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Clifford S. Harris
University of Michigan Law School

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NOTE

A Rule Unvanquished: The New Value Exception to the Absolute Priority Rule

The Bankruptcy Code¹ provides corporations with stability in times of crisis. The Code's framers associated liquidation with economic inefficiency and thus drafted the federal bankruptcy rules to encourage reorganization.² The Code is premised on the belief that unfettered negotiations between a debtor and its creditors will result in the most efficient reorganizations; thus, it provides a mechanism through which interested parties can reach a mutually beneficial solution to a company's insolvency.³ Historically, however, collusion between management and secured creditors corrupted bankruptcy negotiations.⁴ To counter this practice, the Code guarantees the representation of all interests involved in a corporate reorganization.⁵ The Code creates a process of bargaining⁶ for the assets of the collapsed business enterprise that balances the competing interests of creditors and equity holders.

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1. 11 U.S.C. §§ 101-1330 (1988).

2. The premise of a business reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap. . . . If the business can extend or reduce its debts, it often can be returned to a viable state. It is more economically efficient to reorganize than to liquidate, because it preserves jobs and assets.

H.R. REP. NO. 595, 95th Cong., 1st Sess. 220 (1977); see 124 CONG. REC. 32,392 (1978) (statement of Rep. Edwards) ("The amendment also encourages business reorganizations by a streamlined new commercial reorganization chapter . . . . It will protect the investing public, protect jobs and help save troubled businesses."). Representative Edwards also noted that

[f]or both debtors and creditors, the requirements for a reorganization plan are made more flexible, and the court is given the power to confirm the plan even though some creditors do not like the plan. . . . This is very important. This way creditors get more than if the business went into straight liquidation. It also will save more businesses, which will protect jobs and protect public and private investors.

123 CONG. REC. 35,446 (1977) (statement of Rep. Edwards). See generally Jackson, *The Fresh-Start Policy in Bankruptcy Law*, 98 HARV. L. REV. 1393 (1985).

3. See Blum, *The "Fair and Equitable" Standard For Confirming Reorganizations Under the New Bankruptcy Code*, 54 AM. BANKR. L.J. 165, 172 (1980) ("The main protection theme in reorganizations under the new Bankruptcy Code is that adequately informed classes of creditors and shareholders can look after their own interests in the processes of negotiating plans.").

4. Collusive activity tainted some early equity receiverships. See *infra* notes 29-41 and accompanying text.

5. 11 U.S.C. § 1129 (1988).

6. The confirmation rules of § 1129 provide a number of requirements that must be satisfied before a court can confirm a plan of reorganization. 11 U.S.C. § 1129 (1988). These rules guarantee the representation of every class of creditors in the postpetition negotiations. 11 U.S.C. § 1129 (1988). Section 1129, therefore, forces negotiators to consider the claims of every creditor in developing a plan of reorganization.

The absolute priority rule⁷ prohibits a class of claims from participating in a reorganization⁸ unless all claimants with greater seniority are paid in full. This rule severely restricts the shareholders'⁹ ability to retain a stake in a restructured enterprise because the Bankruptcy Code subordinates their claims to those of all classes of creditors.¹⁰ In *Case v. Los Angeles Lumber Products Co.*,¹¹ the Supreme Court recognized that by discouraging shareholder participation, rigid application of the absolute priority rule may contradict the policy of promoting reorganization that underlies the law of bankruptcy.¹² In answer to this concern, the Court developed the new value exception.¹³

The new value exception to the absolute priority rule permits a shareholder who contributes new capital to retain an ownership interest in the bankrupt enterprise ahead of the creditors to an extent equal to the new investment. Application of the exception requires the satisfaction of three requirements: (1) the contribution by the equity holder must be necessary; (2) the equity holder's participation in the reorganization must be reasonably equivalent to the new investment into the enterprise; and (3) the investment must be in cash or its

7. The absolute priority rule states that a [c]ourt may confirm [a reorganization plan] over the dissent of a class of unsecured claims . . . only if the members of the class are unimpaired, if they will receive under the plan property of a value equal to the allowed amount of their unsecured claims, or if no class junior will share under the plan. That is, if the class is impaired, then they must be paid in full or, if paid less than in full, then no class junior may receive anything under the plan. H.R. REP. NO. 95-595, 95th Cong., 1st Sess. 413 (1977), reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6369; see also Skeel, *The Uncertain State of an Unstated Rule: Bankruptcy's Contribution Rule Doctrine After Ahlers*, 63 AM. BANKR. L.J. 221, 222-23 (1989). The absolute priority rule is codified at 11 U.S.C. § 1129(b)(2)(B) (1988).

8. For the purposes of this Note, a class of claims will be deemed to participate in a plan of reorganization if such class receives property of value on account of its claims against the debtor.

9. Shareholders own the equity of the corporation; as such, they represent the residual claimants of the corporation and receive a return on their investment only after the corporation's creditors are paid. R. BREALEY & S. MEYERS, *PRINCIPLES OF CORPORATE FINANCE* 305 (3d ed. 1988); A. CONARD, *CORPORATIONS IN PERSPECTIVE* 261-69 (1976). Bondholders are creditors of the corporation whose claims may be secured by mortgages on the corporation's property. See *id.* at 264. General mortgage creditors hold unsecured debentures of the corporation. *Id.* Because old railroad bonds frequently were secured by mortgages on the railroad property, the old railroad cases often describe the bondholders as "mortgagee" and the company as "mortgagor." *Id.*; see, e.g., *Kansas City Terminal Ry. v. Central Union Trust Co.*, 271 U.S. 445 (1926); *Northern Pac. Ry. v. Boyd*, 228 U.S. 482 (1913).

10. Furthermore, claimants in a bankruptcy proceeding frequently settle for less than full payment in order to prevent liquidation. In such cases, the rule of absolute priority explicitly prohibits shareholder participation. 11 U.S.C. § 1129(b)(2)(B)(ii) (1988); see *supra* note 2.

11. 308 U.S. 106 (1939).

12. 308 U.S. at 121. But see Ayer, *Rethinking Absolute Priority After Ahlers*, 87 MICH. L. REV. 963, 1006-07 (1989) (questioning the utility of the new value exception).

13. 308 U.S. at 116-23.

equivalent.¹⁴ This judicially created¹⁵ aspect of the "cram down"¹⁶ procedure has become a "deeply engraved concept under the bankruptcy laws."¹⁷

The new value exception was an important and well-established principle of law under the old Bankruptcy Act.¹⁸ Most courts simply assumed the continued existence of the exception after the 1978 revision.¹⁹ In the 1988 case of *Norwest Bank Worthington v. Ahlers*,²⁰ however, the Supreme Court confronted the argument that the adoption of the revised Code eliminated the new value exception.²¹ The Court circumvented the issue by holding that even if the exception still existed under the Code, it would not apply to the facts of *Ahlers*.²² Still, the case has sparked a heated debate in both judicial and academic circles concerning the continued viability of the new value exception.²³

This Note examines whether the new value exception remains part

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14. 308 U.S. at 121-22. The Supreme Court has stated that only investments of tangible property satisfy the "money and money's worth" requirement. *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 204-05 (1988).

15. See *infra* notes 25-54 and accompanying text.

16. "Cram down" refers to the process through which a bankruptcy court confirms a debtor's plan of reorganization over the objection of a dissenting class of creditors. See Klee, *All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code*, 53 AM. BANKR. L.J. 133 (1979); Klee, *Cram Down II*, 64 AM. BANKR. L.J. 229 (1990). The Bankruptcy Code applies the absolute priority rule only in the "cram down" procedure codified by 11 U.S.C. § 1129(b) (1988). Therefore, the Code permits senior classes to give up value to junior classes if every intermediate dissenting class is fully compensated. 11 U.S.C. § 1129 (1988); see 5 L. KING, C. CYR, K. KLEE, H. MINKEL & W. TAGGART, *COLLIER ON BANKRUPTCY* ¶ 1129.03[e] (15th ed. 1990).

17. *In re Snyder*, 99 Bankr. 885, 888 (Bankr. C.D. Ill. 1989).

18. Act of June 7, 1934, ch. 424, § 77B, 48 Stat. 911 (1934) (codified as amended at 11 U.S.C. § 207 (1976)) (repealed 1978).

19. See *infra* notes 56-60 and accompanying text. The revision is codified at 11 U.S.C. §§ 101-1329 (1988). The 1978 Code revision completely rewrote the law of bankruptcy which had been codified under the Bankruptcy Act. 123 CONG. REC. 35,444 (1978) (statement of Rep. Rodino).

20. 485 U.S. 197 (1988).

21. The United States as amicus curiae raised this argument in 485 U.S. at 203 n.3. See *infra* notes 65-87 and accompanying text.

22. *Ahlers*, 485 U.S. at 203-06. Under the proposed plan of reorganization in *Ahlers*, the debtors retained an equity stake in their farm in exchange for future contributions of labor, management, and expertise. The Court noted, "*Los Angeles Lumber* itself rejected an analogous proposition, finding that the promise of the existing shareholders to pledge their 'financial standing and influence in the community' and their 'continuity of management' to the reorganized enterprise was '[in]adequate consideration' that could not possibly be deemed 'money's worth'." 485 U.S. at 204 (quoting *In re Los Angeles Lumber Prods. Co.*, 308 U.S. 106, 122 (1939)).

23. See, e.g., *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1361-62 (7th Cir. 1990) (questioning the existence of the new value exception); *In re Stegall*, 865 F.2d 140, 141-42 (7th Cir. 1989) (same); *In re Pullman Const. Indus., Inc.*, 107 Bankr. 909, 945 (Bankr. N.D. Ill. 1989) (new value rule still viable under the Code); *In re Greystone III Joint Venture*, 102 Bankr. 560, 574-75 (Bankr. W.D. Tex. 1989) (exception survives under the Code); *In re Snyder*, 99 Bankr. 885, 886-89 (Bankr. C.D. Ill. 1989) (exception still exists); Ayer, *supra* note 12 (questioning the viability of the new value exception); Paulen & Wuhrman, *The New Value Exception to the Absolute Priority Rule: Is Ahlers the Beginning of the End?*, 93 COM. L.J.

of the revised Bankruptcy Code. Part I discusses the background of the new value exception. Part II traces the development of the conflict concerning the survival of the new value exception subsequent to the adoption of the Code. It then discusses the Supreme Court's opinions in *Midlantic National Bank v. New Jersey Department of Environmental Protection*²⁴ and its progeny, which established the methodology for determining the impact of the revised Bankruptcy Code on preexisting bankruptcy law. Based on an analysis of the *Midlantic* doctrine, Part II concludes that Congress did not intend to eliminate the new value exception when it revised the Code.

