STATEMENT BEFORE THE AMERICAN BANKRUPTCY INSTITUTE
COMMISSION TO STUDY THE REFORM OF CHAPTER 11 BY
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My name is Maria Ellena Chavez-Ruark, and I am a partner in the Bankruptcy and Restructuring Practice Group at Saul Ewing LLP. Thank you for this opportunity to address the Commission.

1. INTRODUCTION

As the Commission is aware, in 1999, the United States Supreme Court issued its decision in Bank of America Nat’l Trust and Sav. Ass’n v. 203 N. LaSalle Street P’ship, 526 U.S. 434 (1999). In LaSalle, the Supreme Court added a requirement to the new value exception – that the stock in a reorganized debtor must be tested by the market so that former equity holders are not given a “sweetheart deal” in purchasing the new entity’s equity. The Supreme Court, however, declined to rule that a new value corollary to the absolute priority rule exists and did not specify what constitutes the requisite market testing. Although the Supreme Court decided LaSalle 14 years ago and new value plans are much less common today than in past years, the Commission should modify Section 1129 of the Bankruptcy Code to address some of the practical and legal questions that arose as a result of the LaSalle decision.

1. ABSOLUTE PRIORITY RULE AND NEW VALUE COROLLARY

In Sections 1123 and 1129, the Bankruptcy Code sets forth 24 confirmation requirements. Section 1129(a)(8) provides that a plan may be confirmed if, with respect to each class of claims or interests, such class accepts the plan or is unimpaired under the plan. 11 U.S.C. § 1129(a)(8).

Section 1129(b), known as the “cramdown provision”, provides that a bankruptcy court may confirm a plan notwithstanding a plan’s inability to satisfy Section 1129(a)(8) if the plan does not discriminate unfairly and is fair and equitable with respect to any class of claims or interests that is impaired and has not accepted the plan. 11 U.S.C. § 1129(b)(1). A plan is fair and equitable with respect to a class of unsecured claims if “the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property.” 11 U.S.C. § 1129(b)(2)(B)(ii). In short, unless a plan proposes to pay the dissenting class’ claims in full, the plan cannot provide that junior classes will receive or retain any property “on account of” their pre-bankruptcy claims or interests. This is commonly referred to as the “absolute priority rule.”

The absolute priority rule comes into play when former equity holders seek to obtain equity in a reorganized debtor. If the necessity for a capital infusion exists and the former equity holders “make a fresh contribution and receive in return a participation reasonably equivalent to their contribution, no objection can be made.” Case v. Los Angeles Lumber, 308 U.S. 106, 121 (1939). Thus, where the former equity holders contribute new value reasonably equivalent to the value of equity in the reorganized debtor, the former equity holders do not violate the absolute priority rule because they receive equity based on their new value contribution rather than “on account of” their pre-bankruptcy interests. This is referred to as the “new value corollary” or “new value exception” to the absolute priority rule. Most bankruptcy courts have recognized the new value corollary to the absolute priority rule.

1. HOLDING AND APPLICATION OF *LASALLE*

In LaSalle, the debtor proposed a plan during the exclusive period under which only the debtor’s former equity holders could make a new value contribution and purchase equity in the reorganized debtor. Id. at 438-440. An impaired creditor, Bank of America, objected to the debtor’s plan, stating that the plan could not be crammed down because former equity holders would receive property even though the bank would not receive payment of its deficiency claim in full, thereby violating the absolute priority rule. Id. at 442.

The bankruptcy court confirmed the plan over the bank’s objection, and the district court affirmed. Id. The United States Court of Appeals for the Seventh Circuit also affirmed, holding that the plan did not violate the absolute priority rule because former equity holders did not receive property “on account of” their old interests, as they contributed “new capital in money or money’s worth, reasonably equivalent to the property’s value, and necessary for successful reorganization of the restructured enterprise.” Id. The Seventh Circuit concluded that the plan did not violate the absolute priority rule because the plan satisfied the new value exception.

On certiorari, the Supreme Court declined to determine whether there was in fact a new value corollary to the absolute priority rule. Rather the Supreme Court narrowly decided:

Whether a debtor’s prebankruptcy equity holders may, over the objection of a senior class of impaired creditors, contribute new capital and receive ownership interest in the reorganized entity, when that opportunity is given exclusively to the old equity holders under a plan adopted without consideration of alternatives.

