No. _____

In the Supreme Court of the United States

OCTOBER TERM, 1997

BANK OF AMERICA NATIONAL TRUST AND SAVINGS ASSOCIATION,
Successor by merger to Bank of America Illinois,
Petitioner,

v.

203 NORTH LASALLE STREET PARTNERSHIP,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

The absolute priority rule, codified at 11 U.S.C. § 1129(b)(2)(B)(ii), provides that a plan of reorganization under Chapter 11 of the Bankruptcy Code may not be confirmed unless either all dissenting classes of unsecured creditors are paid in full, or no holder of a more junior claim or interest "receive[s] or retain[s] under the plan on account of such junior claim or interest any property."

The question presented in this case is the same one this Court granted certiorari to consider, but did not resolve, in *U.S. Bancorp Mortgage Co.* v. *Bonner Mall Partnership*, 513 U.S. 18 (1994):

Whether the Bankruptcy Code authorizes a judge to confirm a Chapter 11 plan of reorganization that grants the pre-bankruptcy equity owners of a debtor an exclusive opportunity to retain or purchase an ownership interest in the reorganized debtor, but does not provide for full payment to a senior, objecting class of unsecured creditors.

RULE 14.1(b) AND 29.6 STATEMENT

The parties in the court of appeals were Petitioner Bank of America Illinois, now known, as a result of a merger, as Bank of America National Trust and Savings Association, and Respondent 203 North LaSalle Street Partnership, an Illinois limited partnership.

Petitioner Bank of America National Trust and Savings Association is a wholly owned subsidiary of BankAmerica Corporation, which is a publicly held company. Bank of America National Trust and Savings Association has no nonwholly owned subsidiaries.

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PETITION FOR A WRIT OF CERTIORARI

Petitioner Bank of America National Trust and Savings Association, successor by merger to Bank of America Illinois (the "Bank"), respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Seventh Circuit.

OPINIONS BELOW

The opinion of a divided panel of the court of appeals (App., *infra*, 1a-47a) is reported at 126 F.3d 955. The order of the court of appeals denying rehearing and denying rehearing en banc by a 5-5 vote (App., *infra*, 48a-49a) is not reported. The opinion of the district court (App., *infra*, 50a-101a) is reported at 195 B.R. 692. The opinion of the bankruptcy court (App., *infra*, 102a-154a) is reported at 190 B.R. 567.

JURISDICTION

The judgment of the court of appeals was entered on September 29, 1997. App., *infra*, 1a. A timely petition for rehearing was denied on November 25, 1997. App., *infra*, 48a-49a. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTE INVOLVED

11 U.S.C. § 1129(b) provides in pertinent part:

(1) * * * the court * * * shall confirm the plan * * * if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.

(2) For the purpose of this subsection, the condition that a plan be fair and equitable * * * includes the following requirements:

* * *

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

> (i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or
>
> (ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property.

STATEMENT

A. The Absolute Priority Rule

The absolute priority rule in bankruptcy "provides that a dissenting class of unsecured creditors must be provided for in full before any junior class can receive or retain any property [under a reorganization] plan." *Norwest Bank Worthington* v. *Ahlers*, 485 U.S. 197, 202 (1988) (internal quotation marks omitted). The rule was originally a judicial development but now is incorporated into the Bankruptcy Code, in 11 U.S.C. § 1129(b)(2)(B)(ii). *Ahlers*, 485 U.S. at 202.

Justice Douglas's opinion for the Court in *Case* v. *Los Angeles Lumber Products Co.*, 308 U.S. 106, 121-122 (1939), contained dicta that have been read to suggest that there was or is a new value exception to the absolute priority rule. *Ahlers*, 485 U.S. at 203. Such an exception, if it exists, would allow the debtor's pre-petition equity holders the right (perhaps the exclusive right) to retain an interest in the reorganized debtor, despite not providing for more senior classes in full, if a bankruptcy judge determines that they have made substantial new contributions in money or money's worth that are reasonably equivalent to the retained interest and necessary to a successful reorganization. App., *infra*, 14a.

The new value exception is difficult to reconcile with the language of Section 1129(b)(2)(B)(ii), which forbids pre-petition

equity holders to "receive or retain under the plan *on account of such junior claim or interest* any property" unless more senior interests consent or are paid in full (emphasis added). Accordingly, this Court in *Ahlers* left open the question whether any new value exception exists. 485 U.S. at 203 n.3. Proponents of the new value exception maintain, however, that it is not actually an "exception" but a "corollary" to the absolute priority rule, because the equity holders' post-petition interests are received "on account of" the contributed new value rather than "on account of" their pre-petition interest. See App., *infra*, 17a, 21a.

This case squarely presents the question left open in *Ahlers*. The Seventh Circuit not only held that a new value exception exists, but also applied it to confirm an otherwise-unconfirmable plan of reorganization. The court did so even though the debtors were given the *exclusive* opportunity to buy into the reorganized debtor by contributing new value.

B. Factual Background

The debtor in this case, respondent 203 North LaSalle Street Partnership, is a real estate limited partnership whose principal asset is fifteen floors of an office building in downtown Chicago (the "Property"). App., *infra*, 2a. The debtor owes the Bank more than $93 million; the debt is secured by a non-recourse first mortgage on the Property that came due in January 1995. *Ibid*. When the debtor was unable to repay the loan, the Bank began foreclosure proceedings; shortly thereafter, the debtor filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code. *Ibid*.

At the time the bankruptcy court confirmed the debtor's Chapter 11 plan of reorganization, the debtor was insolvent and the Bank's secured claim was valued at $54.5 million, leaving the Bank with an unsecured deficiency claim of $38.5 million. App., *infra*, 4a n.4, 115a. The bankruptcy court found that the Property would not appreciate in value during the term of the plan such that (1) the

debtor would ever become solvent, or (2) the Bank would ever receive payment in full of its unsecured claim. *Id.* at 133a. The bankruptcy court also found that the present value of what the Bank would ultimately receive on its unsecured claim under the plan was only about 16% of the Bank's unsecured $38.5 million claim. *Id.* at 28a, 133a. These findings were not disturbed on appeal.

In addition to ensuring that the Bank would never receive payment in full of its $38.5 million unsecured claim, the plan gave the debtor's pre-bankruptcy equity holders the *exclusive* right to retain their equity interests in the debtor if they contributed new capital, the cash or cash equivalent portion of which had a present value of $4.1 million, to be paid over five years.[1] App. *infra*, 4a, 24a, 34a, 111a-112a. Only the debtor's pre-petition equity holders were given the opportunity to contribute new capital in exchange for retention of an ownership interest in the reorganized debtor. *Ibid*.

