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New Capital for Bankruptcy Reorganizations: It's the Amount That Counts,

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NEW CAPITAL FOR BANKRUPTCY REORGANIZATIONS: IT'S THE AMOUNT THAT COUNTS

*Charles W. Adams**

I. INTRODUCTION

A bankruptcy reorganization is a process for restoring financial health to an insolvent corporation. The process normally requires a reduction in the level of corporate debt, and it may also involve an adjustment of the insolvent corporation's capital structure through either an infusion of new capital or the conversion of a portion of the corporation's debt to equity so that its former debt holders become shareholders. Numerous cases and much academic commentary have been devoted to the issue of whether former shareholders should be permitted to receive stock in a reorganized corporation in return for their contribution of new capital.[1]

There has also been considerable discussion of the form that the contribution of new capital should take.[2] The issue of the amount of the new capital contribution has received little attention, but this issue is probably more important than either the source or form of the capital contribution. Much of what has been written, both in the cases and about them, derives from dictum by Justice Douglas in *Case v. Los Angeles Lumber Products Co.*[3] to the effect that a capital contribution must be reasonably equivalent to the ownership interest received in return for it.[4] While superficially plausible, this standard turns out on closer analysis to be merely a tautology.[5] Under the absolute priority rule,[6] all of an insolvent corporation's value must be allocated to its

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[1] *See infra* text accompanying notes 49-68.

[2] *See infra* text accompanying notes 71-83.

[3] 308 U.S. 106 (1939).

[4] *Id.* at 121-22.

[5] *See* Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 STAN. L. REV. 69, 96-101 (1991).

[6] The absolute priority rule was established by the Supreme Court in 1899. *See infra* note 45 and accompanying text.

creditors;[7] accordingly, any debt in excess of its value as a going concern is discharged. When new capital is contributed, the *Los Angeles Lumber* dictum will be satisfied automatically, because the only value not allocated to the creditors is the new capital contribution.

Despite its vacuousness, the *Los Angeles Lumber* standard continues to be recited by courts and commentators as the definitive measure for the capital contribution required in a corporate reorganization. This Article develops a more useful standard based on the feasibility requirement, which limits the confirmation of reorganization plans to those that are not likely to be followed by either liquidation or the need for further reorganization of the corporation.[8]

This Article begins with a review of the role of an equity cushion in a solvent corporation's capital structure and the problems that can arise in the absence of such an equity cushion. There follows a description of how the equity cushion of an insolvent company can be restored through the reorganization process and why the corporation's former shareholders are often the best available source of capital for the new equity cushion. The Article then discusses the absolute priority rule and whether its codification in the Bankruptcy Code, without reference to the new capital exception, has eliminated the exception. Following this is a discussion of the limitations courts have placed on the form of the capital contribution, and finally, the Article analyzes how the courts should determine the amount of capital to be contributed.

II. The Need For An Equity Cushion

The major controversy surrounding the Chapter 11 reorganization process today is whether it should continue to exist. A business reorganization is time consuming and expensive. The insolvent corporation's assets have to be appraised and its liabilities determined, and a reorganization plan must be submitted to all classes of shareholders and creditors for approval and finally to the bankruptcy court for confirmation. The delay and expense of the reorganization process have led a number of influential commentators to question the need for it[9]

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[7] *See* Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 202 (1988) ("As the Court of Appeals stated, the absolute priority rule '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.' ") (brackets in original) (citation omitted).

[8] *See* 11 U.S.C. § 1129(a)(11) (1988).

[9] *See, e.g.*, Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. Legal Stud. 127 (1986); Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 Yale L.J. 1043 (1992).

and to propose a number of market-based alternatives to Chapter 11's combination of negotiation and adjudication.[10]

In a previous article,[11] I explained how the reorganization process provides a mechanism for resolving the conflicts of interest created by a corporation's insolvency. By restoring an equity cushion in the corporation's capital structure, the reorganization process can provide shareholders and management with the appropriate incentives to operate the enterprise efficiently. In many circumstances, the reorganization process may accomplish this result with fewer transaction costs than the market-based alternatives.