Id. at 437. Briefly stated, the Supreme Court determined solely whether it was permissible for a plan proposed during the debtor’s exclusive period to contain a provision giving only former equity holders the opportunity to buy equity in the reorganized debtor without market testing the value of the capital infusion to be contributed by the former equity holders.

Although the Supreme Court declined to determine whether a new value corollary to the absolute priority rule exists, the Supreme Court explored the absolute priority rule and the phrase “on account of” in Section 1129(b)(2)(B)(ii), which provides that a plan is fair and equitable with respect to a class of unsecured claims if the former equity holders will not receive stock in the reorganized entity “on account of” their former equity interests. Id. at 443-58. The Supreme Court concluded that the phrase “on account of” refers to “a causal relationship between holding the priority [equity] interest and receiving or retaining property.” Id. at 451.

The Supreme Court declined to decide the degree of causation necessary to violate the absolute priority rule. Id. at 451-54. The Court stated that one position is that the absolute priority rule is violated whenever “old equity, and not someone on the street,” receives equity in the reorganized debtor and creditors are not paid in full. Id. at 451. The Supreme Court rejected such a strict reading because it would render the phrase “on account of” superfluous and, in fact, “old equity may well be in the best position to make a go of the reorganized enterprise and so may be the party most likely to work out an equity-for-value reorganization.” Id. at 453. A less absolute reading of the statute would follow from reading the “on account of” phrase as sufficient to violate the absolute priority rule and disqualify a plan “whenever old equity’s later property would come at a price that failed to provide the greatest possible addition to the bankruptcy estate.” Id.

Rather than decide which of these interpretations of the absolute priority rule prevailed, the Supreme Court held that the debtor’s plan violated the absolute priority rule because “assuming a new value corollary, … plans providing junior interest holders with exclusive opportunities free from competition and without benefit of market valuation fall within the prohibition of § 1129(b)(2)(B)(ii).” Id. at 458 (emphasis added). However, the Supreme Court declined to state what is necessary for market valuation:

Whether a market test would require an opportunity to offer competing plans or would be satisfied by a right to bid for the same interest sought by old equity is a question we do not decide here. It is enough to say, assuming a new value corollary, that plans providing junior interest holders with exclusive opportunities free from competition and without benefit of market valuation fall within the prohibition of § 1129(b)(2)(B)(ii).

Id.

Although the Supreme Court gave two examples of what may be appropriate to test the market in a commercial real estate case (i.e., an opportunity for competing plans or an opportunity to bid on the reorganized entity’s equity), the Supreme Court declined to determine whether those mechanisms would be appropriate in every Chapter 11 case or whether there may be other means for market valuation. Indeed, the Supreme Court stated:

[W]e emphasize that our holding here does not suggest an exhaustive list of the requirements of a proposed new value plan.

Id. at 453 n.26. The Supreme Court left the decision as to whether the market was sufficiently tested to the bankruptcy courts evaluating debtors’ plans – and rightfully so, as the circumstances surrounding each debtor and each plan of reorganization are different.

1. QUESTIONS ARISING FROM OR LEFT UNANSWERED BY *LASALLE*

LaSalle raised more questions than it answered and created significant practical obstacles to a debtor attempting to confirm a new value plan. This Statement focuses on the following questions:

Does a new value corollary to the absolute priority rule exist?

Does a new value plan require market testing?

What constitutes market valuation as required by LaSalle to confirm a new value plan?

1. RECOMMENDED AMENDMENTS TO CHAPTER 11
2. Does a new value corollary to the absolute priority rule exist?

The overwhelming majority of courts considering new value plans either assumed without any analysis that a new value corollary to the absolute priority rule exists or affirmatively concluded that a new value corollary exists. A handful of courts have declined to recognize the new value corollary. See, e.g., Phoenix Mutual Life Ins. Co. v. Greystone III Joint Venture (In re Greystone III Joint Venture), 995 F.2d 1274 (5th Cir. 1991) (holding that new value exception did not survive enactment of Bankruptcy Code); accord Kham & Nate’s Shoes No. 2, Inc. v. First Bank of Whiting, 908 F.2d 1351 (7th Cir. 1990) (suggesting that new value exception may not have survived 1978 modification to Code). See also In re Drimmel, 135 B.R. 410 (D. Kan. 1991); Piedmont Assoc. v. Cigna Property & Casualty Ins. Co., 132 B.R. 75 (N.D. Ga. 1991); In re Lumber Exch. Ltd. P’ship, 125 B.R. 1000 (Bankr. D. Minn.1991).