Part III discusses the future of the new value exception. This Part proposes a revision of this rule which would protect the rights of unsecured creditors without discarding the equitable principles underlying the rule. As such, the suggested revision responds to the critics of the new value exception without wholly eliminating this time-honored principle of bankruptcy law.

I. THE HISTORICAL FOUNDATION OF THE NEW VALUE EXCEPTION

The new value exception necessarily functions as a corollary to the absolute priority rule.²⁵ Without absolute priority, shareholder participation in the reorganized debtor would not be conditioned on the contribution of fresh capital.²⁶ The absolute priority rule under the old Bankruptcy Act emerged from the equity receiverships used to reorganize America's railroads at the close of the nineteenth century.²⁷ In order to understand the rule of absolute priority, therefore, one must examine the law of equity receiverships.²⁸

During the equity receivership process, managers of the debtor corporation and senior creditors bargained over the future of the enterprise. The debtor's management remained in control of the enterprise while it conducted these elaborate negotiations with

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303 (1988) (asserting that the new value exception furthers the equitable principles underlying the Bankruptcy Code).

24. 474 U.S. 494 (1986).

25. Ayer, *supra* note 12, at 999.

26. *Id.* ("[T]he place to begin the search for a new value rule is in the lore of the absolute priority rule . . .").

27. Baird & Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738, 739-40 (1988).

28. Baird and Jackson explain

The law of equity receiverships was largely judge-made, or, more accurately, lawyer-made. The elite law firms of the era were intimately involved with the development of this doctrine. It was a time when giants walked the earth. Robert Swaine was only an associate at the Cravath firm when he made his contribution to the absolute priority rule while working on the restructuring of the Frisco line out of a Pullman car in a railroad yard in Jefferson City. *Id.* at 739 (citations omitted).

representatives of the senior creditors.²⁹ Frequently, senior creditors friendly with management would develop a plan of reorganization that allowed the debtor's equity holders to retain their interest in the enterprise.³⁰ The unsecured creditors would neither be paid by the debtor nor receive an equity interest in the reorganized enterprise and, thus, they remained unsatisfied.³¹ This problem called for a solution, and the Court created one in the absolute priority rule.

The Court first confronted a manipulative equity receivership in *Louisville Trust Co. v. Louisville, New Albany and Chicago Railway Co.*,³² where bondholders and stockholders of a railway had created a plan that effectively froze out the general creditors.³³ The Court recognized that due to the particular nature of the railroad industry, reorganizations governed by the ordinary priority system failed to protect all of the interests at stake: "[A] railroad is not simply private property, but also an instrument of public service, . . . and [its] public obligations . . . justify a limited displacement of contract and recorded liens in behalf of temporary and unsecured creditors."³⁴

The Court asserted that a legitimate plan of reorganization must recognize the rights of all classes of creditors.³⁵ The equity receivership, therefore, should not be utilized as a mechanism for denying recovery to certain classes of creditors.³⁶ In a sentence that engendered the rule of absolute priority, the Court declared that "any arrangement of the parties by which the subordinate rights and interests of the

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29. *Id.*

30. This practice appears clearly in two U.S. Supreme Court cases from which the absolute priority rule emerged. See *Northern Pac. Ry. v. Boyd*, 228 U.S. 482, 501 (1912) ("[T]he foreclosure sale was void because made in pursuance of an illegal plan of reorganization, between bondholders and stockholders of the Railroad, in which, though no provision was made for the payment of unsecured creditors, the stockholders retained their interest by receiving an equal number of shares in the new railway."); *Louisville Trust Co. v. Louisville, N.A. & C. Ry.*, 174 U.S. 674, 685 (1899) ("[T]hese matters suggest, at least, that there is probable truth in the sworn averment of the petitioner that all was done by virtue of an agreement between mortgagee and mortgagor (bondholder and stockholder) to preserve the relative interests of both, and simply extinguish unsecured indebtedness.").

31. See *Baird & Jackson*, *supra* note 27, at 740.

32. 174 U.S. 674 (1899).

33. 174 U.S. at 675-81. In brief, the Louisville, New Albany and Chicago Railway Company entered into a receivership proceeding and subsequently sold the entire company to the existing bond and stockholders. The sale was designed to create a new company unhindered by the unsecured debt which plagued the insolvent railroad. 174 U.S. at 675-81.

34. 174 U.S. at 682.

35. 174 U.S. at 682-84.

36. The Court asked,

Can it be that when in a court of law the right of an unsecured creditor is judicially determined and that judicial determination carries with it a right superior to that of the mortgagor, the mortgagor and mortgagee can enter into an agreement by which through the form of equitable proceedings all the right of this unsecured creditor may be wiped out, and the interest of both mortgagor and mortgagee in the property preserved and continued? . . . Nothing of the kind can be tolerated.

174 U.S. at 684.

stockholders are attempted to be secured at the expense of the prior rights of [any] class of creditors comes within judicial denunciation."³⁷

The Supreme Court extended the holding of *Louisville Trust in Northern Pacific Railway Co. v. Boyd*.³⁸ The Court previously had refused to determine whether a court, in judging the validity of a foreclosure, always "ought . . . to require an extinction of all the mortgagor's interest and a full transfer to the mortgagee, representing the bondholders."³⁹ *Boyd* answered that question in the affirmative, establishing that a plan of reorganization providing for shareholder participation does not bind nonassenting creditors.⁴⁰ To this end the *Boyd* Court designed the mandate of absolute priority to prevent corporations from utilizing equity receiverships to freeze out unsecured creditors.⁴¹

The *Boyd* Court created a rule that hinders the ability of some enterprises to emerge from bankruptcy by prohibiting shareholder participation in a reorganization. Under certain circumstances the debtor's stockholders represent the only viable source of financing for a reorganization;⁴² as such, the future of the debtor enterprise depends upon cooperation between the shareholders and the bondholders.⁴³ In these cases, the absolute priority rule contradicts the fundamental policy of the bankruptcy law: to encourage efficient reorganizations. The absolute priority rule formulated in *Boyd* thus

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37. 174 U.S. at 684.

38. 228 U.S. 482 (1913). *Boyd* also involved an equity receivership of a railroad. In *Boyd*, the insolvent Northern Pacific Railroad (the Railroad) was sold via receivership to a new corporation, the Northern Pacific Railway (the Railway). The stockholders of the latter corporation were the same as those of the debtor. Not surprisingly, the reorganization plan provided for the payment of the secured creditors and for equity participation by the debtor's shareholders. The unsecured creditors received nothing under the plan. *Boyd*, a general creditor, originally made his claim against the Railroad, which asserted that all its assets had been purchased by the Railway. *Boyd* then brought suit against the Railway, which contended that it had purchased the assets through a bona fide equity receivership proceeding. 228 U.S. at 483-92. The "cooperation" between the secured creditors and the equity holders may be attributable to the influence of J.P. Morgan. See R. CHERNOW, *THE HOUSE OF MORGAN: AN AMERICAN BANKING DYNASTY AND THE RISE OF MODERN FINANCE* 67-68 (1990).

39. *Louisville Trust*, 174 U.S. at 683. The Court refused to make such a determination because the litigants failed to raise the issue. 174 U.S. at 683.

40. *Boyd*, 228 U.S. at 502-03.

41. 228 U.S. at 504-05.

42. See, e.g., *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106, 121-22 (1939) (suggesting such circumstances could exist); *Kansas City Terminal Ry. v. Central Union Trust Co.*, 271 U.S. 445, 455 (1926) (in railroad reorganizations, "the interests of all parties, including the public, are best served by cooperation between bondholders and shareholders"); *In re Jartran, Inc.*, 44 Bankr. 331, 366-67 (Bankr. N.D. Ill. 1984) (shareholder made only offer to finance the reorganization).

43. See *Kansas City Terminal Ry.*, 271 U.S. at 453-54 ("[W]here the value of corporate property to be sold under foreclosure is so great as to render cooperation between bondholders and stockholders essential in order to secure a bidder and prevent undue sacrifice of their interests, they may enter into a fair and open arrangement to that end.").

proved to be an overly rigid restriction on the process of reorganization.

The Supreme Court first recognized this practical difficulty with the absolute priority rule in *Kansas City Terminal Railway Co. v. Central Union Trust Co.*⁴⁴ Strict application of the absolute priority rule made the railway's reorganization unfeasible, undermining the public interest in maintaining the country's railroads. The Court acknowledged its obligation to follow the "fixed principle" of *Boyd*,⁴⁵ yet also recognized that certain circumstances may require shareholders to participate in a reorganization:

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. In such or similar cases the chancellor may exercise an informed discretion concerning the practical adjustment of the several rights.⁴⁶

With these words, the new value exception was born.

The Supreme Court relied on *Kansas City Terminal Railway* as the sole authority for *Case v. Los Angeles Lumber Products Company*,⁴⁷ which placed the new value rule permanently within the corpus of American bankruptcy law. The debtor in *Case* had proposed a plan whereby Class B stockholders⁴⁸ would receive less than full payment, and the remaining shareholders of the debtor would retain an ownership interest in the reorganized company. District Judge Jenney approved the plan; the Court noted his conclusion that "[i]t will be an asset of value to the new company to retain the old stockholders in the business because of their 'familiarity with the operation' of the business and their 'financial standing and influence in the community'; and because they can provide a 'continuity of management.'"⁴⁹

The *Case* court, therefore, first addressed the question whether a plan that provided for shareholder participation in a reorganization

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44. 271 U.S. 445 (1926).

45. 228 U.S. 482 (1913).

46. *Kansas City Terminal Ry.*, 271 U.S. at 455.

47. 308 U.S. 106 (1939). Ironically, the discussion of the new value rule in *Case* was dictum. As discussed, *infra* notes 48-54 and accompanying text, the tradition of new value emerges from a case in which the proposed plan was denied. 308 U.S. at 122-32. The nature of the *Case* pronouncement has provided fertile ground for attacking the legitimate existence of the rule. See Ayer, *supra* note 12, at 999-1007.