The Bank, by far the debtor's largest creditor, objected to confirmation on the ground, among others, that the plan violated the absolute priority rule, because the debtor's pre-bankruptcy equity holders had the exclusive right to retain their equity interests in the debtor even though the Bank's senior, unsecured claim was not satisfied in full under the plan. App., *infra*, 3a. The bankruptcy court nonetheless confirmed the plan; the court held that, although

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[1] Although the ordinary rationale for Chapter 11 reorganization is to ensure that a business with going-concern value can continue in operation despite cash-flow problems that leave it temporarily unable to meet its obligations, that was not the rationale here. As the bankruptcy court specifically found, the partners who owned the debtor in this case were motivated by another consideration: they would owe some $20 million in income taxes if the Bank were permitted to foreclose. App., *infra*, 3a, 112a-113a.

the plan ran afoul of the absolute priority rule, that rule was limited by the new value exception, which the plan satisfied. *Id.* at 135a-140a. The district court affirmed the bankruptcy court's decision. *Id.* at 79a-85a.

C. Proceedings In The Court Of Appeals

A divided Seventh Circuit panel upheld confirmation of the plan, holding among other things that the absolute priority rule codified at 11 U.S.C. § 1129(b)(2)(B) is subject to the new value exception (or new value "corollary"). App., *infra*, 13a-23a. Acknowledging that courts and commentators are "quite divided over this issue," *id.* at 18a n.8, the majority reasoned that

- This Court "established" the new value exception in *Case* v. *Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939), App., *infra*, 14a;
- "[F]or more than fifty years, the new value precept has been recognized as an important corollary or exception to the absolute priority rule," *id.* at 19a;
- When Congress adopted the Bankruptcy Code in 1978, there is "no question" that it "'must have enacted the Code with a full understanding' of the absolute priority rule and its new value corollary," *id.* at 20a; and
- Although "Congress did not explicitly codify the new value corollary" in the Code, the corollary "remains a part of our bankruptcy jurisprudence" because "Congress never explicitly declared * * * that it intended the abolition" of the doctrine, *id.* at 15a, 20a-21a, 23a.

Judge Kanne dissented. To begin with, Judge Kanne explained, "the plain language of the absolute priority rule, *see* 11 U.S.C. § 1129(b)(2)(B)(ii), does not include a new value exception"; indeed, the statutory text "fails to even hint at" the

existence of a new value exception. App., *infra*, 32a, 34a. Recognition of a new value exception is thus inconsistent with "the straightforward text of the statutory absolute priority rule." *Id*. at 38a.

In addition, Judge Kanne concluded that it is not reasonable to assume that Congress implicitly incorporated the new value exception into Section 1129(b)(2)(B)(ii), for two reasons. First, the new value exception rests on a "questionable foundation" under pre-Code law — dicta in *Case*, which "no reported case expressly adopted * * * as its holding until the Code's enactment in 1978" and which has since "'taken on a life of its own in the lower courts.'" *Id*. at 41a, 42a n.5. Second, the principles underlying the new value exception "differ greatly from those under the present Bankruptcy Code." *Id*. at 42a. Because of "the massive changes in bankruptcy procedures brought on by the Bankruptcy Code," "strict adherence to the pre-Code new value exception might *contravene* Congress's intent in codifying the absolute priority rule" and, at a minimum, does not indicate "Congress's intent to *include* a new value exception in § 1129(b)(2)(B)(ii)." *Id*. at 32a, 40a-41a (second emphasis added).

Only 10 of the 11 judges of the court of appeals considered the Bank's request for rehearing *en banc*. Judges Coffey, Easterbrook, Manion, Kanne, and Diane P. Wood voted to grant rehearing *en banc*, but the resultant 5-5 tie led to a denial of rehearing. App., *infra*, 48a-49a.

REASONS FOR GRANTING THE WRIT

Four years ago, this Court granted certiorari in *U.S. Bancorp Mortgage Co.* v. *Bonner Mall Partnership*, 513 U.S. 18 (1994), to decide an issue the Court left open in *Norwest Bank Worthington* v. *Ahlers*, 485 U.S. 197, 203 n.3 (1988): whether there is a new value exception to the absolute priority rule as codified in the Bankruptcy Code. That question is still unresolved. The Court did not decide the issue in *Bonner Mall* — it dismissed

the case as moot after the parties settled, see 513 U.S. at 29 — and since then the validity of a new value exception has continued to be the subject of vigorous debate by judges and commentators alike. See App., *infra*, 18a n.8 (majority opinion), 35a n.2 (dissenting opinion). As one leading scholar has stated, the existence of a new value exception is "[o]ne of the great unresolved questions in the Bankruptcy Code." DOUGLAS G. BAIRD, THE ELEMENTS OF BANKRUPTCY 259 (1993). But until this Court provides a definitive answer to that question, "interpretative chaos reigns" in the lower federal courts. Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 STAN. L. REV. 69, 94 (1991).

The Seventh Circuit's ruling here conflicts directly with decisions of both the Second Circuit, *In re Coltex Loop Central Three Partners, L.P.*, No. 96-5140, slip op. 7-17 (2d Cir. Feb. 19, 1998), and the Fourth Circuit, *In re Bryson Properties*, 961 F.2d 496, 504-505 (4th Cir. 1992). The Second Circuit, in fact, has explicitly rejected the panel majority's holding in this case, instead adopting Judge Kanne's dissent. *Coltex*, slip op. 8 ("the reasoning for our conclusion has been explained very well by the dissent in *LaSalle*").

In both *Ahlers* and *Bonner Mall*, the United States appeared as amicus curiae and urged this Court to hold that the new value exception does not exist or, at a minimum, is not so broad as to permit confirmation of a plan (such as the one here) in which the pre-petition equity holders receive the *exclusive* opportunity to receive a post-petition interest in return for an infusion of "new value." The government took that position in briefs signed by two different Solicitors General, appointed by two different Presidents. Thus, the Seventh Circuit's decision to allow confirmation of a "new value" plan featuring equity holder exclusivity conflicts with the considered views of the Executive Branch as well as decisions of the Second and Fourth Circuits and many lower courts.