A corporation is normally financed partly through equity and partly through debt. Some equity is essential in a corporation's capital structure to capture the residual interest in its future earnings.[12] It is possible for a corporation to have an all-equity capital structure, but most corporations have substantial levels of debt financing. Besides offering a tax benefit,[13] debt in a corporation's capital structure provides leverage to shareholders, enabling them to earn a higher expected return, though at greater risk. The higher expected return may be achieved if the corporation's expected earnings are greater than the rate of interest on the debt; the increased risk results from the accrual of interest at a fixed rate, which must be paid whether the corporation's actual earnings prove to be large or small.[14]

Various costs are associated with the increased risk resulting from debt financing. Two of these are the potential costs of default on the debt and agency costs arising from possible conflicts of interest between shareholders and creditors. If a corporation does not pay its creditors, they may attempt to seize its assets to satisfy the debts, or the corporation may have to file for bankruptcy protection. Either way, the corporation is likely to suffer reduced revenues and incur additional legal and accounting expenses. A conflict of interest can arise between a corporation's shareholders and creditors because the shareholders are entitled to its profits if the corporation succeeds,

[10] *See, e.g.*, THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 218-24 (1986) (recommending sale of company as a going concern); Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311 (1993) (proposing issuance of "Chameleon Equity" instead of traditional debt); Lucian A. Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775, 785 (1988) (advocating the distribution of options to shareholders and junior creditors to purchase shares in the reorganized company); Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527 (1983) (determining valuation by selling a portion of the reorganized company's stock in the market).

[11] Charles W. Adams, *An Economic Justification for Corporate Reorganizations*, 20 HOFSTRA L. REV. 117 (1991).

[12] *See* 1 MODEL BUSINESS CORP. ACT ANN. § 6.01 official comment (3d ed. 1993).

[13] A corporation is allowed to deduct payments of interest to creditors, but not dividends paid to shareholders. I.R.C. § 163 (West 1994).

[14] For a numerical example, see Adams, *supra* note 11, at 119.

while the maximum return for the creditors is the stated rate of interest. If most of a corporation's capital structure is debt and the shareholders have only a small amount of equity invested in it, the shareholders will have an incentive to take excessive risks. The shareholders have everything to gain if a risky venture succeeds and nothing but their equity to lose if it fails.[15] In contrast, the creditors can continue to collect only their fixed interest payments if the venture is successful, and they risk nonpayment of the principal if it is unsuccessful. Although it may appear that shareholders benefit from leverage at the expense of creditors, to the extent that creditors can anticipate the use of leverage by shareholders, they will charge higher interest rates in order to transfer the costs associated with leverage to the corporation and its shareholders.

The potential costs of default and the agency costs associated with leverage are normally held in check by the maintenance of a suitable equity cushion. An equity cushion represents the shareholders' stake in the enterprise, and the presence of a sufficient equity cushion insures that most of the risk is borne by the shareholders rather than the creditors. A suitable equity cushion reduces the risks and, consequently, the costs associated with debt financing.

An insolvent corporation has a capital structure that is pathological. The capital structures of solvent and insolvent corporations are diagrammed in Figure 1. Because liabilities already exceed asset value, an insolvent corporation's shareholders have nothing more to lose from further operating losses. Their main concern will be to have the corporation earn a sufficient return so that it can become solvent again. Because the shareholders bear none of the downside risk, they will favor risky ventures with the potential for large gains over others with more predictable, but smaller, gains.[16] Until the corporation achieves solvency, moderate gains will benefit only the creditors and not the shareholders. Consequently, the shareholders will tend to focus on keeping the company afloat from day to day rather than on its profitability over the long run. Although the corporation's creditors lack direct control over management, they have various ways of enforcing their claims—such as garnishment of bank accounts and execution on corporate assets—that can disrupt corporate operations.

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[15] Of course, shareholders who have personally guaranteed payment of the debts of the corporation will have more than their equity to lose in the event of default, and this will affect their propensity for risk-taking. Guarantees from shareholders with substantial personal assets can reduce creditor risk and provide a substitute for equity capital. For a discussion of the use of shareholder guarantees as a form of capital contribution, see *infra* text accompanying notes 78-91.

[16] As noted earlier, shareholders who are subject to personal guarantees will have different incentives than those who are protected by limited liability. *See supra* note 15.