48. The Los Angeles Lumber Products Company had undergone a voluntary reorganization prior to the financial difficulties that preceded the lawsuit. 308 U.S. at 109-10. Pursuant to this reorganization, the company issued Class A common stock to the company's old stockholders in return for a new capital contribution, and Class B common stock to its bondholders. 308 U.S. at 110. Eight years later, the company filed for reorganization under § 77B of the Bankruptcy Act, a move that preceded the *Case* litigation. The plan submitted as part of the reorganization represented the last attempt by the Class A stockholders to retain their control of the corporation at the expense of its original bondholders — now holders of Class B stock. 308 U.S. at 110-11.

49. 308 U.S. at 112-13.

could be sustained under section 77B of the Bankruptcy Act.⁵⁰ The Court responded to this question by setting forth the new value rule and the requirements for its application.⁵¹ Building on *Kansas City Railway*, the Court defined the contours of the new value exception:

[T]here are circumstances under which stockholders may participate in a plan of reorganization . . . . Especially in [*Kansas City Terminal Railway*] did this Court stress the necessity, at times, of seeking new money "essential to the success of the undertaking" from the old stockholders. Where that necessity exists and the old stockholders make a fresh contribution and receive in return a participation reasonably equivalent to their contribution, no objection can be made.⁵²

The Court, however, went further, and limited the types of fresh capital that would justify continued participation by stockholders in the debtor enterprise: "[T]he stockholders' participation must be based on a contribution in money or in money's worth, reasonably equivalent in view of all the circumstances to the participation of the stockholder."⁵³ Because the plan at issue in *Case* justified the stockholder's participation on the basis of their "financial standing and influence in the community," this requirement proved fatal. Such intangibles would not satisfy the new value standard.⁵⁴

The *Case* Court developed the new value exception in order to rectify problems created by strict application of the absolute priority rule. The *Case* mandate recognizes that, under certain circumstances, shareholder participation may be necessary to ensure the debtor's reorganization. In such cases the absolute priority rule conflicts with the Bankruptcy Code's policy of encouraging reorganization. The new value exception assures that the equitable goals of the Code prevail in such circumstances.

II. *AHLERS* AND THE BIRTH OF AN ISSUE

This Part discusses and critiques the development of the argument that the new value exception does not survive the enactment of the revised Bankruptcy Code. Section A discusses the Solicitor General's amicus brief in *Norwest Bank Worthington v. Ahlers*,⁵⁵ which called for the elimination of the new value exception. Section B examines the post-*Ahlers* decisions that have rejected new value and created contro-

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50. 308 U.S. at 108-09. 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 . . . it is fair and equitable and does not discriminate unfairly in favor of any class of creditors or stockholders, and is feasible. . . ." 308 U.S. at 114 n.6. The absolute priority rule was the judicial definition of the fair and equitable standard.

51. 308 U.S. at 117-21.

52. 308 U.S. at 121 (footnote omitted).

53. 308 U.S. at 122.

54. 308 U.S. at 122.

55. 485 U.S. 197 (1988).

versy within the corporate reorganization bar. Section C argues that the *Ahlers* brief incorrectly characterized the role of the new value exception under the Bankruptcy Code. Finally, section D discusses two leading scholarly articles that have reached inconsistent conclusions concerning the viability of the new value exception under the Bankruptcy Code. This Part concludes that the Solicitor General's *Ahlers* brief incorrectly asserted that the revised Bankruptcy Code eliminated the new value exception to the absolute priority rule.

A. *Ahlers and the Attack on New Value*

With one exception,⁵⁶ all of the pre-*Ahlers* decisions assumed that the new value exception continued to exist after the enactment of the revised Bankruptcy Code.⁵⁷ Opinions such as *In re Sawmill Hydraulics*⁵⁸ ignored the questions raised in the Solicitor General's *Ahlers* brief because the viability of the new value exception was unchallenged.⁵⁹ The early cases recognizing the existence of the new value exception under the Code, therefore, do not directly address the question of its elimination.⁶⁰

*In re Pine Lake Village Apartment Co.*⁶¹ is the only pre-*Ahlers* case that supports the position that the Code eliminated the new value exception.⁶² The bankruptcy court in *Pine Lake* refused to confirm a plan premised on the new value exception, relying on a standard application of the absolute priority rule.⁶³ The court failed to mention *Case* or the new value exception; thus the court may not have recognized the debtor's attempt to circumvent the absolute priority rule through a

56. See *In re Pine Lake Village Apt. Co.*, 19 Bankr. 819 (Bankr. S.D.N.Y. 1982); see *infra* notes 61-64 and accompanying text.

57. See, e.g., *In re United States Truck Co.*, 800 F.2d 581 (6th Cir. 1986); *In re Potter Material Serv. Inc.*, 781 F.2d 99 (7th Cir. 1986); *In re Future Energy Corp.*, 83 Bankr. 470 (Bankr. S.D. Ohio 1988); *In re A.G. Consultants Grain Div., Inc.*, 77 Bankr. 665 (Bankr. N.D. Ind. 1987); *In re Eaton Hose & Fitting Co.*, 73 Bankr. 139 (Bankr. S.D. Ohio 1987); *In re Baugh*, 73 Bankr. 414 (Bankr. E.D. Ark. 1987); *In re Sawmill Hydraulics, Inc.*, 72 Bankr. 454 (Bankr. C.D. Ill. 1987); *In re Brown's Indus. Uniforms*, 58 Bankr. 139 (Bankr. N.D. Ill. 1985); *In re Jartran, Inc.* 44 Bankr. 331, 379 (Bankr. N.D. Ill. 1984); *In re Landau Boat Co.*, 13 Bankr. 788 (Bankr. W.D. Mo. 1981); *In re Marston Enters.*, 13 Bankr. 514 (Bankr. E.D.N.Y. 1981).

58. 72 Bankr. 454 (Bankr. C.D. Ill. 1987).

59. 72 Bankr. at 456 n.1 ("As [the new value exception] is firmly imbedded in reorganization law, this Court does not deem it necessary to go into a detailed discussion of the cases espousing this concept."); see also *In re A.G. Consultants Grain Div., Inc.*, 77 Bankr. 665, 677-78 (Bankr. N.D. Ind. 1987) (assuming, without discussion, the new value exception exists under the Code); *In re Eaton Hose & Fitting Co.*, 73 Bankr. 139, 140 (Bankr. S.D. Ohio 1987) (same).

60. Critics attack the precedential value of these early cases because they assumed without discussion that the new value exception remained viable under the revised Code. See *infra* note 152.

61. 19 Bankr. 819 (Bankr. S.D.N.Y. 1982).

62. See *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 203 n.3 (1988); Brief for the United States as Amicus Curiae Supporting Petitioners at 18, *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988) (No. 86-958) [hereinafter *Ahlers* Brief].

63. *Pine Lake*, 19 Bankr. at 832-33.

contribution of fresh capital.⁶⁴ *Pine Lake*, therefore, represents at best tenuous authority for the proposition that the Code eliminated the new value exception.

The recent attack on the new value exception emerged out of a tradition of widespread judicial acceptance of the rule: throughout the era of the Bankruptcy Act, and in the years immediately following the adoption of the Code, the viability of the *Case* doctrine remained unchallenged. The reason for raising the issue in *Ahlers*, therefore, remains an open question.

The Solicitor General's amicus brief in *Ahlers*⁶⁵ first questioned the continued existence of the new value exception under the Bankruptcy Code.⁶⁶ Solicitor General Charles Fried expounded an interpretation of the Code that eliminated the new value exception. In light of the early opinions uniformly accepting the existence of the new value exception, the brief appears to be more of an attack on the merit of the new value exception than an exercise in statutory interpretation.⁶⁷ The Solicitor General's argument proved persuasive, if not immediately successful; after *Ahlers*, courts questioned the assumptions upon which opinions such as *Sawmill Hydraulics*⁶⁸ rested. New value had come under siege.

The Solicitor General grounded his argument on the ability of parties to a Chapter 11 proceeding to negotiate an agreement providing for shareholder participation.⁶⁹ The confirmation standard delineated in section 1129(a) of the Code⁷⁰ denies minority dissenting creditors the right to prevent confirmation:⁷¹ if two thirds in value and more

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64. 19 Bankr. at 832-33; see also Ayer, *supra* note 12, at 1009-10.

65. See *Ahlers* Brief, *supra* note 62.

66. *Ahlers*, 485 U.S. at 203 n.3. The United States was interested in the result of *Ahlers* because its agencies, such as the Federal Deposit Insurance Corporation and the Federal Savings and Loan Insurance Corporation, often act as creditors in bankruptcy proceedings. See *Ahlers* Brief *supra* note 62, at 1-2.

67. See generally *Ahlers* Brief, *supra* note 62.

68. 72 Bankr. 454 (Bankr. C.D. Ill. 1987); see *supra* notes 61-64 and accompanying text.

69. Chapter 11 permits the creditor classes to agree to equity-holder participation, even though creditors' claims are not fully honored, when the creditors, voting as classes, believe that their best interests would be served. Rather than require every plan of reorganization to be fair and equitable (as old Chapter X did), Chapter 11 provides that a class of creditors may consent to a plan under which its members' claims are not fully honored and junior claimants nevertheless participate. The express purpose of this is to provide a mechanism whereby the parties in interest can reach a mutually beneficial agreement as determined by the requisite vote of each class.

See *Ahlers* Brief, *supra* note 62, at 14-15 (citation and footnote omitted).

70. 11 U.S.C. § 1129(a) (1988).