The panel majority's decision also is at odds with the Bankruptcy Code. The existence of a new value exception is inconsistent with the plain language of Section 1129(b)(2)(B) as well as with the fundamental policy underlying the Bankruptcy Code: that the

interests of creditors take precedence over the interests of an insolvent debtor's equity holders. The new value exception contravenes that policy by permitting an insolvent debtor's insiders — who no longer have any economic interest in the debtor's property — to grant themselves the exclusive opportunity to obtain interests in the reorganized property without having to worry about competitive bids from creditors or outsiders. As a result, during the negotiations that accompany any proposed plan of reorganization, bargaining leverage will be tilted heavily in favor of the insolvent debtor's equity holders and away from its creditors.

There is little to be gained from further consideration of the issue by lower levels of the judiciary. Hundreds of decisions and law review articles have discussed the new value exception in excruciating detail, considering every possible nuance of the issue. In the meantime, plans of reorganization that are premised on the existence of a new value exception are becoming increasingly common. Since 1978, "there has been an explosion of cases which discuss the new value 'exception' to the absolute priority rule." Markell, *supra*, 44 STAN. L. REV. at 93. This trend has continued in the four years since the Court granted certiorari in *Bonner Mall*.

Whether there is a new value exception to the absolute priority rule needs to be resolved once and for all. The question has enormous practical significance in reorganizations under Chapter 11 and is squarely presented by this case. The petition should be granted.

I. COURTS AND COMMENTATORS ARE SHARPLY DIVIDED ON THE VALIDITY OF A NEW VALUE EXCEPTION TO THE ABSOLUTE PRIORITY RULE

Unless a plan of reorganization provides for payment in full to a dissenting, senior class of unsecured creditors, the absolute priority rule prohibits the confirmation of any plan if a junior class of unsecur-

ed creditors or equity interest holders "receive[s] or retain[s] under the plan on account of such junior claim or interest *any property*." 11 U.S.C. § 1129(b)(2)(B)(ii) (emphasis added). See also *Ahlers*, 485 U.S. at 202 ("'a dissenting class of unsecured creditors must be provided for in full before any junior class can receive or retain any property [under a reorganization] plan'"). Twice in recent years, this Court has expressly left open whether the absolute priority rule is subject to a new value exception. *Id*. at 203 n.3; *Bonner Mall*, 513 U.S. at 20 n.1. Since *Ahlers*, the lower federal courts have provided flatly inconsistent answers to that question.

1. It cannot seriously be doubted that the exclusive right to retain an equity interest in a business enterprise is "property" within the meaning of Section 1129(b)(2)(B)(ii). "[W]hile the Code itself does not define what 'property' means as the term is used in § 1129(b), the relevant legislative history suggests that Congress' meaning was quite broad," and included "'both tangible and intangible property.'" *Ahlers*, 485 U.S. at 208 (quoting H.R. Rep. No. 95-595, at 413 (1977)). Thus, "[e]ven where debts far exceed the current value of assets, a debtor who retains his equity interest in the enterprise retains 'property.'" *Id*. at 207-208. See also, *e.g.*, *Kham & Nate's Shoes No. 2, Inc.* v. *First Bank*, 908 F.2d 1351, 1360 (7th Cir. 1990) ("[a]n option to purchase stock also is 'property'" under § 1129(b)).

The Second and Fourth Circuits have relied on this broad definition of property in overturning confirmations of plans of reorganization that were the same in all material respects as the plan upheld by the Seventh Circuit in this case. Like the plan here, the *Coltex* and *Bryson* plans provided the debtor's pre-bankruptcy equity holders with the exclusive right to contribute new capital to, and receive equity interests in, the reorganized debtor, while at the same time denying full payment to senior classes of unsecured creditors. *Coltex*, slip op. 9; *Bryson*, 961 F.2d at 504-505.

Applying what each court held was "plain" statutory language, the Second and Fourth Circuits ruled that the plans violated the absolute priority rule. See *Coltex*, slip op. 9 ("the *exclusive* right to retain the debtor's property upon making a capital contribution is itself property," which was received "on account of equity's prior position"); *Bryson*, 961 F.2d at 504 (the "exclusive right to contribute [new capital] constitutes 'property' under § 1129(b)(2)(B)(ii), which was received or retained on account of a prior interest").[2]

On the same operative facts, the panel majority here reached precisely the opposite conclusion. The majority held that a plan that offered the debtor's prior equity owners the exclusive right to retain their ownership interests, in exchange for a contribution of new capital, passed muster under the Bankruptcy Code because the new value exception "remains a part of our bankruptcy jurisprudence." App., *infra*, 23a.

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[2] In *Bryson*, the Fourth Circuit also noted in passing that the proposed plan gave the equity holders "the right to return of their new capital prior to [the senior creditor's] recovery of its unsecured claim," 961 F.2d at 504, but that fact played no role in the court's ultimate holding. Rather, the court stated that its decision turned on "whether the equityholders receive[d] anything 'on account of' their prior interest" — and the only "'property'" that the court held "was received or retained on account of a prior interest" was the "exclusive right to *contribute*" new capital. *Ibid.* (emphasis added). In *Coltex*, the Second Circuit speculated that in the Seventh Circuit's *LaSalle* decision "it does not appear that the lender attempted to file a competing plan." Slip op. 7 n.1. In fact, the Bank *did* move to file a competing plan of reorganization here; the bankruptcy court denied that request. BAI R. 104.

The panel majority's holding conflicts directly with the decisions of the Second and Fourth Circuits. The *Coltex* court expressly agreed with the dissent in this case. The *Bryson* court stopped short of holding that the new value exception is not embodied in Section 1129(b), but its holding would require a different outcome in this case than the one reached by the Seventh Circuit. Both the Second and Fourth Circuits concluded that, even if a limited new value exception existed under the Code, it would not apply when a plan gave prior equity owners the *exclusive* opportunity to contribute new capital and receive or retain an equity interest in the reorganized business. *Coltex*, slip op. 13-14, 17; *Bryson*, 961 F.2d at 505. The same *exclusive* opportunity for prior equity holders exists in this case and in most other Chapter 11 proceedings in which a new value plan is proposed (including *Bonner Mall*).[3] See, *e.g.*, BAIRD, ELEMENTS OF BANKRUPTCY at 261. Had the present case arisen in the Second Circuit or the Fourth Circuit, those courts would have rejected the same plan of reorganization that the Seventh Circuit accepted.