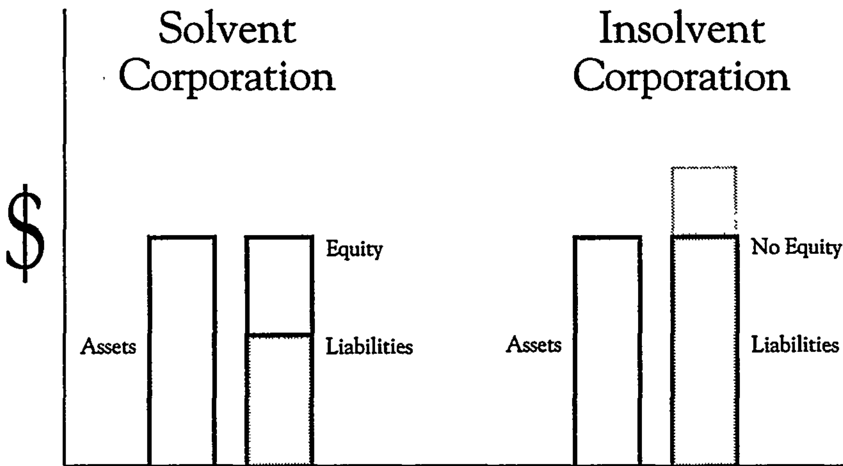

Figure 1
Comparison of Capital Structures of a Solvent and Insolvent Corporation

Unfortunately, both creditors and shareholders of an insolvent corporation lack incentives for maximizing its long-term interests.[17] Insolvency generates destructive conflicts of interest between the corporation's shareholders and creditors, with shareholders concentrating on its short-term survival and creditors trying to collect on their claims through seizure of the corporation's assets.[18] A corporation cannot operate effectively until these conflicts are resolved. Their resolution, through the restoration of a sound capital structure, is the fundamental purpose of the bankruptcy reorganization process.[19]

III. Cures for Insolvency

In many cases, liquidation is a preferable alternative to reorganization. The causes of a corporation's insolvency may be a decline in demand for its goods or services, or other insurmountable problems that will prevent it from ever operating profitably. Reorganizing a corporation's capital structure will not solve its economic problems, and if a corporation has no prospects of achieving profitability, liquidation should be ordered so that its assets can be put to better use elsewhere.

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[17] *Cf.* Principles of Corporate Governance: Analysis & Recommendations § 2.01 (1994) ("[A] corporation . . . should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain.").

[18] *See* Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. Pa. L. Rev. 669, 683-88 (1993) (pointing out conflicts between senior and junior interests in insolvent corporations).

[19] Adams, *supra* note 11, at 117-38, 157-58.

That a corporation is experiencing financial distress[20] does not necessarily mean that it is not economically viable, however.[21] Insolvency may have been caused by inadequate initial capitalization or a particular economic problem that has been remedied. If so, reorganization of the corporation's capital structure may be economically justified as a means of preserving its going concern value. Liquidation would be economically wasteful if an insolvent corporation were worth more as a going concern than its assets were worth if sold separately. This is illustrated in Figure 2. An excess of going concern

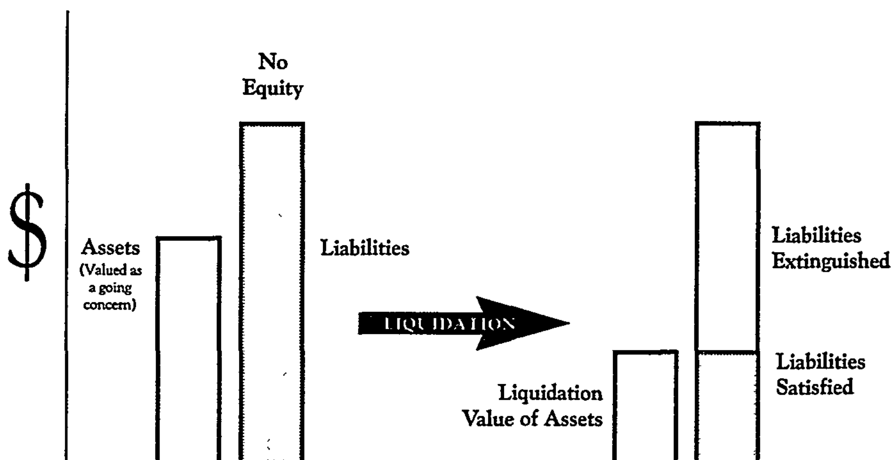

Figure 2
Liquidation of Insolvent Corporation

value over the liquidation value of a corporation's assets may be due to a synergy among its tangible assets as well as the presence of intangible assets that might evaporate in a liquidation, such as employee know-how, a valuable corporate franchise or monopoly power, good will, trademarks, or a net operating loss carryover.[22] A corporate reorganization would not be justifiable from an economic standpoint unless the corporation had a greater going concern value than liquidation value. In addition, a bankruptcy court should consider the costs of a reorganization in relation to the costs of liquidating the

[20] *See* Robert Gertner & David Scharfstein, *A Theory of Workouts and the Effects of Reorganization Law*, 46 J. FIN. 1189, 1190 (1991) (discussing the distinction between financial and economic distress).

