68. Second, Warren's theory does not address the critical issues of control and distribution of that enhanced estate value. Even if owner participation enhances value, that value will either be distributed to creditors, retained in the company, or distributed to the owners. Warren's theory does not address what group should receive the benefit of that enhanced value. Alan R. Resnick, *Commentary on Professor Warren's Paper: Absolute Priority*, 1991 Ann. Surv. of Am. Law, at 59-60.

to balance the values implicated by a particular legal issue, this theory leaves decision-makers without guidance.

In deciding whether a particular business should reorganize and how its control and value should be distributed in the absence of a consensual plan, at least two values are important in defining the desirable social order: (i) the desire to pay existing creditors as much as possible and (ii) the desire to place the risk of business failure on the owner, not the creditors. These two competing values help determine when owner participation is preferred in spite of creditor dissent. However, these values cannot be reconciled with a general rule for determining, in all cases, whether an owner should participate as an owner in the reorganized business. The new value exception is a tool the court could use for reconciling these two values in particular cases. Thus, the criteria of the new value exception should be applied in each case in such a way as to reconcile the competing values of the greatest possible repayment to creditors and owner assumption of the risk of business failure.

The current new value criteria are that the proposed contribution consist of the following: (i) Fresh (ii) money or money's worth that is (iii) substantial, (iv) necessary, and (v) reasonably equivalent to the interest in the reorganized debtor that the owner of the debtor-enterprise receives or retains.[85] The first four criteria can be used to allocate the risk of business failure to the owner. The fifth criterion can be used to maximize repayment to existing creditors.

In every business reorganization, the risk of failure is twofold. First, there is the risk of the initial failure that resulted in using the reorganization process. Second, there is the risk that the business will fail after the reorganization process. By the time the owner invokes the Chapter 11 process, the first business failure is occurring or has occurred. The business has failed for the second time if the reorganization plan is confirmed but the debtor-enterprise is unable to complete the plan, or the business fails after the plan is completed.[86] The first four criteria of the new value rule can be used to keep the risks of both business failures on the owner.

The criterion that the contribution be money or money's worth helps keep both risks of failure on the owner. When the owner oper-

85. *See supra* notes 27-30 and accompanying text.

86. The feasibility requirement contained in the confirmation standards is designed to guard against the second risk of failure. *See supra* note 19 and accompanying text. However, if the reorganization plan is unsuccessful, the owners of the reorganized debtor-enterprise should bear the risk of that second failure.

ates and/or manages the business, the owner is already contributing labor and expertise when the business failed the first time. Thus, if an owner's future labor contribution were sufficient to allow her continued ownership in the business, the creditors, not the owner, would have borne the first risk of failure. Similarly, promising to contribute labor does not cause the owner to incur any additional risk that would warrant giving her a second chance to make the business successful. Requiring the contribution of "hard assets," however, does place the second risk of failure on the owner.[87]

The next two criteria, that the contribution be fresh and substantial, also place the risk of both failures on the owner. A "fresh" contribution means that the contribution cannot come from the assets of the failed business. A "substantial" contribution means that the loss of the funds, if the business fails for the second time, will hurt the owner. Both of these requirements force the owner to bear the risk of the first failure because the owner must put more assets at risk in order to have a second chance. Moreover, these two criteria force the owner to risk losing these assets in the event the business fails a second time.

The criterion that the contribution be necessary places the risk of the first failure on the owner and lessens the risk of the second failure occurring at all. Currently, the necessity criterion means that the contribution is necessary to fund the plan.[88] This inquiry is misdirected because the owner will always write the plan so that the contribution is necessary to fund the plan.[89] The inquiry should be: Is it necessary that *this* owner contribute the funds? By requiring some explanation for why the business failed in the first place, this inquiry holds the owner responsible for the first failure and also reduces the likelihood of a second failure.

For example, if the business failed because of mismanagement, the owner should have to surmount a relatively high showing of necessity in order to buy her way back into the ownership position. In addition, if the creditors claim that the owner's contribution is not necessary, the creditors should have the opportunity to select someone who is able to make the contribution and to operate the business competently.[90] Thus, the thrust of the necessity requirement should

87. One author has argued for a best efforts standard to judge labor contributions in Chapter 11. Peeples, *supra* note 8, at 103-07. That is the standard used in Chapter 12 and 13 reorganizations. *See supra* note 8. In evaluating the desirability of a best efforts standard, the issue is whether that standard would allow the owner of the debtor-enterprise to escape the risks of business failure in a manner compatible with societal values.