2. In other cases, as well, the courts of appeals have expressed divergent views on whether there is a new value exception to the absolute priority rule. Before the Seventh Circuit's ruling here, the Ninth Circuit — in the case this Court agreed to review, but ultimately did not decide, in *Bonner Mall* — was the only court of appeals to have concluded that the new value exception continues

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[3] For extensive criticism of the Ninth Circuit's *Bonner Mall* decision (equally applicable to this case) on the ground that it allowed debtor exclusivity while simultaneously maintaining that the debtor was receiving nothing of value "on account of" pre-petition interests, see Michael H. Strub, Jr., *Competition, Bargaining, and Exclusivity Under the New Value Rule: Applying the Single-Asset Paradigm of Bonner Mall*, 111 BANKING L.J. 228 (1994). See also Brief for the United States as Amicus Curiae at 25-30, *Bonner Mall* (No. 93-714).

to exist. *In re Bonner Mall Partnership*, 2 F.3d 899, 906-918 (9th Cir. 1993). See also *In re U.S. Truck Co.*, 800 F.2d 581, 588 (6th Cir. 1986) (a pre-*Ahlers* decision, assuming without analysis that a new value exception exists).

But, as the Ninth Circuit recognized in *Bonner Mall*, other courts of appeals have taken different positions on whether there is a new value exception to the absolute priority rule. 2 F.3d at 901 ("dicta in several opinions demonstrate intra- and inter-circuit disagreements" on the question). See also *Coltex*, slip op. 7 (the "courts of appeal * * * have employed different reasoning to reach variable results"); 7 COLLIER ON BANKRUPTCY ¶ 1129.04[4][c], at 1129-102 (L. King 15th ed. rev. 1997) ("One of the more hotly contested issues after adoption of the Code has been whether the so-called 'new value' cases continued to have validity. * * * [T]he circuits are currently in disarray.").

In addition to the decisions of the Second and Fourth Circuits, a Fifth Circuit panel held flatly that the new value exception does not exist under the Bankruptcy Code. *In re Greystone III Joint Venture*, 995 F.2d 1274, 1282-1284 (5th Cir. 1991). The relevant portion of the opinion was later vacated by the panel, but Judge Jones (author of the panel opinion) vigorously dissented: "[I]n reaffirming what I wrote about the 'new value exception' in Part IV of the original opinion, * * * I would hope to stand with Galileo, who, rebuffed by a higher temporal authority, muttered under his breath, 'Eppur si muove.' ('And yet it moves.')." *Id.* at 1285. And, before the panel decision in this case, another Seventh Circuit panel strongly suggested, but did not decide, that the new value exception did not survive the codification of the absolute priority rule in 1978. *Kham & Nate's Shoes*, 908 F.2d at 1360-1362.

3. There is also a pronounced disagreement among district and bankruptcy courts concerning the new value exception. The Ninth Circuit noted in *Bonner Mall* that "[d]istrict and bankruptcy

courts are sharply divided on the question * * *. The question will in all probability be decided by the Supreme Court." 2 F.3d at 901. The panel majority here echoed that observation: "The district and bankruptcy courts are quite divided over this issue." App., *infra*, 18a n.8. See also *Bryson*, 961 F.2d at 503 ("courts are divided as to whether codification of the absolute priority rule * * * tolled a death knell for the [new value] exception"); J. Ronald Trost, et al., *Survey of the New Value Exception to the Absolute Priority Rule and the Preliminary Problem of Classification*, SB37 ALI-ABA 595, 677-699 (1997) (available on Westlaw) (collecting more than 100 published post-*Ahlers* decisions discussing whether a new value exception exists).

4. Bankruptcy scholars similarly dispute whether there is a new value exception to the absolute priority rule. See App., *infra*, 18a n.8 ("[a]cademics and commentators, too, have not agreed on the issue") (citing articles on each side of the debate); *Bonner Mall*, 2 F.3d at 901 (commentators are "sharply divided on the question").[4]

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[4] See also, *e.g.*, Trost, et al., *supra*, SB37 ALI-ABA at 603 ("The viability of new value plans under the Code has been hotly debated by courts and commentators"); Jarlon Tsang, *The New Value Exception: Valuation Obstacles to the Absolute Priority Rule*, 14 ANN. REV. BANKING L. 361, 369 (1995) (the Court's decision in *Ahlers* "ignited judicial and academic debate on [an] issue already clouded with uncertainty"); Salvatore G. Gangemi & Stephen Bordanaro, *The New Value Exception: Square Peg in a Round Hole*, 1 AM. BANKR. INST. L. REV. 173, 179 (1993) (*Ahlers* "has caused extensive comment within the legal community and much division among lower courts"); Clifford S. Harris, Note, *A Rule Unvanquished: The New Value Exception to the Absolute Priority Rule*, 89 MICH. L. REV. 2301, 2312 (1991) ("A significant

(continued...)

Many of the most thoughtful commentaries conclude — contrary to the Seventh Circuit here — that there is no such exception under the Code.[5] Others conclude — also inconsistently with the Seventh Circuit's position — that, if any such exception exists, it must not be applied so as to allow the debtor the *exclusive* right to infuse new equity.[6] The editors of one treatise find the issue so close that they have reached opposite conclusions in consecutive revisions of the same edition. Compare 7 COLLIER ON BANKRUPTCY ¶ 1129.04[4][c][iii], at 1129-117 to 1129-119 (L. King 15th ed. rev. 1997) (concluding that exception exists) with 5 COLLIER ON BANKRUPTCY ¶ 1129.03[e][i], at 1129-101 to 1129-102 (L. King 15th ed. 1996) (concluding that exception does not exist). This is manifestly an issue in need of resolution by this Court.

* * *

It has been nearly a decade since this Court left open the validity of the new value exception in *Ahlers*. After ten years of spirited debate, the federal courts and the commentators are in disarray on the issue. The differences are clear and well developed, and addi-

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[4] (...continued)
divergence of opinion concerning the viability of the new value rule has developed in the courts since *Ahlers*.").

[5] See, *e.g.*, Brian A. Basil, *The New Value Exception to Absolute Priority in Bankruptcy*, 101 COM. L.J. 290 (1996); Lawrence B. Gutcho, *Real Estate Lenders and the Battle over "New Value,"* 110 BANKING L.J. 423 (1993); Julie L. Friedberg, Comment, *Wanted Dead or Alive: The New Value Exception to the Absolute Priority Rule*, 66 TEMPLE L. REV. 893 (1993).

[6] See, *e.g.*, Strub, *supra*, 111 BANKING L.J. 228; Elizabeth Warren, *A Theory of Absolute Priority*, 1991 ANN. SURVEY AM. LAW 9, 39.

tional reflection by the lower courts is unlikely to result in a consensus view. It is time for this Court to resolve the question.