[21] *Cf.* Lynn M. LoPucki, *A General Theory of the Dynamics of the State Remedies/Bankruptcy System*, 1982 WIS. L. REV. 311, 325 (1982) ("Under some circumstances, it may be desirable to permit and encourage the continued operation of an insolvent, unprofitable business.").

[22] *See* I.R.C. § 172 (West 1994) (authorizing taxpayers to carry net operating loss deductions back 3 years and forward 15 years).

company's assets when evaluating whether to proceed with a Chapter 11 reorganization.[23]

Alternatives to reorganization may preserve an insolvent corporation's going concern value. For example, it may be possible to avoid the expense and delay of the Chapter 11 process by arranging a workout or a private restructuring of the corporation's debt.[24] A private restructuring may not be successful, however, if there are numerous classes of debt,[25] particularly if any of them are subject to the Trust Indenture Act of 1939,[26] which requires unanimous consent of bondholders to any change in the principal amount, interest rate, or maturity date of a bond indenture.[27] Another option that some commentators have urged is the sale of an insolvent corporation as a going concern.[28] There are typically significant transaction costs associated with such a sale, however, such as underwriter fees and other charges for arranging financing, and these could exceed the costs of the reorganization process.[29] Similarly, other alternatives that have been suggested may be inferior to the Chapter 11 reorganization process because they involve high transaction costs or have other shortcomings.[30]

Whatever mechanism is employed, its main objective should be reestablishing an equity cushion to neutralize the potential conflict of interest between the corporation's shareholders and creditors and to reduce the interest cost of debt financing. The sources of this equity cushion are discussed in the next Part.

IV. Former Shareholders as a Source of New Capital

There are three potential sources of capital for an equity cushion in a reorganized corporation: its creditors, its shareholders, and

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23 *See generally* LoPucki & Whitford, *supra* note 18, at 753-67 (comparing problems and costs of liquidation and reorganization).

24 *See* Gertner & Scharfstein, *supra* note 20, at 1189-1222; Stuart C. Gilson et al., *Troubled Debt Restructurings: An Empirical Study of Private Reorganization of Firms in Default*, 27 J. Fin. Econ. 315 (1990).

25 Gilson, *supra* note 24, at 345.

26 15 U.S.C. § 77ppp (1988).

27 *See* Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 Yale L.J. 232 (1987) (urging repeal of the provision prohibiting modification of bond indenture terms except by unanimous consent).

28 Jackson, *supra* note 10, at 209-24; Baird, *supra* note 7, at 127.

29 *See* Adams, *supra* note 11, at 146 (reporting that SEC studies show the average cost of flotation for underwriting common stock offerings was 12.43% of the gross proceeds); Douglas G. Baird, *Revisiting Auctions in Chapter 11*, 36 J.L. & Econ. 633, 641-47 (1993) (comparing both direct and indirect costs of reorganization to costs of initial public offerings); LoPucki & Whitford, *supra* note 18, at 765 ("When the fees of the investment banker are considered, the cost of liquidating under chapter 7 may exceed the cost of reorganizing under chapter 11.").

30 Adams, *supra* note 11, at 148-57.

outside investors.[31] First, the necessary capital may come from the corporation's creditors by means of a conversion of their debt into equity. This is illustrated in Figure 3.

