Statement Before American Bankruptcy Institute Commission to Study the Reform of Chapter 11 -- April 19, 2013 --

My name is Barbara Houser and I am the Chief Bankruptcy Judge in the Northern District of Texas, sitting in Dallas, Texas. I appreciate the invitation to speak at this hearing focused on issues relating to small and middle market Chapter 11 reorganization cases. I have chosen to focus on the difficulties presented by the application of the absolute priority rule in these types of cases, particularly those in which there is an unhappy, under-secured creditor (perhaps this is redundant) whose secured claim and deficiency unsecured claim when voted against the plan will trigger the need to confirm the plan over the lender's objection.

As Judge Dow has already observed, the complexity, time, and costs of the Chapter 11 process impose obstacles that small and middle market businesses often cannot overcome. But, even when these businesses make it to a confirmation hearing, the challenges they face may be virtually impossible to overcome. Let me explain.

Again, let us assume a small to mid-size business with a secured creditor who finds itself under-secured. As you know, that lender's secured claim (limited to the value of its collateral) will be placed in a separate class and its unsecured deficiency claim will either be placed in a class of general unsecured claims or, assuming a basis for separate classification exists, the lender's deficiency claim may be separately classified. Assume further that the lender votes against the plan in both classes, causing both classes to reject the plan. This scenario triggers the need for the debtor to attempt confirmation of its plan pursuant to the terms of section 1129(b) of the Bankruptcy Code -- or in the parlance of us bankruptcy geeks -- the debtor will attempt to cram the plan down over the lender's objection. To do so, the plan must not

discriminate unfairly against the lender and the lender's treatment under the plan must be "fair and equitable." With respect to the rejecting secured class, section 1129(b)(2)(A) provides various requirements that are not the focus of my testimony. However, with respect to the rejecting unsecured class, in order to satisfy the so-called "fair and equitable test," the lender must either be paid in full or no class of claims or interests junior to that unsecured rejecting class "can receive or retain any property on account of" its former claim or interest.

So, where a small to mid-sized business debtor cannot pay its unsecured claims in full with a market rate of interest over the life of the plan (a common occurrence), the junior class of interest holders may not receive or retain any property under the plan "on account of" their former interests. This is because of the application of what we call the absolute priority rule. The application of this rule and the so-called "new value exception" to it in small to mid-size Chapter 11 cases proves problematic.

The “on account of” phrase in section 1129(b)(2)(B)(ii) requires bankruptcy courts to determine whether a reorganization plan that gives stock to former equity holders does so primarily because of their old interests in the debtor or for legitimate business reasons. The new value doctrine provides the means by which a court can discover whether a particular new capital transaction is proposed “on account of” old equity's prior ownership or “on account of” its new contribution. In other words, in evaluating whether a reorganization plan satisfies the requirements of the new value exception a court is in fact determining whether old equity is unjustifiably attempting to retain its corporate ownership powers in violation of the absolute priority rule or whether there is a genuine and fair exchange of new capital for an equity interest in the reorganized debtor.

The traditional factors that are required to prove the so-called new value exception to the absolute priority rule are that the offered value be: (1) new; (2) substantial; (3) money or money's worth; (4) necessary for a successful reorganization; and (5) reasonably equivalent to the value or interest received. There is little controversy over at least two of these factors. That the contribution be in the form of money or money's worth is easily understood, as is the requirement that the contribution be new. And, while the requirement that the contribution be in an amount reasonably equivalent to the value or interest being received may be a disputed question of fact requiring judicial determination based upon competing expert testimony, courts resolve those types of issues regularly, although the cost of obtaining such expert testimony in a small Chapter 11 case is of some concern. However, the remaining two factors -- that the contribution be (1) substantial, and (2) necessary to the debtor's successful reorganization -- have proven problematic in smaller cases.