II. WHETHER THERE IS A NEW VALUE EXCEPTION TO THE ABSOLUTE PRIORITY RULE IS AN IMPORTANT AND RECURRING ISSUE

When this Court granted certiorari in *Bonner Mall*, it recognized the importance of deciding sooner rather than later whether the new value exception exists. Unfortunately, the parties' settlement left the Court unable to resolve the issue in that case. But it is just as true now as it was at the time of *Bonner Mall* that "[t]he 'new value' issue is perhaps the single most important bankruptcy law issue facing lenders today." Gutcho, *supra*, 110 BANKING L.J. at 423. "The split among and even within the circuits as to the viability of the exception has created unpredictability for debtors and the courts." Michelle Craig, Note & Comment, *The New Value Exception: A Plea for Modification or Elimination*, 11 BANKR. DEV. J. 781, 788 (1995). "Confusion over the absolute priority rule is deplorable, especially when the rule is fundamental to reorganization." Markell, *supra*, 44 STAN. L. REV. at 96.

It is particularly important that this Court rule on whether a new value exception exists because the question arises with such frequency in Chapter 11 proceedings. From the time this Court's decision in *Ahlers* first "caused a furor among lower courts," Markell, *supra*, 44 STAN. L. REV. at 95, until May 1997, federal courts published more than 100 decisions discussing the viability of a new value exception. See Trost, et al., *supra*, SB37 ALI-ABA at 677-699 (listing published rulings — the survey does not include unpublished decisions). The issue has also generated considerable scholarly debate. See *id*. at 672-676 (bibliography of relevant articles). "Few topics in bankruptcy have generated as much literature as the new value or fresh capital 'exception' to the absolute priority rule." Strub, *supra*, 111 BANKING L.J. at 233; see also, *e.g.*, Tsang, *supra*, 14 ANN. REV. BANKING L. at 363 ("the new

value exception is one of the most actively debated issues in bankruptcy").

As suggested by the sheer number of judicial decisions and academic commentaries on the topic, whether there is a new value exception to the absolute priority rule is an issue of "enormous practical import." Strub, *supra*, 111 BANKING L.J. at 233. Indeed, "[t]he issue of new value is critical because the principles underlying this concept are at the very core of bankruptcy law and the notion of reorganization." David R. Kuney & Timothy R. Epp, *Aftermath of* Bonner Mall: *Evolution or Regression in the Notion of "New Value"?*, 5 J. BANKR. L. & PRAC. 211, 211 (1996).

"Negotiations are the lifeblood of a corporate reorganization," BAIRD, ELEMENTS OF BANKRUPTCY at 266, and whether there is a new value exception will have a profound effect on the course of those negotiations. As the Ninth Circuit summarized in *Bonner Mall*, "[w]hether this doctrine is viable under the Bankruptcy Code has significant implications for the relative bargaining power of debtors and creditors in Chapter 11 cases." 2 F.3d at 901.

This is because the absolute priority rule, when "applied rigorously," acts as a "powerful brake on the debtor's behavior and a strong influence on the negotiation that is likely to occur over a reorganization plan" — it "make[s] the debtor more willing to negotiate" with creditors. DAVID G. EPSTEIN, STEVE H. NICKLES, & JAMES J. WHITE, BANKRUPTCY 839 (1993). If the absolute priority rule is watered down with a new value exception, there is a risk that the debtor's appraiser will convince "a sympathetic judge * * * that the value of the property in the bankruptcy estate is much lower than the creditors believe it to be." *Ibid*. See also BAIRD, ELEMENTS OF BANKRUPTCY at 266 ("the most serious danger that the new value exception introduces is that the judge will put a value on the firm that is too low"). This will decrease the amount paid to creditors, while at the same time permitting the debtor's pre-bankruptcy equity

holders to retain an ownership interest in the post-bankruptcy business at a bargain price. EPSTEIN, ET AL., BANKRUPTCY at 839; BAIRD, ELEMENTS OF BANKRUPTCY at 262-263, 266. "The shareholders will be getting a good deal at the creditors' expense," *id*. at 266, or, at a minimum, will be able to impose a plan of reorganization that dissenting classes of senior creditors have concluded is not in their best interests. See *Greystone*, 995 F.2d at 1284-1285 (Jones, J., dissenting) ("Negotiations between creditors and the debtor against such a 'new value exception' backdrop would be enormously skewed in favor of old equity and would seriously erode the utility of the creditors' votes."). If, on the other hand, the absolute priority rule is "applied rigorously," each class of creditors can protect itself against the possibility of a "small recovery" (or an otherwise unacceptable reorganization scheme) by "vetoing the plan." EPSTEIN, ET AL., BANKRUPTCY at 839.[7]

The "threat" of a new value plan "is often a powerful consideration at the negotiating table," Trost, et al., *supra*, SB37 ALI-ABA at 620, and thus the negotiations that occur in all Chapter

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[7] In enacting the Bankruptcy Code, Congress intended to promote consensual plans, but at the same time maintain the integrity of the absolute priority rule. It did so by granting the debtor the exclusive initial right to propose a plan of reorganization, see 11 U.S.C. § 1121, but providing that a plan ultimately could not be confirmed without satisfying the absolute priority rule. Thus, Congress placed the initial bargaining leverage in the hands of the debtor through its initial exclusive right to propose a plan, but intended the *ultimate* leverage to be with the creditors pursuant to the absolute priority rule. See generally *Coltex*, slip op. 13 (discussing "the balance sought to be achieved by Congress" in Chapter 11). The decision of the panel majority eviscerates this congressional design by vesting both the initial and ultimate leverage in the debtor's pre-bankruptcy equity holders.

11 proceedings will be shaped largely by whether or not the absolute priority rule is limited by a new value exception. In the end, the identity of the constituency that will determine the ultimate outcome of Chapter 11 cases when the debtor is insolvent — senior, unsecured creditors or the debtor's pre-bankruptcy equity holders — will depend on the answer to the question presented in this case.

III. THE PANEL MAJORITY'S DECISION IS FUNDAMENTALLY FLAWED

In addition to being inconsistent with the decisions of other courts, the panel majority's holding is seriously flawed. The language enacted by Congress in 1978 does not contain a single reference to the new value exception. Congress was not silent on how it wanted the absolute priority rule applied: the plain terms of the statute list the ways in which a plan can be crammed down on unconsenting creditors, and the new value exception is not among them. There is still less basis for postulating congressional "silence" and interpreting it as tacit acceptance of well-settled doctrine. On the contrary, the exception rests on the shakiest of legal foundations: a dictum that had never been the basis for the holding of *any* reported decision before adoption of the Bankruptcy Code nearly 40 years later. What is more, the legal landscape that prompted the suggestion of a new value exception in 1939 is fundamentally different from the law of bankruptcy that exists today. Finally, the new value exception violates basic principles of bankruptcy law; it permits those at the bottom of the priority ladder to control the debtor's property to the detriment of impaired creditors with a higher priority.