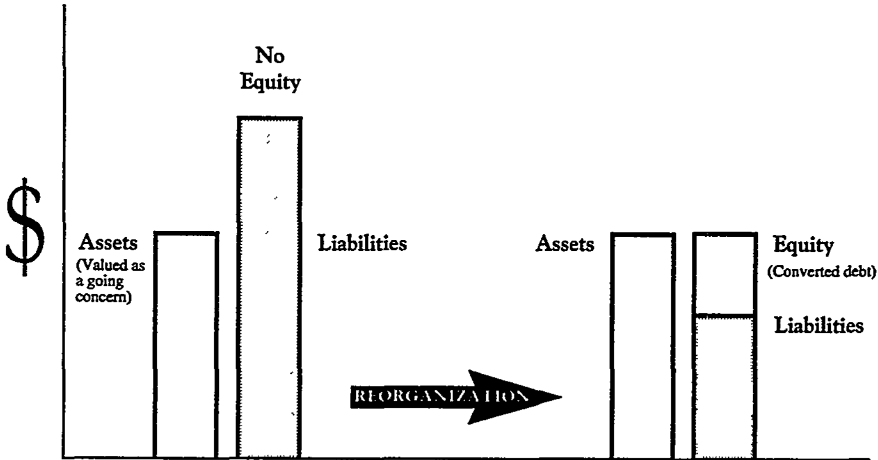

Figure 3
Reorganization By Converting Some Debt to Equity

The insolvent corporation's stock is retired, the portion of debt that exceeds the corporation's going concern value is discharged, and the creditors are issued new stock and debt in the reorganized corporation. The discharge of some of the debt and the conversion of another part into stock produces the equity cushion needed to cure the insolvency. The major disadvantage of this approach to reorganization is that it may not be feasible for some creditors to become equity owners of the reorganized corporation. Banks are a major source of debt financing, for example, and the Glass-Steagall Act[32] imposes significant restrictions on their ownership of common stock.[33] In the absence of an active market for the stock in the reorganized corporation, banks and creditors with preferences for debt would have difficulty disposing of the stock. Even if there were an active market for the stock, the creditors would incur transaction costs, such as broker's commissions, to sell the stock. Therefore, issuing stock to creditors

[31] Outside investors could include managers and other corporate employees.

[32] 12 U.S.C. § 24 (1988) (prohibiting national banks from purchasing stock in corporations).

[33] *See* 12 C.F.R. § 225.22(c)(1)(i) (1993) (allowing bank holding companies to hold voting securities if they are acquired in the ordinary course of collecting a debt and they are divested within two years of acquisition); *see also* 12 U.S.C. § 335 (1988) (prohibiting state member banks of the Federal Reserve System from purchasing stock in corporations); FREDERICK K. BEUTEL & MILTON R. SCHROEDER, BANK OFFICER'S HANDBOOK OF COMMERCIAL BANKING LAW §§ 4-30, 5-30 (5th ed. 1982).

who then sell it is less efficient than having the purchasers buy the stock directly from the reorganizing corporation.

Outside investors are an alternative source of new capital for the equity cushion. Again, the insolvent corporation's old stock is retired, and the portion of debt that exceeds the corporation's going concern value is discharged. The outside investors are then issued all the stock in the reorganized corporation in return for new capital contributions, and their ownership interest constitutes the equity cushion, as displayed in Figure 4. The major disadvantage to this approach is the

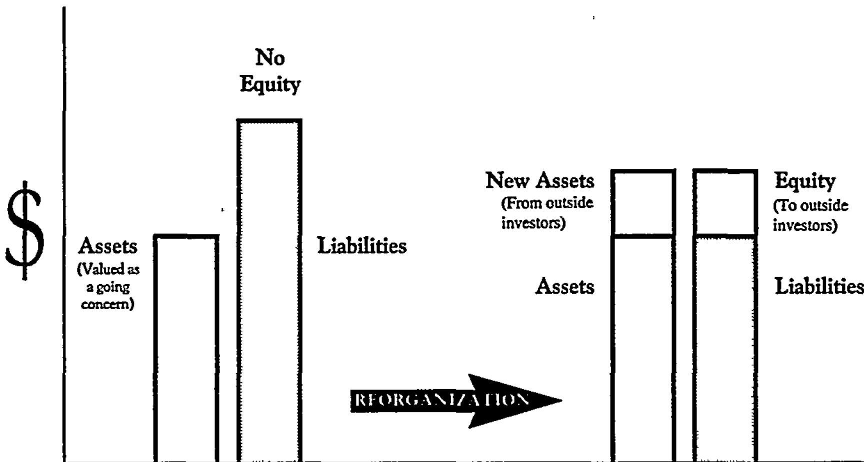

Figure 4
Reorganization Though Outside Investment

probable difficulty of finding outside investors to contribute capital to the insolvent corporation.