71. See *Ahlers* Brief, *supra* note 62, at 14-15; see also *In re Winters*, 99 Bankr. 658, 663 (Bankr. W.D. Pa. 1989). The *Winters* court stated that "[i]f the standard contained in section 1129 were applied to the facts of [*Case*] the plan there would have been confirmed." 99 Bankr. at 663. The statement implies that the *Case* court created the new value exception to ensure confirmation under the restrictive rules of the old Act. The *Winters* court apparently overlooked the fact that the *Case* court did not confirm the plan at issue, notwithstanding the application of the new value exception. The Supreme Court did not create the new value exception in order to

than one half in number of each class of creditors votes to permit shareholder participation, the plan will be confirmed.⁷² According to the Solicitor General, the added flexibility provided by Chapter 11 obviated the principal purpose of the new value exception: counterbalancing the rigidity of the absolute priority rule.⁷³

Furthermore, the Solicitor General asserted that by specifically defining "fair and equitable" in the Bankruptcy Code, Congress eliminated the judicial gloss surrounding the term under the Act, thereby removing the need for the new value exception.⁷⁴ The Code states that a plan is fair and equitable with respect to an impaired⁷⁵ dissenting class of unsecured creditors under only two circumstances:

- (i) [t]he 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.⁷⁶

These conditions, the Solicitor General argued, are violated when an equity holder attempts to invoke the new value rule. No provision of the Bankruptcy Code can be legitimately interpreted to permit, over the objection of a class of creditors, participation in a plan by a person that contributed new capital without having a prior interest in the estate.⁷⁷ Under the new value exception, therefore, shareholders retain property on account of their preexisting interest in the estate.⁷⁸ The express terms of section 1129(b)(2)(B), however, forbid such participation unless all creditors in the dissenting class receive full payment of their claims. Solicitor Fried asserted that the language and structure of the Code thereby explicitly eliminated the new value exception.⁷⁹

The Solicitor General argued that Congress chose to eliminate the new value exception because it recognized that two conditions that

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confirm the plan at issue in *Case*. Rather, *Case* put forth the new value exception as the necessary complement to the absolute priority rule, serving to promote the equitable interests at stake in a bankruptcy proceeding. See *supra* notes 47-54 and accompanying text.

72. 11 U.S.C. § 1126(c) (1988).

73. See Ahlers Brief, *supra* note 62, at 14-16.

74. *Id.* at 19-21.

75. Section 1124 states that a class of claims is unimpaired if the plan (1) leaves unaltered the legal, equitable, and contractual rights to which such claim or interest entitles the holder of such claim or interest; (2) cures any default that occurred with respect to such claim; or (3) pays the holder of such claim the allowable amount of such claim. 11 U.S.C. § 1124 (1988).

76. 11 U.S.C. § 1129(b)(2)(B) (1988).

77. Ahlers Brief *supra* note 62, at 21 n.18.

78. *Id.* at 20-21.

79. *Id.* at 21. But see *infra* notes 135-37 and accompanying text discussing the principles of statutory interpretation set forth in *Midlantic*.

necessitated its existence no longer exist.⁸⁰ First, the Court premised its decision in *Case v. Los Angeles Lumber Products Co.*⁸¹ on the assumption that under certain circumstances equity holders represent the only source of capital for the reorganization.⁸² The Solicitor General criticized this assumption because today's capital markets make it easier for a worthwhile enterprise to obtain financing: "[T]he inability of a reorganized company to convince anyone other than a pre-petition equity holder to lend it money today suggests not a failure of the capital markets as much as a realistic assessment that the reorganization is not likely to succeed."⁸³

Second, under the Bankruptcy Act the bankruptcy judge ensured that a plan of reorganization protected the interests of every class of creditors.⁸⁴ Congress reduced the judiciary's role in developing the substance of a reorganization plan when it adopted the Bankruptcy Code. The policy that the parties should control postpetition negotiations underlies the new law, which attempts to minimize judicial interference in the confirmation process.⁸⁵ Consequently, the objection by one class of creditors to a plan providing for shareholder participation signifies a belief that such participation is not in the best interest of the class.⁸⁶ Because the Code leaves the decisionmaking process in the creditor's hands, the argument concludes, courts no longer retain the responsibility for deciding whether shareholder participation is necessary to ensure a successful reorganization.⁸⁷ The revised Code, therefore, eliminated the role performed by the new value exception in the confirmation process.

B. *The Post-Ahlers Attack on New Value*

A significant divergence of opinion concerning the viability of the new value rule has developed in the courts since *Ahlers*.⁸⁸ Decisions recognizing the viability of the new value exception⁸⁹ have relied on

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80. *Ahlers* Brief, *supra* note 62, at 22.

81. 308 U.S. 106 (1939).

82. *Ahlers* Brief, *supra* note 62, at 22; *see also Case*, 308 U.S. at 121-22 ("Especially in [*Kansas City Terminal Railway*] did this Court stress the necessity, at times, of seeking new money 'essential to the success of the undertaking' from the old stockholders.").

83. *Ahlers* Brief, *supra* note 62, at 22; *see Blum & Kaplan, The Absolute Priority Doctrine in Corporate Reorganizations*, 41 U. CHI. L. REV. 651, 672 (1974) ("Current data do not support the belief that old shareholders are a fruitful source of additional funds when the public capital markets are unlikely to provide funds."). *But see infra* notes 126-28 and accompanying text.

84. *See Ahlers* Brief, *supra* note 62, at 14-15.

85. *Ahlers* Brief, *supra* note 62, at 22; *see also Blum, supra* note 3, at 172.

86. *Ahlers* Brief, *supra* note 62, at 22.

87. *Id.* at 22-23.

88. *See supra* note 23.

89. *See In re Mortgage Inv. Co.*, 111 Bankr. 604, 617-19 (Bankr. W.D. Tex. 1990); *In re Pullman Constr. Indus., Inc.*, 107 Bankr. 909, 943-48 (Bankr. N.D. Ill. 1989); *In re Greystone III Joint Venture*, 102 Bankr. 560, 572-75 (Bankr. W.D. Tex. 1989).

the principles of interpretation set out in *Midlantic National Bank v. New Jersey Department of Environmental Protection*.⁹⁰ Decisions espousing an opposing view argue that Congress rejected the new value exception by failing to include any reference to it in the Code.⁹¹ This section examines these opinions and concludes that the opinions rejecting the new value exception have misconstrued the importance of Congress' failure to mention it explicitly in the Code.

The bankruptcy court in *In re Greystone III Joint Venture*⁹² held that codification of the absolute priority rule included the new value exception.⁹³ The *Greystone* court premised its opinion on the assertion that the new value exception protects the equitable goals underlying the law of bankruptcy in the face of the rigid rule of absolute priority.⁹⁴ Thus the exception allows courts to confirm corporate restructurings that fail to meet the standards required by the absolute priority rule.⁹⁵

According to the *Greystone* court, the structure of the Bankruptcy Code did not expressly eliminate the equitable principles underlying the new value exception;⁹⁶ still, Congress may have intended to eliminate only the exception. The *Greystone* court asserted that when Congress reenacts a statute that was subject to a widely accepted judicial gloss, it adopts the judicial construction as well, unless it makes its intent to eliminate it clear.⁹⁷ The position of the *Greystone* court typi-

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90. 474 U.S. 494 (1986). The *Midlantic* doctrine states that a congressional amendment of a statute codifies preexisting judicial interpretations of the law unless Congress expressly repudiates them. See *infra* notes 129-57 and accompanying text.

91. Two bankruptcy courts and the Seventh Circuit have adopted this view. See *Kham & Nate's Shoes No. 2 v. First Bank of Whiting*, 908 F.2d 1351, 1360-63 (7th Cir. 1990); *In re Stegall*, 865 F.2d 140, 142 (7th Cir. 1989); *In re Drimmel*, 108 Bankr. 284, 288-90 (Bankr. D. Kan. 1989); *In re Winters*, 99 Bankr. 658, 660-63 (Bankr. W.D. Pa. 1989).

92. 102 Bankr. 560 (Bankr. W.D. Tex. 1989).

93. 102 Bankr. at 574-75.

94. 102 Bankr. at 574-75.

95. See *supra* notes 44-54 and accompanying text. The essence of the new value rule is succinctly stated by Professor Raymond Nimmer:

The basis of the new value contribution rule reflects the fact that any reorganization plan that eliminates prior ownership must provide for the future ownership of the company or its assets. The new capital can be viewed as a purchase of ownership. More accurately, however, it is a method that permits the owners to retain control if they are willing to place new assets at risk for the benefit of creditors. . . . [T]he owners share the risk of further loss and, in return, receive potential benefits by retaining control of the company.

Nimmer, *Negotiated Bankruptcy Reorganization Plans: Absolute Priority and New Value Contributions*, 36 EMORY L.J. 1009, 1050 (1987).

96. 102 Bankr. at 575. The Court asserted that [t]he same equitable considerations that motivated the recognition of the "exception" in *Kansas City Terminal [Railway]* and reaffirmed its vitality under Section 77B in *Case*, commend its preservation under the Bankruptcy Code, to assure that an overstrict application of the "fair and equitable" standard does not strangle the debtor and leave the reorganization stillborn.

102 Bankr. at 575.

97. 102 Bankr. at 575 n.20. The court expressly stated that [i]t is a time-honored principle of statutory construction that legislators are presumed to be

fies the response of post-*Ahlers* cases supporting the viability of the new value exception.⁹⁸

The courts that explicitly rejected the new value exception adopted the Solicitor General's position in *Ahlers*.⁹⁹ The bankruptcy court in *In re Winters*¹⁰⁰ grounded its decision on an examination of the historical purpose of the absolute priority rule and the judicial definition of "fair and equitable."¹⁰¹ According to the *Winters* court, Congress was aware when it revised the Bankruptcy Code that the judicial gloss attached to the definition of "fair and equitable" greatly affected the application of the absolute priority rule.¹⁰² The definition of the fair and equitable standard in section 1129(b)(2)(B) directly responded to the absolute priority rule as judicially embodied under the Bankruptcy Act¹⁰³ and, therefore, is controlling:

Congress did not rely on "the words 'fair and equitable' as . . . words of art which . . . had acquired a fixed meaning through judicial interpretation." Rather, Congress specifically defined "the condition that a plan be fair and equitable with respect to a class" in § 1129(b)(2). In doing

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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 long-standing equitable expansion of the absolute priority rule should be presumed to still be good law. 102 Bankr at 575 n.20. See *infra* notes 129-57 and accompanying text.