A. The Plain Statutory Language Does Not Include A New Value Exception

The "cardinal canon" of statutory construction is that "courts must presume that a legislature says in a statute what it means and means in a statute what it says there." *Connecticut Nat'l Bank* v.

Germain, 503 U.S. 249, 253-254 (1992). Thus, when a statute is unambiguous, judicial inquiry begins and ends with "the words of [the] statute." *Id.* at 254. In a case involving interpretation of the Bankruptcy Code, no less than any other statute, when "the statute's language is plain, 'the sole function of the courts is to enforce it according to its terms.'" *United States* v. *Ron Pair Enterprises*, 489 U.S. 235, 241 (1989) (quoting *Caminetti* v. *United States*, 242 U.S. 470, 485 (1917)).

The statute here is unambiguous. Section 1129(b)(2)(B)(ii) states that a plan that does not provide a dissenting class of unsecured creditors with property of a value equal to the amount of their claims *cannot* be confirmed unless "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*." (Emphasis added.) The language is unequivocal; it does not allow a junior class to receive "any" property "on account of" its pre-petition interest until senior classes are paid in full. Nor is there the slightest indication in the statute that the broad prohibition on the receipt of "any" property by junior classes is qualified by any type of exception. See *Bates* v. *United States*, 118 S. Ct. 285, 290 (1997) ("we ordinarily resist reading words or elements into a statute that do not appear on its face").

The court below, and other proponents of a new value exception, have attempted to find ambiguity in the statutory language through two devices. The first is the purest bootstrapping: because courts and commentators have differed about whether the new value exception exists, there *must* be ambiguity. See, *e.g.*, App., *infra*, 18a-19a. But that one-way ratchet, which renders the Bankruptcy Code more and more ambiguous whenever courts purport to find ambiguity in it leading to different constructions, is the path to interpretive chaos — not just in this case, but in every case involving any issue of even the slightest difficulty under the Code. Moreover,

the approach cannot be reconciled with this Court's decisions. In *Ron Pair*, for example, the majority found the Code unambiguous even though four Justices thought that the better construction was the one rejected by the majority. As Judge Kanne rightly pointed out, *all* of this Court's bankruptcy decisions "command courts to apply a statute's unambiguous language without looking beyond it." *Id.* at 38a.[8]

The second argument often advanced to try to fit the new value exception within the statutory language is that the equity holders' post-petition interest is not received or retained "on account of" their

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[8] The panel majority relied in part on the notion that past bankruptcy practice cannot be disregarded "absent a clear indication that Congress intended to break from those practices." App., *infra*, 20a. But as the Second Circuit recognized in *Coltex*, slip op. 10, this Court has stressed that the unambiguous words of a statute must be applied even when the statute changes established pre-Code practice. See *Dewsnup* v. *Timm*, 502 U.S. 410, 419-420 (1992) ("Of course, where the language is unambiguous, silence in the legislative history cannot be controlling"); *Pennsylvania Dep't of Public Welfare* v. *Davenport*, 495 U.S. 552, 560-564 (1990) (enforcing plain meaning of Bankruptcy Code provision even though it abrogated pre-Code practice). Applying the plain language of Section 1129(b) is particularly warranted here because there is no affirmative support in the Code's legislative history for the continued existence of the new value exception. See *Kham & Nate's Shoes*, 908 F.2d at 1361-1362. The complete absence of supporting legislative history distinguishes this case from *Dewsnup*, where there was legislative history indicating that Congress intended the pre-Code practice to survive. 502 U.S. at 419. See also *Union Bank* v. *Wolas*, 502 U.S. 151, 159 & n.14 (1991) (rejecting the argument that Congress intended to codify pre-Code law where the statute itself gave no such indication and the legislative history "does not even mention" the pre-Code practice).

pre-petition interest but rather "on account of" the new value they contribute. See, *e.g.*, App., *infra*, 17a, 21a. That argument suffers from the flaw of assuming that there is an inconsistency between occurring "on account of" one thing and *also* occurring "on account of" something else. For example, Justices sit on this Court "on account of" their appointment by the President, but they also enjoy their positions "on account of" confirmation by the Senate. It would be absurd to claim that a Member of this Court does not hold his or her seat "on account of" presidential appointment merely because it is *also* true that senatorial confirmation is necessary. So too in this case, the equity holders enjoy their post-petition interest under the plan "on account of" *both* their prior equity positions and their promise to contribute new value — in contravention of the plain language of Section 1129(b)(2)(B)(ii).

That is especially clear in this case because the debtor's pre-petition equity holders were given the *exclusive* right to propose a plan involving their own new contributions. Whatever force the "on account of" argument might have when an auction of some sort is held (see *In re Homestead Partners, Ltd.*, 197 B.R. 706, 714-716 & n.9 (Bankr. N.D. Ga. 1996)),[9] it falls apart when the equity holders' pre-petition interest gives them the *exclusive* right to participate over creditor dissent by providing "new value." See *Coltex*, slip op. 14 (explaining that the new value exception permits insiders to obtain the debtor's property at a "bargain" price "untested by market forces").

As noted earlier, the right of the debtor's partners to retain their equity interests is "property" for purposes of this section. See pp. 9-10, *supra*. Moreover, this is "property" that is to be received or retained "on account of" the partners' pre-petition ownership in the

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[9] For a fuller listing of cases suggesting an auction "solution," see Trost, et al., *supra*, SB37 ALI-ABA at 651-652 & nn.208-211, 658 & nn.242-243, 666-667 & nn.281-293.

debtor. On the facts of this case, they are receiving this *exclusive* opportunity *solely* "on account of" their prior equity interests in the debtor. Prior equity holders are the *only* persons permitted to make such an investment; other investors are barred from doing so. See App., *infra*, 34a (Kanne, J., dissenting); *Coltex*, slip op. 9-11; *Bryson*, 961 F.2d at 504-505; *Greystone*, 995 F.2d at 1283, 1285 (Jones, J., dissenting).