A significant disadvantage to obtaining equity cushion capital from either creditors or outside investors is that these approaches offer no benefit to the existing shareholders of the insolvent corporation, whose stock is retired and who lose control in the reorganized corporation. In many cases, the existing shareholders may be familiar with the business operations and involved in managing of the corporation; thus, the reorganized corporation may be disadvantaged by the loss of their association with it.[34] Of course, if that is so, the corporation's new owners (whether they are the former creditors or outside

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[34] *See In re* Bonner Mall Partnership, 2 F.3d 899, 916 (9th Cir. 1993), *cert. granted*, 114 S. Ct. 681, *dismissed as moot*, 115 S. Ct. 386 (1994) (denying motion to vacate court of appeals decision after case was rendered moot by voluntary settlement).

investors) may offer the former shareholders compensation to continue their involvement with the corporation.[35]

A more serious problem with these approaches is that neither offers shareholders any reason to initiate the reorganization process. The decision to file a Chapter 11 proceeding is normally made by a corporation's board of directors[36] rather than the shareholders, but directors generally perceive an obligation to act in the interest of the shareholders. If the directors and shareholders have no reason to file a reorganization proceeding, they will be inclined to seek delay and to take increasingly risky gambles hoping that solvency will be restored eventually through some financial miracle. This is likely to lead to further financial deterioration, until recovery is no longer possible.[37] To be sure, the insolvent corporation's creditors have an incentive to file involuntary Chapter 11 proceedings in order to maximize their recovery. However, initiating an involuntary proceeding is difficult and risky for creditors,[38] and creditors generally lack immediate access to the corporation's financial information.

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[35] Baird, *supra* note 7, at 141 ("[T]he managers' expertise and the need to compensate them for it exists regardless of whether or not managers have ownership interests in the firm. Giving stockholders shares in the reorganized company cannot be justified on the ground that it ensures continued participation of the managers. If the owners as a group want the managers to stay with the firm, they can pay them in cash, stock, or some other way. Compensating them, however, should have nothing to do with dividing rights to the firm among the existing owners."). *See also* Victor Brudney, *The Bankruptcy Commission's Proposed "Modifications" of the Absolute Priority Rule*, 48 AM. BANKR. L.J. 304, 336 (1974) ("If the stockholders are not synonymous with management, whatever the latter may be entitled to, the former are entitled to nothing unless they contribute money or 'money's worth reasonably equivalent to the participation accorded' to them (*Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106, 122 (1939)).").

[36] *See In re* Moni-Stat, Inc., 84 B.R. 756, 757 (Bankr. D. Kan. 1988) ("[T]he law is clear that the decision of whether or not a corporation should file bankruptcy is a business decision to be made only by the board of directors.").

[37] *See generally* LoPucki, *supra* note 21, at 312 ("In all but a few cases, the meaningful stages of financial decay, recovery or liquidation occur outside the bankruptcy court. The bankruptcy court deals not with businesses in financial difficulty, but with their skeletons, already picked clean by workouts, state court proceedings, informal liquidations, or merely the ravages of time and poor management.").

[38] Where a debtor has more than 12 creditors, 3 creditors with claims that are "not contingent as to liability or the subject of a bona fide dispute" must join in an involuntary petition. 11 U.S.C. § 303(b) (1988). If the debtor opposes the involuntary petition, the creditors must prove at a trial either that "the debtor is generally not paying such debtor's debts as such debts become due unless such debts are the subject of a bona fide dispute" or else that a custodian has taken charge of substantially all the debtor's property. *Id.* Proving that the debtor is "generally" not paying its debts, as opposed to proving that it is not paying particular debts, is difficult for creditors, who usually will not know whether the debtor is paying its other creditors, because they do not have access to the debtor's books. If the creditors fail to establish grounds for an involuntary proceeding, the court may award reasonable attorney's fees against them, and in appropriate cases, compensatory and punitive damages. Filing an involuntary proceeding can cause substantial harm to a debtor, and so significant restrictions on creditors are appropriate. However, these restrictions do limit the use of involuntary proceedings. *See generally* Douglas G. Baird, *The Initiation Problem In Bankruptcy*, 11 INT'L REV. L. & ECON. 223 (1991) (giving managers

An additional justification for the participation of the former shareholders in the reorganized corporation is that the shareholders may be the best source of new capital. Many years ago, counsel for the reorganized railroad in *Northern Pacific Railway v. Boyd*[39] expressed this point well:

> [B]etween 1892 and 1900, a large number of the railroad companies of the United States, by their necessities, were forced to submit to foreclosure. They have been succeeded by a system of vigorous, solvent, prosperous and useful corporations. The change, obviously to the public advantage, was the result of reorganizations so-called, of which almost all were based upon plans similar to that involved in the present case. The principle of such plans was that financial necessities of the physical properties could be met only by sufficient and prompt provision of additional cash capital for the new corporation; and that for prompt and sufficient cash provision the most available source was and would be those who already were acquainted with the physical property and would have faith in its future possibilities. Manifestly these were, and must continue to be, those who had been interested in the old company, either as bondholders or stockholders, and not necessarily or probably those who were its general creditors.[40]

Over the years since *Boyd*, there has been persistent pressure to find some way for the insolvent corporation's shareholders to be included in the reorganized corporation. Several decades ago, a number of influential commentators advocated what is known as the relative priority rule,[41] which would permit the level of debt to be scaled down to issue new stock in the reorganized corporation to the former shareholders. This is illustrated in Figure 5. The relative priority rule ran counter to basic principles of corporate law,[42] however, and it was

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control of the initiation of bankruptcy is economically justified in many cases); Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336, 369-70 (1993) (explaining that a debtor is usually in the best position to decide when to initiate bankruptcy).