98. See also *In re Snyder*, 99 Bankr. 885 (Bankr. C.D. Ill. 1989). The *Snyder* court asserted [t]he fresh capital exception is viable until eliminated by a higher court. The fresh capital exception developed by the Supreme Court has become a deeply engraved concept under the bankruptcy laws. There is nothing in the legislative history which indicates that Congress, in enacting Section 1129, intended to eliminate this long standing concept. Although there is some judicial authority which indicates that the exception is no longer viable, most courts have concluded that the exception survives the transition from the Bankruptcy Act to the Bankruptcy Code. . . . Notwithstanding the statement in *In re Steagall* . . . it is better judicial policy for this Court to apply the long standing concept . . . until the United States Supreme Court . . . rules the exception no longer exists. 99 Bankr. at 888-89 (citations omitted).

99. See *supra* notes 65-87 and accompanying text.

100. 99 Bankr. 658 (Bankr. W.D. Pa. 1989).

101. 99 Bankr. at 660-61.

102. 99 Bankr. at 661-62.

103. 99 Bankr. at 662. The new value exception developed concomitantly with the Supreme Court's interpretation of § 77B(f) of the Bankruptcy Act requiring

that a plan had to be approved by the required percentages of each class of security holders and that the plan complied with the fair and equitable standard which embodied the absolute priority rule. Thus, under this interpretation, even though the requisite majority of a class accepted the plan, if a minority dissenting creditor within the accepting class objected, the court could not confirm a plan if the plan did not strictly comply with the absolute priority rule.

99 Bankr. at 662.

Under the new standards created by 11 U.S.C § 1129(a) (1988), if the requisite majority (two thirds of amount and half of number) of each class of creditors accept the plan, then the plan need not comply with the absolute priority rule. 99 Bankr. at 663. The emphasis placed on this new standard by the *Winters* court echoes the argument of the Solicitor General in his *Ahlers* Brief. See *supra* notes 65-87 and accompanying text. The *Winters* court asserted that the revision of the confirmation standard effectuated by the Bankruptcy Code eliminated the purpose of the new value exception.

so, Congress changed the absolute priority rule so that it now applies only to each class as a whole, and not to minority dissenters within a class. Congress, with apparent deliberation, did not mention the "infusion of new capital" as a consideration in applying the fair and equitable test.¹⁰⁴

The *In re Drimmel*¹⁰⁵ court followed *Winters*. The *Drimmel* court also focused on Congress' definition of "fair and equitable" found in section 1129(b)(2)(B): "This court views Congress' failure to include the exception in this new definition as the significant factor here rather than its failure to expressly repudiate the exception."¹⁰⁶ Where congressional intent is clear it should be followed, and Congress, the court felt, plainly expressed its intention to eliminate the rule of new value by not discussing it in the legislative history of the Code.¹⁰⁷

The Seventh Circuit also has questioned the viability of the new value exception.¹⁰⁸ The Circuit first addressed the issue in *In re Potter Material Service Inc.*¹⁰⁹ In *Potter*, the court confronted a challenge to a proposed plan that provided for shareholder participation. At that time, the court implicitly recognized the rule of new value¹¹⁰ and affirmed the bankruptcy court's confirmation of the plan.¹¹¹

Judges Posner and Easterbrook, however, have initiated a rethinking of the new value exception's existence in the Seventh Circuit Court. In *In re Stegall*,¹¹² Judge Posner reopened the question of the viability of the new value exception by denying the precedential value of *Potter*:

The "fresh capital" exception to the absolute-priority rule pre-dates the Bankruptcy Code of 1978; does it survive it? We assumed so without discussion of the question in *In re Potter* . . . . The Supreme Court [in *Ahlers*] declined the Solicitor General's invitation to resolve the issue. No more need we try to resolve it today, since this case, like *Ahlers*, is not within the fresh-capital exception even if that exception survived the enactment of the 1978 Code. We emphasize, however, that the issue is an open one in this circuit, *Potter* notwithstanding. A point of law merely assumed in an opinion, not discussed, is not authoritative.¹¹³

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104. 99 Bankr. at 663 (quoting *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106, 115 (1939)).

105. 108 Bankr. 284 (Bankr. D. Kan. 1989).

106. 108 Bankr. at 289.

107. 108 Bankr. at 289. The *Drimmel* Court relied on *Winters* as authority for its opinion concerning the legislative history of the Code. 108 Bankr. at 289-90. Neither case, however, discussed the *Midlantic* doctrine. See *infra* notes 129-57.

108. See *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351 (7th Cir. 1990); *In re Stegall*, 865 F.2d 140 (7th Cir. 1989).

109. 781 F.2d 99 (7th Cir. 1986).

110. 781 F.2d at 101 (applying the new value exception without discussing the question of its viability).

111. 781 F.2d at 104.

112. 865 F.2d 140 (7th Cir. 1989).

113. 865 F.2d at 142 (citations omitted).

Judge Easterbrook amplified Judge Posner's hostility toward the new value exception in *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*.¹¹⁴ Though the court resisted its inclination to rule on the new value exception,¹¹⁵ Judge Easterbrook described it in terms similar to those used by Professors Baird and Jackson:¹¹⁶ "A 'new value exception' means a power in the *judge* to 'sell' stock to the managers even when the creditors believe that this transaction will *not* augment the value of the firm."¹¹⁷ Furthermore, like the bankruptcy judges in *Winters* and *Drimmel*, Judge Easterbrook placed great emphasis on the Bankruptcy Code's definition of "fair and equitable": "Holdouts that spoiled reorganizations and created much of the motive for having judges 'sell' stock to the manager-shareholders no longer are of much concern, now that § 1126(c) allows the majority of each class (two-thirds by value) to give consent."¹¹⁸ The judge concluded that the rule of new value now serves no legitimate purpose under the Code.¹¹⁹

C. *The Ahlers Brief Critiqued*

This section argues that the *Ahlers* Brief incorrectly characterized the role of the new value exception under the Bankruptcy Code. Subsection one argues that the new value exception still performs an important function under the revised Code by limiting the inequitable consequences that may result from a rigid application of the absolute priority rule. Subsection two utilizes the *Midlantic* doctrine to question the Solicitor General's assertion that Congress revealed an intent to eliminate the new value exception by not expressly including it in the Code. This section concludes that the Solicitor General's argument that the revised Bankruptcy Code eliminated the new value exception to the absolute priority rule should not be accepted.

1. *The Rigidity of the Absolute Priority Remains*

The Solicitor General based his criticism of the new value exception on the assertion that the confirmation rules codified in section 1129 eliminated the rigidity of the absolute priority rule, thus obviat-

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114. 908 F.2d 1351 (7th Cir. 1990).

115. The court refused to acquiesce in the Bank's request to hold that the new value exception disappeared in 1978 for two reasons: "first, the consideration for the shares is insufficient even if the new value exception retains vitality; second, although Bank vigorously argues the merits of the new value exception in this court, it did not make this argument in the bankruptcy court." 908 F.2d at 1362. Although the court did not expressly repudiate the new value exception, the language it used to describe the rule's function under the bankruptcy law implies that the court would make such a repudiation were it provided with the proper opportunity.

116. See *infra* notes 160-67 and accompanying text.

117. 908 F.2d at 1360.

118. 908 F.2d at 1361.

119. 908 F.2d at 1361.

ing the new value exception. The Solicitor General's argument, however, fails for two reasons: first, section 1129(b)'s confirmation standard allows slightly more than one third of a class of creditors to veto a plan accepted by every other party to the reorganization; and second, it gives a large investor who owns an entire class of securities the power to block any suggested confirmation plan that involves shareholder participation. The rigidity of the absolute priority rule, therefore, continues to interfere with the Code's objective of promoting reorganization.

Under the Code, the new value exception continues to prevent the inequity which can result from a rigid application of the absolute priority rule. *In re Jartran, Inc.*¹²⁰ lucidly illustrates the importance of retaining the new value exception under the Code. Jartran, a truck rental corporation, had filed for bankruptcy.¹²¹ For three years the parties to the reorganization unsuccessfully attempted to sell the company to a third-party investor.¹²² The proposed plan under which equity holders retained an ownership interest in the restructured debtor under the new value exception, therefore, represented the only feasible method of reorganization. The plan was rejected by the class of claims controlled by U-Haul — the debtor's competitor.¹²³ The facts of the case seem to imply that U-Haul sought to liquidate the company because such a result would eliminate a competitor.¹²⁴ Certainly in this case equity strongly favored allowing confirmation of the plan through an application of the new value exception.¹²⁵

Furthermore, the Solicitor General incorrectly asserts that the inability of a debtor to obtain financing necessarily signifies an assessment by the capital markets that the reorganization will fail.¹²⁶ In periods characterized by increasing numbers of bank failures, banks protect themselves by restricting the number of their outstanding loans; such a practice can create a "credit crunch," which may dramatically affect the ability of businesses to obtain the capital they need.¹²⁷ In such circumstances, banks restrict their lending policies

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120. 44 Bankr. 331 (Bankr. N.D. Ill. 1984).

121. 44 Bankr. at 337-42.

122. 44 Bankr. at 339-42.

123. 44 Bankr. at 337-38.

124. 44 Bankr. at 331-63.

125. The case illustrates the power one class of creditors retains in the reorganization process under § 1129. Although the Code's confirmation standard provides more flexibility than the old Bankruptcy Act, the rigid rule of absolute priority still permits one large creditor to block a feasible plan of reorganization.

126. Ahlers Brief, *supra* note 62, at 22. *But see* Nimmer, *supra* note 95, at 1052 (Circumstances exist where "[n]ew investors cannot easily be found, while the original owners are willing to take on a new risk to keep their business.").

127. See Edelman, *Business Groups Urge Easier Credit*, Boston Globe, Dec. 28, 1990; *How to Ease the Killer Credit Crunch*, L.A. Times, Feb 18, 1991, at B4, col. 3 (editorial); Johnson, *Low Bank Lending Growth Fuels Credit Crunch Fears*, Fin. Times, Apr. 20, 1991, at 1; Pine, 'Credit

and small businesses become "the victims of [a] nationwide credit crunch."¹²⁸ It certainly seems plausible that in a period of tight credit, shareholders could represent the only source of financing for the reorganization of a bankrupt enterprise. The new value exception, therefore, would represent the only potential source of financing for the debtor enterprise.