88. Peeples, *supra* note 8, at 80-83.

89. *But see* Markell, *supra* note 9, at 112-13 (the "necessary" criterion is not necessary).

90. Some authors have suggested a bidding process to accomplish this goal. *See*

be an inquiry into alternative funding and a decision whether the current owner is the best possible candidate to reorganize and operate the business successfully. If the owner is allowed to buy back the ownership position without the court making the above inquiry, the owner has avoided bearing the risk of the first failure altogether, as well as increased the risk of the second failure.

The final criterion is that the contribution be reasonably equivalent to the interest the owner will receive or retain in the reorganized business. This requirement should be used to maximize repayment of creditors by preventing the owner from capturing any of the going concern value that is not directly attributable to her participation in the business.[91] The parties should submit estimates of the business' going concern value without the owner's participation. That amount must be distributed to existing creditors, not retained in the company. Any part of the going concern value that is attributable to the owner's participation need not be distributed to creditors. This division of the going concern value between the owner and the creditors is an accommodation of two fundamental beliefs: insolvent companies should belong to existing creditors[92] and creditors are not entitled to the continued participation of the owner.[93] Thus, creditors are repaid the maximum amount possible given the societal value that prohibits the owner's involuntary servitude.

Bankruptcy judges should use the new value criteria to make the inquiries described above. The new value rule would then be an effective tool to accommodate the conflict between the two major values that define the circumstances in which owner participation should occur over the dissent of unpaid creditors. If the owner's pro-

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Richard L. Epling, *The New Value Exception: Is There a Practical, Workable Solution?*, 8 BANKR. DEV. J. 335, 340-47 (1991) (noting that a market process is probably unworkable in the closely held business context); Klee, *supra* note 9, at 243-44; *In re* Bjolmes Realty Trust, 134 B.R. 1000, 1008-10 (Bankr. D. Mass. 1991). One difficulty with the bidding process is the informational deficit that non-owners have in determining what to bid for a company. Warren, *Absolute Priority*, *supra* note 59, at 15-18.

91. *See In re* Jartran, 44 B.R. 339, 368 (Bankr. N.D. Ill. 1984); Markell, *supra* note 9, at 97-98. According to Professor Markell, the principle of absolute priority is respected as long as the going concern value is distributed to creditors. *See also* Walter J. Blum & Stanley A. Kaplan, *The Absolute Priority Doctrine in Corporate Reorganizations*, 41 U. CHI. L. REV. 651, 668-71 (1974); *In re* Bjolmes Realty Trust, 134 B.R. 1000, 1011 (Bankr. D. Mass. 1991) (recognizing that shareholders should be able to capture the difference in value based upon their contribution to the business).

92. The judicial development of the absolute priority rule reflects this idea. *See supra* note 26 and accompanying text.

93. *See* S. REP. NO. 989, *supra* note 10, at 32, *reprinted in* 1978 U.S.C.C.A.N. at 5818; H.R. REP. NO. 595, *supra* note 10, at 322, *reprinted in* 1978 U.S.C.C.A.N. at 6278.

posed contribution were evaluated using the concepts described above, the new value exception would allow all interested parties an opportunity to determine whether the past owner's skill and expertise are most likely to make the reorganization successful and whether the creditors are receiving all of the value to which they are entitled.

## VI. Conclusion

Bankruptcy issues should be evaluated according to their impact on the functions of bankruptcy law and based upon explicit identification and reconciliation of conflicting societal values. The approach advocated herein is merely a starting point for examining bankruptcy issues. A balance between the competing values could be struck in different ways.[94] Where to strike the balance is not nearly as important as recognizing the connection between doctrines and values. Reasonable people can disagree about what values should be emphasized and where the line between competing values should be drawn. However, to ignore or deny that doctrinal debates involve value-laden choices is to offer seemingly simplistic solutions to complex problems that are not really solutions at all.

Based upon the functional value-balancing approach described herein, the new value exception to the absolute priority rule should exist. The application of the exception should allow reorganization with owner participation over the objection of unpaid, unsecured creditors as long as (i) the risks of business failure rest squarely with the owner, (ii) the maximum reorganization value is distributed to creditors, and (iii) the contributing owner's continued operation of the business is the best option available for all of the creditors.

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94. For example, the ability of owners to participate in reorganizations and the conditions upon that participation are different in Chapter 12 and 13 reorganizations. *See supra* note 8. The Chapter 12 and Chapter 13 criteria reflect a different accommodation of the same two conflicting values discussed in this article.