Had Congress wanted to include a new value exception in the Bankruptcy Code, it could have done so easily. It did not. See Felix Frankfurter, *Some Reflections on the Reading of Statutes*, 47 COLUM. L. REV. 527, 536 (1947) (in interpreting a statute, "[o]ne must * * * listen attentively to what it does *not* say") (emphasis added).[10] As enacted, the Code "strikes a considered balance between creditor and debtor interests, which creditors, debtors, and courts must scrupulously respect." *Coltex*, slip op. 13. Courts "must enforce the statute according to its terms," *Patterson* v. *Shumate*, 504 U.S. 753, 759 (1992), and by its terms, the Bankruptcy Code simply does not include a new value exception to

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[10] Having made no mention of any new value exception in the statute, Congress, of course, provided no guidance as to the content of any such exception. Any such development, therefore, must occur entirely in the courts. But Congress knows how to say when it intends such judicial development of the content of a Bankruptcy Code provision. See, *e.g.*, 124 Cong. Rec. H11095 (daily ed. Sept. 28, 1978) ("It is intended that the in term 'principles of equitable subordination' [in 11 U.S.C. § 510(c)] follow existing case law and leave to the courts development of this principle"); *id.* at S17412 (daily ed. Oct. 6, 1978) (same). That Congress did not do so here reinforces the conclusion that it intended the codified absolute priority rule to be enforced as written, not to be subject to an exception — uncodified and unmentioned in the legislative history — to be developed by the courts.

the absolute priority rule — certainly not one broad enough to allow the pre-petition equity holders to enjoy the exclusive right to contribute new value that they were accorded here.

B. Congress Did Not Adopt The New Value Exception *Sub Silentio* When It Enacted The Bankruptcy Code In 1978

The panel majority's decision rested on its belief that this Court "established" the new value exception in 1939, and that when Congress enacted the Bankruptcy Code nearly 40 years later, it "must have" done so with a "full understanding" of this doctrine, which "has long been ensconced in our bankruptcy practice." App., *infra*, 14a, 20a. None of the panel majority's premises is correct.

1. This Court has never "established" a new value exception. The exception is rooted in dicta found in Justice Douglas's opinion for the Court in *Case* v. *Los Angeles Lumber Prods. Co.*, 308 U.S. 106, 121-122 (1939). But the Court has never adopted those dicta as the basis for the holding in any case; as Judge Easterbrook has noted, "[s]o far as the Supreme Court is concerned," the development of the new value exception "has been 100% dicta." *Kham & Nate's Shoes*, 908 F.2d at 1360.[11]

2. Nor was the doctrine "established" in the lower courts before 1978. As the Second Circuit and Judge Kanne have noted, *Coltex*, slip op. 11; App., *infra*, 42a n.5, before Congress adopted

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[11] Moreover, it is generally understood that the *Case* dicta themselves are "based on a misunderstanding of earlier law." BAIRD, ELEMENTS OF BANKRUPTCY at 263. See also App., *infra*, 41a; *Kham & Nate's Shoes*, 908 F.2d at 1360-1361; EPSTEIN, ET AL., BANKRUPTCY at 841-843; John D. Ayer, *Rethinking Absolute Priority After Ahlers*, 87 MICH. L. REV. 963, 999-1007 (1989).

the Bankruptcy Code in 1978, "*no* reported case seems to have adopted Justice Douglas' dicta as its holding," Markell, *supra*, 44 STAN. L. REV. at 92 (emphasis added). Accord, *e.g.*, Ayer, *supra*, 87 MICH. L. REV. at 1016 ("Justice Douglas' supposed 'exception' * * * is nowhere present as a rule of decision in Chapter X cases [under the prior statute, the Bankruptcy Act of 1898]. New value under Chapter X, then, is an illusion."); Tsang, *supra*, 14 ANN. REV. BANKING L. at 368 ("Prior to the revisions of the Code, the new value exception espoused in *Case* had appeared in no reported cases. After * * * 1978, litigation over the existence and application of the new value exception exploded in the lower courts."). In short, at the time Congress enacted the Bankruptcy Code, the *Case* dicta were "seemingly moribund." 7 COLLIER ON BANKRUPTCY ¶ 1129.04[4][c][i][A], at 1129-108. Given the absence of any reported decision before 1978 purporting to apply the exception, the panel majority's statement that "the new value exception traditionally has played" a "major role * * * in the bankruptcy field," App., *infra*, 20a, is dubious at best.[12]

3. In addition to the fact that *Case*'s remarks about new value were dicta, not a holding, and that no published decision had ever adopted those dicta as the basis for a holding in the ensuing 40 years, there is another reason why congressional "silence" on the new value exception in enacting the Bankruptcy Code cannot be

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[12] Since *Ahlers* began the current furor over new value, very few new value plans have actually been confirmed, but the vast majority of those that have been confirmed — including the plan in the present case — have been confirmed very recently. See Trost, et al., *supra*, SB37 ALI-ABA at 619 & n.77, 644 & n.174. Thus, ironically, the Bankruptcy Code, whose language and structure are far more inhospitable to any new value exception than pre-Code law, is being construed to allow *greater* practical opportunities to buy into a reorganized business over creditors' objections than the prior law.

taken as tacit acquiescence of the exception. The bankruptcy scheme that existed in 1939 — and that prompted the *Case* dicta — was vastly different from the Bankruptcy Code adopted in 1978.

Before enactment of the Bankruptcy Code, bankruptcy proceedings had been governed by the Bankruptcy Act of 1898, which contained three rehabilitative chapters, Chapters X, XI, and XII. Each chapter differed from the others with respect to the standards that had to be met in order to confirm a plan over a dissenting class of unsecured claims, commonly known as "cramdown." Chapter X (and its predecessor, Section 77B) authorized a court to approve a plan only if it was "fair and equitable," but the statute did not define that phrase. *Case*, 308 U.S. at 114-115. Chapter X also required *unanimous* consent of all creditors to confirm a plan. *Ibid.* It was against this backdrop, in the course of elucidating the meaning of the "fair and equitable" requirement, that Justice Douglas suggested that there might be a judicially created exception to the absolute priority rule. *Id*. at 114-121.

Two other rehabilitative chapters also existed before adoption of the Bankruptcy Code. Under Chapter XI, as amended in 1952, there was no "fair and equitable" requirement; thus, "the absolute priority rule did not apply in Chapter XI proceedings," and new value issues "never arose." Markell, *supra*, 44 STAN. L. REV. at 92 & n.152. Chapter XII, which dealt with real estate reorganizations, also "did not require that a plan conform to the absolute priority rule" after the statute was amended in 1952, and thus new value was not an issue under Chapter XII either. Gangemi & Bordanaro, *supra*, 1 AM. BANKR. INST. L. REV. at 188 & n.106.