In LaSalle, the Supreme Court declined to determine whether there was in fact a new value corollary to the absolute priority rule, but the Supreme Court’s decision effectively assumed that the corollary exists. The Supreme Court also skirted the issue in an earlier decision. Norwest Bank Worthington v. Ahlers, 485 U.S. 197 (1988) (declining to rule on issue of whether new value exception had survived enactment of Bankruptcy Code and holding that, even if it did exist, promise of future labor did not constitute money or money’s worth under Case v. Los Angeles Lumber).

Whether the corollary exists is not a hotly contested issue; the corollary is almost universally recognized. Nevertheless, I recommend that Section 1129(b) be amended to recognize the corollary and put the issue to rest. The corollary makes sense from a policy standpoint. The underlying policy for a reorganization is rehabilitation of the business, as failed businesses lead to a loss of jobs and loss of capital, both manifestations of economic inefficiency. The new value corollary recognizes that equity holders who inject new capital into a restructured business are not gaining a position ahead of creditors because of their old equity position. Instead, they are taking a concrete step to restore the business to solvency by paying fair value for the reorganized debtor’s stock.

1. Does a new value plan require market testing?

LaSalle makes clear that a debtor proposing a new value plan must demonstrate that the stock in the reorganized entity has been tested by the market so that former equity holders are not given a “sweetheart deal” in purchasing the new entity’s equity. I recommend that Section 1129(b) be amended to codify this requirement and, as discussed below, to define and give parameters for the market testing requirement.

1. What constitutes market valuation as required
by *LaSalle* to confirm a new value plan?

In LaSalle, the Supreme Court concluded that a market test required either termination of exclusivity or a right for parties in interest to bid on equity in the reorganized debtor. Some courts applying LaSalle have concluded that these are the only two means of market testing. See, e.g., In re Situation Mgmt. Sys., 252 B.R. 859, 861, 865 (Bankr. D. Mass. 2000) (concluding that “the provisions for competitive bidding in the Debtor’s proposed plan [which allowed existing equity holders to purchase 100% of the equity in the reorganized debtor and invited other parties to bid on the shares if the competing bid exceeded the existing equity holders’ bid by at least 5%] warrant termination of exclusivity” because the debtor’s new value plan “was not confirmable in the absence of competitive bidding for the equity interests to determine the adequacy of the new value contribution”).

LaSalle, however, did not limit market valuation to termination of exclusivity or auction of the reorganized entity’s equity. LaSalle concluded that “plans providing junior interest holders with exclusive opportunities free from competition and without benefit of market valuation fall within the prohibition of § 1129(b)(2)(B)(ii).” LaSalle, 526 U.S. at 458. The Supreme Court declined to state what is necessary for market valuation:

Whether a market test would require an opportunity to offer competing plans or would be satisfied by a right to bid for the same interest sought by old equity is a question we do not decide here. It is enough to say, assuming a new value corollary, that plans providing junior interest holders with exclusive opportunities free from competition and without benefit of market valuation fall within the prohibition of § 1129(b)(2)(B)(ii).

Id.

LaSalle was a commercial single asset real estate case, and under such circumstances, it very well may be appropriate to limit market valuation to the two means discussed by the Supreme Court (i.e., an opportunity for competing plans or an opportunity to bid on the reorganized entity’s equity). However, the Supreme Court declined to determine whether those mechanisms would be appropriate in every Chapter 11 case or whether there may be other means for market valuation. In fact, the Supreme Court appeared to recognize the need to determine market valuation on a case-by-case basis when it stated, “we emphasize that our holding here does not suggest an exhaustive list of the requirements of a proposed new value plan.” Id. at 453 n.26.

Courts concluding that every new value plan violates the absolute priority rule unless the bankruptcy court terminates exclusivity or the plan provides for an auction of the reorganized entity’s equity dramatically overstate the holding of LaSalle. In LaSalle, the Supreme Court merely suggests that terminating exclusivity and soliciting bids for the equity are two ways to test the market in that particular case, but the Court does not go so far as to limit market testing to those two alternatives and instead states that its decision is not intended to set forth an exhaustive list of the requirements for new value plans. Undoubtedly, there are many ways a debtor can test the market, and whether the market has been testified is a factual inquiry. It cannot be anything but a factual inquiry, as each business debtor in bankruptcy has a different market that must be tested and different circumstances to consider.