2. *The Midlantic Critique of the Solicitor General*

The confirmation rules codified by section 1129(b) of the Code retained the Bankruptcy Act's "fair and equitable" standard.¹²⁹ Under the old Act, the new value exception was part of the judicial definition of this standard.¹³⁰ The question remains, however, whether Congress meant the 1978 codification of the "fair and equitable" standard to include the new value exception. Because Congress failed to mention the new value exception in the legislative history,¹³¹ any determination of the scope of the "fair and equitable" standard involves an interpretation of legislative inaction.¹³² This subsection examines the Supreme Court's decisions in *Midlantic National Bank v. New Jersey Department of Environmental Protection*¹³³ and its progeny, which developed a rule of statutory interpretation specifically addressing the problem of legislative inaction during the revision of the federal bankruptcy law.¹³⁴

In *Midlantic*,¹³⁵ the Supreme Court set forth the basic principle for

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Crunch' Fears Growing: Despite Federal Assurances, Tales of Tight Money Have Experts Concerned that the Economy Could Be Pushed into a Recession, L.A. Times, July 1, 1990, at D1, col. 4; Rea, *U.S. Bankers Say Unlikely to Lend More on Fed Move*, Reuters, Dec. 4, 1990 (Money Report, available on NEXIS); *Little Evidence of Credit Crunch Easing Seen*, Reuters, Feb. 21, 1991 (Financial Report, Smith, available on NEXIS).

128. Pine, *supra* note 127, at D1, col. 5.

129. 11 U.S.C. § 1129(b)(1) (1988) ("[I]f all of the applicable requirements of subsection (a) of this section . . . are met with respect to a plan, a court . . . shall confirm the plan . . . if the plan does not discriminate unfairly, and is fair and equitable . . ."); see Ahlers Brief, *supra* note 62, at 20.

130. Prior to the adoption of the Bankruptcy Code in 1978, the term "fair and equitable" was not statutorily defined. See Ahlers Brief, *supra* note 62, at 20. The Supreme Court asserted that a plan met the fair and equitable standard only if it satisfied the requirements of the absolute priority rule. *Louisville Trust Co. v. Louisville, New Albany & Chicago Ry.*, 174 U.S. 674, 683-84 (1899); see *supra* notes 32-37 and accompanying text. The Court developed the new value exception in *Case* as an equitable solution to problems created by the rigid absolute priority rule. See *supra* notes 47-54 and accompanying text. The judicial interpretation of the fair and equitable standard set forth in § 77B of the Bankruptcy Act, therefore, included the new value exception.

131. See, e.g., H.R. REP. NO. 95-595, 95th Cong., 1st Sess. 413, reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6369.

132. See Eskridge, *Interpreting Legislative Inaction*, 87 MICH. L. REV. 67 (1988) (discussing various methods of statutory interpretation applied to problem of legislative inaction).

133. 474 U.S. 494 (1986).

134. See *Kelly v. Robinson*, 479 U.S. 36, 44-47 (1986).

135. 474 U.S. 494 (1986).

interpreting the impact of revised Code provisions on pre-Code bankruptcy law: "[t]he normal rule of statutory construction is that if Congress intends for legislation to change the interpretation of a judicially created concept, it makes that intent specific. The Court has followed this rule with particular care in construing the scope of bankruptcy codifications."¹³⁶ This principle has governed the Supreme Court's interpretations of the revised Code's effect on preexisting judicial doctrine.¹³⁷

In *Kelly v. Robinson*,¹³⁸ the Court relied on the *Midlantic* doctrine to hold that section 523(a)(7) preserves from discharge in Chapter 7 any condition imposed by a state criminal court as part of a criminal sentence.¹³⁹ The Supreme Court reversed the Second Circuit's discharge of the respondent's debt, asserting that a judicial exception preventing discharge of a criminal penalty developed under the old Bankruptcy Act remained viable under the revised Code, notwithstanding the language of section 523(a)(7).¹⁴⁰ Although the most reasonable interpretation of section 17 of the old Bankruptcy Act clearly permitted the discharge of criminal penalties in bankruptcy,¹⁴¹ courts refused to allow such discharge.¹⁴² Relying on *Midlantic*, the *Kelly* majority held that this widely accepted judicial exception remained viable under the Bankruptcy Code in the absence of a clear expression of congressional intent to eliminate it.¹⁴³ *Kelly* and *Midlantic* therefore establish the interpretive principle that congressional inaction signifies an intent to accept pre-Code law.¹⁴⁴

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136. 474 U.S. at 501 (citation omitted). The *Midlantic* decision focused on whether the pre-Code rule that a bankruptcy trustee "could not exercise his abandonment power in violation of certain state and federal laws," 474 U.S. at 495, survived the 1978 code revision. Four dissenters rejected the Court's conclusion that 11 U.S.C. § 554 (1988) codified the preexisting law. 474 U.S. at 507-17. The dissent, however, accepted the majority's reasoning, arguing only that "three rather isolated cases do not constitute the sort of settled law that we can fairly assume Congress intended to codify absent some expression of its intent to do so." 474 U.S. at 512 (Rehnquist, J., dissenting). The division of opinion, therefore, centered on the application of the *Midlantic* doctrine, not on its legitimacy.

137. See *infra* notes 138-57 and accompanying text.

138. 479 U.S. 36 (1986).

139. 479 U.S. at 50-51. Section 523(a)(7) states that a discharge does not relieve a debtor from any debt "to the extent such debt is for a fine, penalty, or forfeiture payable to and for the benefit of a governmental unit, and is not compensation for actual pecuniary loss, other than a tax penalty . . . ." 11 U.S.C. § 523(a)(7) (1988). The respondent in *Kelly* pleaded guilty to larceny based on her wrongful receipt of welfare payments; the court placed her on probation, conditioned upon her making monthly restitution payments to the State of Connecticut Office of Adult Probation. 479 U.S. at 38-39. The case centered on the question of whether such payments could be discharged in bankruptcy. 479 U.S. at 43.

140. 479 U.S. at 44-47 (Congress "enacted the Code in 1978 against the background of an established judicial exception to discharge for criminal sentences, including restitution orders. . .").

141. 479 U.S. at 44-45.

142. 479 U.S. at 45.

143. 479 U.S. at 47.

144. The Court, however, recently interpreted the meaning of *Kelly* and *Midlantic* in a man-

The *Midlantic* doctrine emerged from the long tradition of cases establishing the reenactment doctrine,¹⁴⁵ which holds that "the reenactment by Congress, without change, of a statute, which had previously received long continued executive [or judicial] construction, is an adoption by Congress of such construction."¹⁴⁶ *Hecht v. Malley*¹⁴⁷ illustrates the application of the doctrine in a nonbankruptcy context. *Hecht* questioned whether the Revenue Acts of 1916 and 1918 subjected "Massachusetts trusts" to a special excise tax imposed upon certain organizations.¹⁴⁸ The Court noted that the Act of 1916 utilized

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ner that limits their value as precedent establishing the reenactment doctrine. *United States v. Ron Pair Enters.*, 489 U.S. 235 (1989). Written by Chief Justice Rehnquist, the author of the *Midlantic* dissent, *Ron Pair* asserted that in both *Midlantic* and *Kelly* the Court "looked to pre-Code practice for interpretive assistance, because it appeared that a literal application of the statute would be 'demonstrably at odds with the intentions of its drafters.'" 489 U.S. at 244 (quoting *Griffin v. Oceanic Contractors, Inc.*, 458 U.S. 564, 571 (1982)). *Ron Pair* thus limits the application of the *Midlantic* doctrine to cases involving ambiguous statutory language.

Two factors, however, mitigate the significance of *Ron Pair*. First, the Court goes to great lengths to explain that the practice of denying postpetition interest to the holders of nonconsensual liens, while granting it to holders of consensual liens, was not well established under the Bankruptcy Act. *Ron Pair*, 489 U.S. at 246-49. *Ron Pair*, therefore, fell outside the purview of the *Midlantic* doctrine and thus the case can be interpreted as applying the *Girouard v. United States*, 328 U.S. 61 (1946), exception to the reenactment doctrine. Under the *Girouard* exception, a court will refuse to apply the reenactment doctrine where it finds that congressional silence evidenced a belief that the prior judicial law was unclear. 328 U.S. at 69-70.

Second, Justice O'Connor, who joined the dissent in *Midlantic*, wrote a vigorous dissent to the majority's interpretation of *Midlantic* in *Ron Pair*. Because there exists a long tradition of judicial acceptance of the reenactment doctrine, see *infra* notes 145-51 and accompanying text, the Court probably will refuse to overrule *Midlantic* in order to avoid calling the entire doctrine into question. *Ron Pair*, therefore, should be understood merely as an application of the *Girouard* exception to the reenactment doctrine.

145. See, e.g., *Edmonds v. Compagnie Generale Transatlantique*, 443 U.S. 256, 266-67 (1979) ("The reports and debates leading up to the 1972 Amendments contain not a word of this concept. This silence is most eloquent, for such reticence while contemplating an important and controversial change in existing law is unlikely."); *Lorillard v. Pons*, 434 U.S. 575, 580 (1978) ("Congress is presumed to be aware of an administrative or judicial interpretation of a statute and to adopt that interpretation when it re-enacts a statute without change."); *Morissette v. United States*, 342 U.S. 246, 263 (1952) (In cases where Congress employs well-understood legal terms of art, it presumably "knows and adopts the cluster of [legal] ideas that were attached to each borrowed word," and the "absence of contrary direction may be taken as satisfaction with widely accepted definitions, not as a departure from them."); *Hecht v. Malley*, 265 U.S. 144, 153 (1924) ("In adopting the language used in an earlier act, Congress must be considered to have adopted also the construction given by this Court to such language, and made it a part of the enactment."); *Sessions v. Romadka*, 145 U.S. 29, 42 (1891) ("Congress, having in the Revised Statutes adopted the language used in the act of 1837, must be considered to have adopted also the construction given by this court to [the sentence in question], and made it a part of the enactment."); *Shaw v. Railroad Co.*, 101 U.S. 557, 565 (1880) ("No statute is to be construed as altering the common law, farther than its words import.").

146. *United States v. Cerecedo Hermanos y Compania*, 209 U.S. 337, 339 (1908). The Court has recognized two exceptions to the rule. First, the Court will not apply the reenactment doctrine where it finds that congressional silence signified a belief that the prior judicial law was unsettled. See *Girouard v. United States*, 328 U.S. 61, 69-70 (1946). Second, the Court will reject the reenactment doctrine when a preexisting judicial concept directly contradicts clear statutory language. See *United States v. Ron Pair Enters.*, 489 U.S. 235 (1989); *Leary v. United States*, 395 U.S. 6, 18-29 (1969); see also *Eskridge*, *supra* note 132, at 81-83.