39 228 U.S. 482 (1913).

40 *Id.* at 495 (argument for Appellant).

41 *See, e.g.*, James C. Bonbright & Milton M. Bergerman, *Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization*, 28 COLUM. L. REV. 127 (1928); E. Merrick Dodd, Jr., *The Securities and Exchange Commission's Reform Program for Bankruptcy Reorganizations*, 38 COLUM. L. REV. 223, 235-36 (1938); Harry G. Guthmann, *Absolute Priority in Reorganization: Some Defects in a Supreme Court Doctrine*, 45 COLUM. L. REV. 739 (1945); Robert T. Swaine, *Reorganization of Corporations: Certain Developments of the Last Decade*, 27 COLUM. L. REV. 901 (1927).

42 *See* 1 MODEL BUSINESS CORP. ACT ANN. § 6.40(c)(2) (3d ed. 1993) (stating that distributions to shareholders are not allowed if they would cause the corporation's total assets to become less than its total liabilities plus an amount needed to satisfy any preferential claims of preferred shareholders); 2 MODEL BUSINESS CORP. ACT ANN. § 87(b) (2d ed. 1971) (stating that, upon dissolution, a corporation must satisfy its liabilities before distributing any remaining assets among its shareholders); Walter J. Blum, *The Law and Language of Corporate Reorganization*, 17 U. CHI. L. REV. 565, 581 (1950) ("In theory the contractual priorities affecting the rights of creditors and shareholders are to be recognized in full. Senior claimants are supposed to be completely compensated, which includes being given equitable compensation for loss of any val-

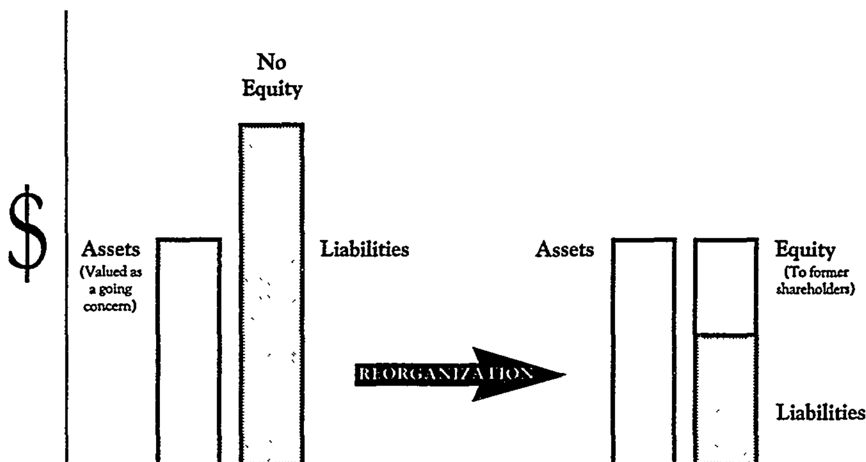

Figure 5
Reorganization Using the Relative Priority Rule

soon rejected by the Supreme Court[43] in favor of its converse, the absolute priority rule, which requires satisfaction of the claims of creditors in full before the shareholders can receive anything in a reorganization.

A variation of the relative priority rule was one of the recommendations made by the Commission on the Bankruptcy Laws of the United States in its 1973 report to Congress[44] that proposed sweeping revisions of the bankruptcy laws. Ultimately Congress rejected the

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uable rights, before junior claimants are permitted to receive anything of value."); *see also* UNIF. FRAUDULENT TRANSFER ACT § 5, 7A U.L.A. 657 (1985) (stating that a transfer is fraudulent as to existing creditors if the debtor did not receive reasonably equivalent value in exchange for the transfer and it was made while the debtor was insolvent, or the debtor became insolvent as a result of the transfer).