The following example is helpful in demonstrating some courts’ misapplication of LaSalle. Consider XYZ Corporation, a Chapter 11 debtor, which filed a plan of reorganization providing that anyone (including but not limited to creditors and former equity holders) may purchase stock in the reorganized debtor at an auction. Assume that notice of the auction was proper. Assume further that only the former equity holders appeared at the auction and purchase the stock in the reorganized entity for $1. According to courts misapplying LaSalle, this is sufficient to satisfy the cramdown provisions of the Bankruptcy Code because the plan called for competing bids. However, clearly this would be unfair and inequitable if the fair market value of the stock were higher than $1 (for example, $100,000).

The foregoing illustrates two key points. First it confirms that whether there has been market valuation is a factual inquiry, and therefore the Bankruptcy Court’s decision may be set aside only if it is clearly erroneous. Second, it demonstrates that termination of exclusivity and an opportunity for competing bids cannot be the only means for testing the market. In this example, purchase of the reorganized entity’s stock for $1 by former equity holders is clearly unfair to the creditors if the stock is actually valued at $100,000.

I recommend that Chapter 11 be amended to state that market valuation requires a two-part analysis: first, the debtor must demonstrate to the bankruptcy court that it has identified and targeted the appropriate market, and second, the debtor must demonstrate that it tested that market. I also recommend that the Bankruptcy Code be amended to confirm that the market for the reorganized debtor’s equity has been tested if (i) the exclusive period has been terminated, (ii) parties in interest and/or third parties have been given the opportunity to bid to purchase some or all of the reorganized entity’s equity, or (iii) the debtor has introduced sufficient evidence for the court to conclude that the market for the reorganized entity’s equity has been tested to ensure that the plan does not provide junior interest holders with exclusive opportunities free from competition and without benefit of market valuation. An example of this third category would include testimony from a broker that it has marketed the reorganized entity’s stock to potential purchasers and investors but that the new value contribution by existing equity holders exceeds the price that would be paid by anyone else.

In practice, we see that most creditors do not have the financial ability and/or interest in proposing a competing plan or purchasing the reorganized debtor’s equity. Yet, the debtor should still be required to test the market and demonstrate that its existing equity holders are not getting a “sweetheart deal.”

The underlying purpose of Chapter 11 – rehabilitation and maximization of value for the benefit of creditors – must remain the ultimate goal and cornerstone of a new value plan. Thus, in considering a new value plan, a court must be able to consider whether the market valuation furthers the debtor’s rehabilitation and maximizes the return to creditors. For example, a bid to purchase the stock of a small, closely-held entity by someone other than existing equity may not be in anyone’s best interest, as is sometimes the case in smaller Chapter 11 proceedings when the debtor’s competitive advantage is based on the owners’ relationships with customers, suppliers or others. Courts must consider the appropriate market and market valuation on a case-by-case basis.

It is important to note that whether the market has been tested (as required by LaSalle) and whether the new value contribution is fair consideration for the reorganized entity’s stock are two different issues. As described in more detail in the testimony of The Honorable Barbara Houser on April 19, 2013, courts considering confirmation of a new value plan must take into account five factors: (i) the contribution must be new, (ii) the contribution must be substantial, (iii) the contribution must be money or money’s worth, (iv) the contribution must be necessary for a successful reorganization, and (v) the contribution must be the reasonably equivalent value of the stock being received. See, e.g., Bonner Mall P’ship v. United States Bancorp Mort. Co. (In re Bonner Mall P’ship), 2 F.3d 899, 908 (9th Cir. 1993). I refer the Commission to Judge Houser’s testimony regarding the practical difficulties in applying these factors, and I recommend that the Commission codify these factors in Section 1129.

1. CONCLUSION

With LaSalle, the Supreme Court imposed a new requirement in confirmation of new value plans – that the stock in a reorganized debtor must be tested by the market so that former equity holders are not given a “sweetheart deal” in purchasing the new entity’s equity. However, the Supreme Court provided no guidance on what constitutes the requisite market testing. With the downturn in the economy, new value plans have become much less common, but an improvement in the economy and a corresponding improvement in the lending market may result in more new value plans in the future. Any reform of Chapter 11 should address the practical and legal questions that arose as a result of the LaSalle decision.

Once again, thank you for the opportunity to address the Commission on these important issues. I welcome any questions you may have.