147. 265 U.S. 144 (1924).

148. 265 U.S. at 145-46.

the language "now or hereafter organized under the laws of the United States, or any State or Territory" in precisely the same manner as the 1909 Act.¹⁴⁹ The 1911 case of *Eliot v. Freeman*¹⁵⁰ had held that this language did not subsume "Massachusetts trusts"; thus, the *Hecht* court ruled that the Act of 1916 did not apply to "Massachusetts trusts" because "[i]n adopting the language used in an earlier act, Congress must be considered to have adopted also the construction given by this Court to such language, and made it a part of the enactment."¹⁵¹ *Midlantic*, therefore, did not create new doctrine, but rather applied a standard principle of statutory interpretation to the Bankruptcy Code.

The new value exception was a well-established principle when Congress drafted the 1978 Bankruptcy Code.¹⁵² As the Supreme Court recently asserted in a case involving an analogous issue of statutory construction, "[s]uch a major change in the existing rules would not likely have been made without specific provision in the text of the statute; it is most improbable that it would have been made without even any mention in the legislative history."¹⁵³ *Midlantic* creates a

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149. 265 U.S. at 152-53.

150. 220 U.S. 178 (1911).

151. *Hecht*, 265 U.S. at 153. Because the Revenue Act of 1918 utilized different language than the previous two Acts, the Court held that it did apply the excise tax to "Massachusetts trusts." 265 U.S. at 154-62.

152. See *supra* notes 25-54 and accompanying text; see also Klee, *Cram Down II*, *supra* note 16, at 241 ("Admittedly, no reported decision appears to exist under the Bankruptcy Act in which the exception applied, but there can be little doubt that the new value exception existed."). But see Ayer, *supra* note 12, at 1006-07 ("[N]either of the cases taken as seminal for the new value doctrine can be read as an application of the new value doctrine. *Kansas City Terminal [Railway]* 'states' it, but in a self-contradictory manner, and accepts the ruling of the lower court when that court chose not to apply it. *Case* 'states' it well enough . . . but then refuses to apply it on the particular facts."); White, *Absolute Priority and New Value*, 8 COOLEY L. REV. 1, 5 (1991) (stressing that the creation of the new value exception was dictum).

Critics of the new value exception overemphasize the *Case* court's refusal to apply the new value exception — this fact alone is not sufficient to characterize the rule as dictum. The term "dictum" refers to "an observation or remark made by a judge in pronouncing an opinion upon a cause, concerning some rule, principle, or application of law, or the solution of a question suggested by the case at bar, but not necessarily involved in the case or essential to its determination." BLACK'S LAW DICTIONARY 454 (6th ed. 1990). *Case* refused to confirm the plan at issue because it failed to meet the "money or money's worth" requirement of the new value exception. See *supra* notes 47-54 and the accompanying text. The Court's discussion of the new value exception, therefore, represented an integral part of this holding and was essential to the decision. *Case* is meaningless if one ignores the existence of the new value exception.

The fact that the new value exception remained unchallenged until after the *Ahlers* decision, see *supra* notes 56-60 and accompanying text, undermines the position of Professors White and Ayer. Without judicial authority for their position, Professors White and Ayer rely on arguments that question the rule's merits. See Ayer, *supra* note 12, at 1011-16; White, *supra*. Professor White in particular reveals the problems surrounding the rule and persuasively argues that it should not exist. Such arguments, however, must be distinguished from those addressing the question whether the Bankruptcy Code eliminated the new value exception. To paraphrase Justice Scalia's concurrence in *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69, 96-97 (1987), the law can be economically inefficient and still be the law.

153. *United Savings Assn. v. Timbers of Inwood Forest*, 484 U.S. 365, 380 (1988). Although the *Timbers* Court is referring to the petitioner's interpretation of 11 U.S.C. § 326(d)(1) (1988)

presumption that congressional silence concerning the effect of a statutory revision upon preexisting law signifies an acceptance of such doctrine.

The Solicitor General's interpretation of the Code ignores the statutory construction rule announced in *Midlantic*.¹⁵⁴ The bankruptcy court in *In re Greystone III Joint Venture*¹⁵⁵ articulated this inherent weakness in the Solicitor General's argument:

It is fair to assume that Congress was aware of *Case* when it passed the Bankruptcy Code. . . . 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 long-standing equitable expansion of the absolute priority rule should be presumed to still be good law.¹⁵⁶

The Solicitor General's brief proves unpersuasive because its reading of the Bankruptcy Code contradicts traditional methods of statutory construction. The inherent weakness in the Solicitor General's argument is best revealed by his inability to invoke a principle of statutory interpretation contrary to the *Midlantic* doctrine. The *Ahlers* brief relies on the legislative silence concerning the new value exception as evidencing legislative intent to eliminate it;¹⁵⁷ yet, the Supreme Court explicitly rejected this form of analysis in *Midlantic*. Ultimately the Solicitor General challenged an established principle of law on the strength of a strained interpretation of the Code — virtually no case law supported the Solicitor General's position. Courts, therefore, should resist the temptation to adopt his analysis.

D. *Economic Principles and the Attack on New Value*

This section discusses the arguments raised by scholars utilizing economic analysis to examine the viability of the new value exception under the Bankruptcy Code. It first examines Professors Douglas Baird and Thomas Jackson's economic critique of the new value exception.¹⁵⁸ It next discusses Professor Raymond Nimmer's economic

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and its effect on doctrine created by the courts under the Bankruptcy Act, the statement is relevant to the present discussion. See also *Kelly v. Robinson*, 479 U.S. 36, 51 (1986) (quoting *TVA v. Hill*, 437 U.S. 153, 209 (1978) (Powell, J., dissenting)) ("If Congress had intended [to alter such an important judicially created doctrine] 'we can be certain that there would have been hearings, testimony, and debate concerning consequences so wasteful, so inimical to purposes previously deemed important, and so likely to arouse public outrage.'").

154. 474 U.S. 494 (1986); see *supra* notes 65-79 and accompanying text.

155. 102 Bankr. 560 (Bankr. W.D. Tex. 1989).

156. 102 Bankr. at 575 n.20. But see *In re Drimmel*, 108 Bankr. 284, 289 (Bankr. D. Kan. 1989) (arguing that the Code's failure to include the new value exception signified congressional intent to eliminate the rule).

157. See *supra* notes 65-87 and accompanying text.

158. Baird & Jackson, *supra* note 27.

defense of the new value exception.¹⁵⁹ This section concludes that although Baird and Jackson reveal the shortcomings of the present formulation of the new value exception, Nimmer's analysis more clearly comports with the purposes of the Bankruptcy Code. Economic analysis, therefore, supports the conclusion mandated by the *Midlantic* doctrine, showing that the new value exception should continue to exist.

Baird and Jackson mount their strongest attack on the new value exception as part of their economic critique of the absolute priority rule.¹⁶⁰ They assert that the absolute priority rule exists because the legal community believes that a special forum is required to govern post-bankruptcy negotiations. They note, however:

This premise is fundamentally flawed. The ambition of a bankruptcy code should not be to ensure that everyone can participate in all post-petition renegotiations. There is no virtue in bargaining for its own sake. Bankruptcy law should ensure that fights about who owns a firm's assets should not undercut efforts to use them in the most beneficial way possible. The best way to achieve this goal is to identify the residual owners and give them the power to make decisions. The residual owners should always be the ones who enjoy the benefits of making good decisions and incur the costs of making bad ones. The *Boyd* rule does not do this.¹⁶¹

Baird and Jackson focus on situations in which the senior creditor's claims outstrip the value of the firm.¹⁶² In such cases, the senior creditor is entitled to all of the firm's assets and thus effectively owns the firm.¹⁶³ The Bankruptcy Code should provide the senior creditor with the power to determine the future of the organization, just as the actual owner of an enterprise governs its existence under normal circumstances. Therefore, according to Baird and Jackson, the senior creditor should be free from legal rules that protect claimants who no longer have any legitimate economic interest in the firm.¹⁶⁴

Once the law decides to place the bankrupt enterprise under the control of the senior creditors, Baird and Jackson argue, the new value exception will cease to exist. Because senior creditors will bargain to achieve shareholder participation if they think it will prove economically efficient, the rule does not necessarily assist the process of reorganization.¹⁶⁵ Shareholders benefit from application of the new value

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159. Nimmer, *supra* note 95.

160. Baird & Jackson, *supra* note 27; see also Ayer, *supra* note 12; White, *supra* note 152.

161. Baird & Jackson, *supra* note 27, at 787-88.

162. *Id.* at 742-73.

163. *Id.*

164. *Id.* at 743.

165. See Ayer, *supra* note 12, at 1011-16. If the old shareholder is willing to pay for continued participation in the firm, then she must believe that such continued participation is worth more than the payment assuring it — otherwise, no rational person would make the payment. Thus, some excess value must be obtained by keeping the firm together as a going concern. This value should, under traditional principles of bankruptcy, be allocated to the intermediate credi-

exception only in cases where the residual owner believes shareholders' participation is not in the reorganization's best interest.¹⁶⁶ Thus, Baird and Jackson assert that the new value exception encourages inefficiency¹⁶⁷ and should have no role in the revised Code.