When Congress enacted the Bankruptcy Code in 1978, it "radically altered reorganization strategy," Markell, *supra*, 44 STAN. L. REV. at 123, in ways that removed any need or basis for the new value exception proposed in *Case*. Congress replaced three disparate statutory schemes with a single one, Chapter 11. The statute no longer required unanimous class consent to confirm a plan,

11 U.S.C. § 1126(c), and the "fair and equitable" test applied only if class acceptance did not occur, 11 U.S.C. § 1129(b)(1). These changes mean that, if *Case* arose today, a new value exception would not be needed to ensure continued shareholder control; the vote in that case — approval by more than 90% of each class of creditors, 308 U.S. at 111-112 — would satisfy Section 1126(c) of the current Code. BAIRD, ELEMENTS OF BANKRUPTCY at 262. Finally, the Code — unlike Chapter X — includes an elaborate definition of the "fair and equitable" standard. 11 U.S.C. § 1129(b)(2). Nothing in that definition, however, mirrors the new value dictum articulated in *Case*.

These features of Chapter 11 "represent[] a significant change from pre-Code bankruptcy law and arguably render[] the new value exception unnecessary." App., *infra*, 43a (Kanne, J., dissenting); see also *Greystone*, 995 F.2d at 1282, 1285 (Jones, J., dissenting); EPSTEIN, ET AL., BANKRUPTCY at 844-845. In fact, as Judge Kanne concluded, "cutting and pasting pre-Code practice into a fundamentally different bankruptcy context" results in a "new" statute "that Congress likely never intended." App., *infra*, 46a; see also *Coltex*, slip op. 11-13. In light of the dramatic changes made in 1978 to the statutory framework for business reorganizations, there is no basis for concluding that Congress meant to continue the use of a doctrine founded on dicta written in a significantly different legal environment — particularly when those dicta had never been followed in the four ensuing decades. See *Wolas*, 502 U.S. at 160 (given the "substantial changes in the preference provision, there is no reason to assume" that pre-Code rules should apply under the 1978 Code).

C. A New Value Exception Would Be Inconsistent With The Policies Underlying The Bankruptcy Code

Besides having no basis in the statutory text, the new value exception adopted by the Seventh Circuit is inconsistent with basic Bankruptcy Code principles. To begin with, a new value exception would turn the bankruptcy priority scheme on its head. The exception not only permits prior equity holders to participate in the reorganized entity, but it gives the parties in interest with the *lowest* legal priority the ultimate right to control a debtor and its property, even if their pre-petition economic position in the debtor has become valueless and senior, unsecured creditors will not receive payment in full of their claims. Cf. *CFTC* v. *Weintraub*, 471 U.S. 343, 355 (1985) ("One of the painful facts of bankruptcy is that the interests of shareholders become subordinated to the interests of creditors").

This is contrary to a fundamental precept of the Bankruptcy Code. "Creditors effectively own bankrupt firms," *Kham & Nate's Shoes*, 908 F.2d at 1360, and "the Code provides that it is up to the creditors — and not the courts — to accept or reject a reorganization plan which fails to provide them adequate protection or fails to honor the absolute priority rule," *Ahlers*, 485 U.S. at 207. See also *Greystone*, 995 F.2d at 1283-1285 (Jones, J., dissenting). The new value exception reverses the roles of creditors and courts. It "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," *Kham & Nate's Shoes*, 908 F.2d at 1360, or otherwise be in their best interests. See also *Coltex*, slip op. 17 (approving a new value plan "for the benefit of insiders" would stymie a creditor "in its legitimate attempts to obtain the value of its claims"). And because of the deferential standard of review, "each bankruptcy court can impose its freewheeling view of reorganization policy without fear of appellate reversal." *Greystone*, 995 F.2d at

1284-1285 (Jones, J., dissenting). The Code does not give bankruptcy judges this power.

As applied in this and many similar cases involving debtor exclusivity, moreover, the new value exception permits the debtor's insiders effectively to sell the debtor's property to themselves on their own chosen terms. The only check on abuse of that power is a bankruptcy judge's necessarily imperfect attempt at valuation — rather than the market discipline that would be provided if there were competitive bids from creditors or outsiders. See *Coltex*, slip op. 12 (noting the danger of "self-dealing"). No provision in Chapter 11 of the Code permits this type of self-interested conduct by the debtor's owners. See *In re A.V.B.I., Inc.*, 143 B.R. 738, 747 (Bankr. C.D. Cal. 1992). Indeed, case law under 11 U.S.C. § 363, the principal Code provision governing the sale of assets, flatly prohibits such closed, insider-only sales. *E.g.*, *In re W.A. Mallory Co.*, 214 B.R. 834, 838 (Bankr. E.D. Va. 1997).

The panel majority speculated, without citation, that the new value exception "has been a major source of new funding in reorganizations for the past fifty years" and that the absence of a new value exception might threaten "the continued existence[] of many corporate entities." App., *infra*, 21a. On its face, this is a questionable proposition, given that there are *no* reported cases before 1978 approving a plan of reorganization incorporating the new value exception. In any event, the absolute priority rule does not bar prior equity holders from providing new capital; it only prohibits the pre-bankruptcy shareholders from having the exclusive or prior option of retaining control of the reorganized business *over the objections of a senior class of impaired unsecured creditors*. Creditors will *consent* to a plan that involves an infusion of new value when, in their estimation, it truly is in the best interests of creditors and the estate. See *Kham & Nate's Shoes*, 908 F.2d at 1360; Basil, *supra*, 101 COM. L.J. at 303-304 & n.83. The true policy issue in new value cases is not whether old equity can participate by contributing new value, but whether *a bankruptcy judge* should be

able to *force* creditors to participate in such a plan by telling them that they have misperceived their own best interests.[13]

Finally, even if pre-bankruptcy equity holders were a significant source of reorganization funding in 1939, when the country was not yet out of the Depression, today's capital markets make it much easier for worthwhile ventures to obtain financing. See Walter J. Blum & Stanley A. 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. In recent years shareholders have seldom contributed new capital"). The 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.

At bottom, the panel majority's decision is contrary to the principal underlying premise of equity ownership in an enterprise: in exchange for its greater potential for return, equity takes the greater risk of loss. See Basil, *supra*, 101 COM. L.J. at 302-303. It is antithetical to the principles underlying the absolute priority rule to permit a debtor's equity holders, who would have kept all of the profits in the enterprise had there been any, to shift the risk of loss to a senior class of creditors when business turns sour.

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[13] In fact, as Dean Baird has pointed out, the new value exception is a one-way ratchet allowing equity holders first to see whether a judge undervalues the firm and only then to commit themselves to invest in it. BAIRD, THE ELEMENTS OF BANKRUPTCY at 262-263.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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February 1998