Taking the requirement that the contribution be substantial, the question becomes in comparison to what? Some courts compare the contribution to the value of the enterprise, others compare it to the amount of unsecured debt, while still others compare it to the net available cash in the debtor. At least one court has applied a two-part test: is the contribution substantial for (1) the type of business, and (2) the old equity holder. Another court used "special factors" to determine whether a contribution is substantial in the context of a small, closely-held entity: (1) whether the proposed payment represents the partner's best efforts, and (2) the amount of the contribution compared to the projected return to creditors. While a leading bankruptcy treatise notes that the substantiality requirement is of "dubious heritage" and "unnecessary" in light of the "necessary" requirement I'll discuss in a moment, it observes

that courts often look at whether the payment is substantial "based upon the ratio of the amount of the proposed contribution to the amount of claims affected by the plan."

Applying a requirement that the contribution be substantial in smaller cases is difficult, particularly if the comparison is to be between the amount of the contribution and the amount of unsecured debt - either the amount of debt being discharged or the projected amount to be paid to unsecured creditors under the plan. The debtor's pre-petition equity holders in closely-held cases often have everything tied up in the business with little available to them to contribute given the earlier requirements that the value be new and money or money's worth. In these circumstances, it is quite difficult for a pre-petition equity holder's contribution to be found substantial in comparison to the amount of claims being affected by the plan or under even the less stringent tests applied by some courts.

Turning to the requirement that the contribution be necessary to the debtor's successful reorganization, here too the courts have come to different conclusions as to what is required. Some courts follow a more restrictive or, according to a leading treatise, "narrow" view that the funds must be necessary to continued operations of the debtor. Under this view, that the contribution may be used to pay claims, including administrative claims like attorneys' fees is not enough. Other courts have applied a more open view and have found that if the contribution is necessary to pay, for example, administrative claims of the debtor's professionals, it is necessary to the debtor's successful reorganization because the debtor must pay those claims in cash, in full pursuant to the terms of the Bankruptcy Code in order to obtain confirmation of a plan and achieve its reorganization.

Finally, I wish to address the Supreme Court's requirement in *203 North LaSalle* that the value of the interest being received be subjected to a market test. How to achieve this market test in smaller cases is problematic. First, is it sufficient that the debtor allow exclusivity to terminate so that any party-in-interest can propose a plan of reorganization if they wish to own the reorganized debtor? A very recent decision from the 7th Circuit suggests that a termination of exclusivity alone is not a sufficient market test. Alternatively, if the plan proposes an auction of the reorganized debtor's equity at the confirmation hearing, with an opening bid amount by the pre-petition equity holders stated in the plan and auction procedures described in the disclosure statement, is that a sufficient market test given the reality that the "market" to whom the plan and disclosure statement have been sent are the under-secured lender described above and a relative handful of unsecured creditors who have no interest in owning the reorganized debtor?

If neither of these alternatives satisfy the market-test requirement, then what is the closely-held debtor in a small to mid-size case to do? It cannot solicit interest in its equity beyond its creditor base because to do so would be outside the protection provided by section 1145 and require it to comply with the securities laws, which are cost-prohibitive and time consuming.

Having said all this, what do I suggest that you consider in evaluating possible changes to the Bankruptcy Code relating to closely-held small and mid-size business attempting to reorganize in Chapter 11? First, you should consider whether these entities should have the opportunity to reorganize over the objection of an under-secured creditor who controls the unsecured vote. Second, if these entities should have an opportunity to successfully

reorganize, then you should consider changes to the Bankruptcy Code that will clarify the circumstances under which old equity may acquire the equity in the reorganized debtor and what they must do or pay to do so. Third, consider whether the requirements should vary depending upon the size of the business being reorganized. Whatever the right answer is, it should be codified in the Bankruptcy Code to avoid at least some of the controversy surrounding the absolute priority rule and the new value exception to that rule that has arisen under the current Bankruptcy Code.

Once again I appreciate having been given the opportunity to speak to the commission about these issues and I would be glad to answer any questions you may have.