Nimmer, however, has argued in favor of the new value exception. He asserts that the new value exception serves as a method of loss allocation, providing the old shareholders with a bargaining tool in negotiations with creditors:

The owners . . . are a source of capital different in kind from new investors in that they have an ongoing role in the reorganization and a prior investment in the company. The new value concept is a loss allocation rule. Permitting a new capital contribution as a way to continue ownership not only permits the new investment, but also gives the owners an additional tool with which to negotiate a plan. The owners' increased influence is based on their willingness to increase their risk.¹⁶⁸

The greater leverage provided to the debtor by the new value rule thus increases the loss allocative efficiency of the Bankruptcy Code.¹⁶⁹

Bankruptcy rules, according to Nimmer, serve to allocate the losses associated with the debtor's insolvency.¹⁷⁰ The Bankruptcy Code governs the process through which the parties negotiate a settlement: "Chapter 11 rules allocate leverage that permits the parties to reach tailored outcomes of allocated loss and retained benefits."¹⁷¹ Debtor protection, Nimmer argues, represents a significant policy goal of bankruptcy law,¹⁷² one that can be achieved only to the extent that the Code provides debtors with leverage in the postpetition negotiations.¹⁷³

The new value exception provides such leverage by allowing the

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tors. No sale, therefore, should be allowed. *Id.*; see also Baird & Jackson, *supra* note 27, at 743-45. At the very least, in such a situation the intermediate creditors should have an opportunity to outbid the old shareholder for the continued participation in the firm so as to capitalize on the enterprise's going-concern value. See *infra* notes 178-91 and accompanying text.

166. Baird & Jackson, *supra* note 27, at 743-60.

167. *Id.* at 787-89.

168. Nimmer, *supra* note 95, at 1052.

169. *Id.* at 1082-84.

170. *Id.* at 1010.

171. *Id.* at 1083.

172. *Id.* at 1027-32, 1082 ("[A]s a general matter, bankruptcy law substitutes a theme of debtor protection for a state law theme of creditor dominance in debt collection matters.").

173. *Id.* at 1017-23. Nimmer argues that, particularly in the case of the close corporation, shareholders deserve increased leverage precisely because bankruptcy proceedings involve noneconomic issues:

It is fully appropriate to permit the individual to exercise leverage in negotiations based on a willingness to invest time, cash, or effort into a business, a substantial portion of which will accrue to the creditors. Treating the individual who is willing to make such a commitment in the same manner as if he were a mere shareholder-investor who was protecting only a financial stake would simply ignore the reality of personal commitment that should be encouraged, not disregarded, in bankruptcy.

Id. at 1084.

debtor's shareholders to retain ownership of the debtor over the creditors' objection.¹⁷⁴ This leverage counterbalances the power granted the creditors by the absolute priority rule. Without the new value exception, creditors retain the power to liquidate the debtor corporation even in cases where reorganization would prove beneficial to society.¹⁷⁵ To the extent that the Bankruptcy Code allows negotiations between the parties to determine the fate of the debtor corporation, the new value exception increases allocative efficiency — one-sided negotiations rarely achieve efficient results. Nimmer therefore concludes that the new value exception significantly assists the process of reorganization and thus should remain an integral part of the Bankruptcy Code.¹⁷⁶

Nimmer's examination of the new value exception directly confronts the idea that debtor protection is an important aspect of bankruptcy law.¹⁷⁷ As such, it views the question concerning the new value exception as part of a larger debate surrounding the proper aims of the Bankruptcy Code. Rather than challenging the congressionally mandated policies of federal bankruptcy law, Nimmer adopts a position entirely consistent with the underlying policy goals of the Bankruptcy Code. Nimmer's argument, therefore, proves persuasive — economic analysis supports the proposition that the new value exception continues to exist under the Bankruptcy Code.

III. THE FUTURE OF NEW VALUE

The arguments raised in opposition to the new value exception fail to address the *Midlantic* standard. Decisions critical of the exception attack only the merits of the rule — challenging the basis of the Supreme Court's opinion in *Case*¹⁷⁸ rather than confronting the lack of evidence that Congress intended to remove the exception from the Code. This Part discusses the future of the new value exception under the Bankruptcy Code. This Note proposes that a plan relying on the new value exception should initiate a process providing all interested parties with the opportunity to bid for the shareholder's stake in the reorganized debtor; this revision would protect the rights of unsecured creditors without denying debtors access to this important bargaining tool. The revised new value exception could serve to silence the economic criticism of its detractors without compromising its utility in softening the rigidity of the absolute priority rule.¹⁷⁹

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174. *Id.* at 1083.

175. This argument is only suggested by Nimmer, although it implicitly underlies his conclusions. *See id.* at 1082-84.

176. *Id.*

177. *Id.* at 1027-32.

178. *Case v. Los Angeles Prods. Lumber Co.*, 308 U.S. 106 (1939).

179. It is important to recognize that under certain circumstances, the new value exception

Critics of the new value exception assert that the rule enables judges to force a "sale" of the debtor enterprise to its prepetition equity holders.¹⁸⁰ Such a system, critics argue, promotes inefficiency by providing the owners with an unjust bargaining chip in negotiations surrounding the company's reorganization.¹⁸¹ The absolute priority rule protects unsecured creditors against abuses which frequently froze them out of reorganization plans in early bankruptcy proceedings.¹⁸² The new value exception, critics claim, undermines this protection without justification.¹⁸³ Although critics of new value overstate the case, the thrust of their argument has merit — the new value exception allows the debtor to retain assets which could be allocated to the unsecured creditors. The question remains, however, whether the exception still performs a legitimate function within the structure of the Bankruptcy Code.

The new value exception allows a court to confirm the shareholder's proposed plan over the objection of the unsecured creditors. As such it enables the court to interfere with the creditor's ability to control the debtor enterprise. This power limits the rights of unsecured creditors whose interests are statutorily prioritized above those of the shareholders.¹⁸⁴ Yet in order to promote the policy of reorganization mandated by the Code, shareholder participation in a reorganization is sometimes necessary. The challenge, then, is to retain the benefits of the new value exception in the Code without overly restricting the senior creditor's ability to control the process of reorganization.

The simple revision of the new value exception proposed by this Note could protect the rights of the unsecured creditors without eliminating the equitable underpinnings of the rule. Creditors who wish to prevent shareholder participation deserve the opportunity to provide a greater amount of capital than that offered by the equity holders.¹⁸⁵ At the same time, if no one will outbid the shareholders, the bankruptcy law should encourage the shareholders' participation because they represent the cheapest source of financing for the

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serves to protect against the inequitable results of a rigid application of the absolute priority rule. See *supra* notes 120-28 and accompanying text.

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

181. See Baird & Jackson, *supra* note 27, at 760-75.

182. See *supra* notes 29-40 and accompanying text.

183. See Ayer, *supra* note 12, at 1011-16.

184. 11 U.S.C. § 507 (1988).

185. Creditors could not include a forgiveness of debt in their bid, except to the extent that they were compensated under the proposed plan. For example, if a class of creditors was owed \$10 million but would receive only \$1 million under the plan of reorganization, they should be allowed to include only \$1 million of debt in their bid. Because the court is willing to confirm the plan over their objection, the creditors' claims already have suffered a reduction in value by 90%, and should be valued as such in the bidding process.

reorganization.¹⁸⁶

Shareholder participation in the reorganized debtor interferes with the contractually defined method of loss allocation that uniformly subordinates the shareholder's interests to those of the creditors.¹⁸⁷ The new value exception, therefore, should permit such participation *only* when it is justified by principles of equity.¹⁸⁸ The price of the shareholder's investment reflects her assumption of the risks associated with the restructuring process; concomitant with this risk is the reward of success. Thus, although some of the profits may be allocated to the impaired unsecured creditors, the equity holders should be allowed to reap the benefits of a successful reorganization.¹⁸⁹

In this revised form, the new value exception would provide for shareholder participation only in circumstances where they represented the only viable source of financing for the debtor. Creditors would unite to outbid the equity holders in any case where they believed the firm's going concern value outstripped the amount allocated to the creditors under the reorganization plan,¹⁹⁰ thus preventing the latter's participation in the reorganization. Under such conditions, the new value exception would serve only to initiate reorganizations requiring participation by the old shareholders.¹⁹¹ The foundation of the economic critique of the new value exception, therefore, would be eliminated.

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186. From the creditors' perspective, a problem arises when a proposed plan premises shareholder participation on a large capital investment. In such a case, unsecured creditors must either invest a large sum of money into a failing corporation or allow the court to eliminate their contractual rights. The apparent inequity created in such a situation is counterbalanced by the problems associated with the rigid application of the absolute priority rule. See *supra* notes 42-52 and accompanying text. Furthermore, as Professor Nimmer has argued, the new value exception is a loss allocation rule that protects the debtors' interests in postpetition negotiations. See *supra* notes 168-77 and accompanying text. The new value exception simply restricts a creditor's rights on the assumption that it creates a more equitable forum in which to conduct postpetition negotiations.

187. See Nimmer, *supra* note 95, at 1056.

188. Professor Nimmer asserts that principles of equity justify shareholder participation only in those cases where "the transaction clearly benefits the creditors and represents a significant investment risk for the owners." *Id.* at 1065.

189. Obviously, if a group of creditors outbid the shareholders, they should reap the benefits of a successful reorganization.

190. For example, imagine that the equity holders propose a plan which provides them with an equity stake in the reorganized enterprise in exchange for an investment of \$1 million; furthermore, assume that an impaired class of creditors objects because they would receive only \$250,000 on their claim of \$1 million under the plan. If the equity holders proposed the plan because they believe that the company provides a reasonable profit opportunity, the creditors have a choice: (1) if they believe they can operate the company in an efficient manner and reap the potential profits, they can outbid the shareholders, assuming such an investment provides a return greater than the \$750,000 loss allocated to them under the proposed plan; or (2) they can concede that the equity holders are more efficient operators of the firm and accept partial payment on their debt. In either case, the reorganized debtor will be operated by the most efficient owner.

191. Application of the new value exception in such cases promotes reorganization — the principle goal of the Bankruptcy Code. See *supra* note 2 and accompanying text.

CONCLUSION

The debate concerning the continuing viability of the new value exception centers on conflicting interpretations of the congressional codification of the "fair and equitable" standard. *Midlantic* requires an explicit statement of congressional intent if legislation is to change the interpretation of judicially created concepts. Neither the Bankruptcy Code nor its legislative history evidences Congress' desire to eliminate the well-established principle of new value. The new value exception, therefore, remains a living principle of American bankruptcy law.

The new value exception is an important part of the tradition of American bankruptcy law; it represents a judicial recognition that the rigid application of the absolute priority rule frequently produces inequity. Critics argue that the rule weakens the position of unsecured creditors for no legitimate reason. The judiciary could silence such criticism by adopting the revision suggested by this Note, which would allow creditors to outbid shareholders for the right to participate in the plan of reorganization. Congressional action, however, is necessary to eliminate the rule.

— *Clifford S. Harris*