43 Louisville Trust Co. v. Louisville, N.A. & C. Ry., 174 U.S. 674, 684 (1899) ("[T]he stockholder's interest . . . is subordinate to the rights of creditors; first of secured and then of unsecured creditors. And any arrangement of the parties by which the subordinate rights and interests of the stockholders are attempted to be secured at the expense of the prior rights of either class of creditors comes within judicial denunciation.").

44 The Commission's Report stated in part:

> The Commission recommends that:
> 1. The fairness test be modified (a) by substituting for the unqualified "fair and equitable" criterion, *i.e.*, "absolute or strict priority", a test that precludes participation by junior interests where the going concern value does not cover senior interests, but easing the evidentiary basis for the valuation of the business; (b) allowing another look after the facts are in, and (c) by allowing equity security interests to participate if their future contributions, *e.g.*, continued management, are essential to the business.

REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. No. 137, 93d Cong., 1st Sess. 258 (1973).

Commission's recommendation, though, and instead adopted a form of the absolute priority rule as part of the current Bankruptcy Code.[45]

The Bankruptcy Code's absolute priority rule is qualified: it applies only if there is a class of unsecured creditors that is impaired under the reorganization plan and has not accepted the plan by the requisite majority in number of creditors and two-thirds in the dollar amount of claims.[46] Thus, a reorganization plan may be confirmed without the unanimous consent of the creditors.[47] This gives the present reorganization process an important advantage over workouts and informal negotiations outside the bankruptcy forum, where unanimous consent is required.[48] Still, it is not always possible to obtain acceptance from each class of unsecured creditors, particularly if a substantial number of the creditors is convinced that the Bankruptcy Code's absolute priority rule guarantees full payment of their claims before the shareholders are entitled to receive any share in the reorganized corporation.

Without an exception to the absolute priority rule, a plan would have to be accepted by each class of unsecured creditors to be confirmed. Unless acceptances from all classes could be obtained, the reorganization would fail and the creditors could wind up receiving less

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[45] Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 202 (1988) ("The [absolute priority] rule . . . was incorporated into Chapter 11 of the Bankruptcy Code adopted in 1978." (citation omitted)). Section 1129(b)(1) of Chapter 11 provides that if a plan has not been accepted by each class of claimants, it must be "fair and equitable" with respect to each class of claims that is impaired under, and has not accepted, the plan. 11 U.S.C. § 1129(b)(1) (1988). Section 1129(b)(2)(B) then states that in order to be "fair and equitable" the plan must satisfy the following requirement:

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

11 U.S.C. § 1129(b)(2)(B) (1988).

[46] *See* 11 U.S.C. §§ 1126, 1129(a)(8), (b)(1) (1988); *see also* Peter F. Coogan, *Confirmation of a Plan Under the Bankruptcy Code*, 32 CASE W. RES. L. REV. 301, 326 (1982) ("[T]he fair and equitable requirement survives in [S]ection 1129(b), but that situation applies only where consent of at least one impaired class has not been obtained.").

[47] The Bankruptcy Code has therefore partially overruled *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106 (1939), in which the Supreme Court reversed the confirmation of a reorganization plan that had been approved by more than 90% of the creditors. *Id.* at 115 ("[I]n this case the fact that 92.81% in amount of the bonds, 99.75% of the Class A stock, and 90% of the Class B stock have approved the plan is as immaterial on the basic issue of its fairness as is the fact that petitioners own only $18,500 face amount of a large bond issue.").

[48] *See* Varouj A. Aivazian & Jeffrey L. Callen, *Corporate Leverage and Growth*, 8 J. FIN. ECON. 379, 397 (1980) ("In an informal reorganization, all claimants must agree or be compensated. One can readily envisage small bondholders or shareholders threatening to abort the reorganization unless they are fully compensated. These threats are far less effective in a formal reorganization since the Bankruptcy Act [sic] requires that only two-thirds agreement (by face value of the claims) need be obtained for the reorganization.") (footnote omitted).

in liquidation than they would have received under the plan. The absolute priority rule could thus be detrimental to the interests of the very unsecured creditors it was designed to protect. To avoid such a perverse result, attorneys and courts have sought an alternative that would allow shareholders to participate in the reorganized corporation without having to satisfy all the claims of creditors.

V. THE SOURCE OF THE NEW CAPITAL CONTRIBUTION

The principal means by which shareholders have tried to participate in the reorganized corporation is by contributing new capital through the purchase of stock.[49] This has been called the "new capital exception" to the absolute priority rule. To support the exception, attorneys and judges have pointed to dictum from the Supreme Court decision in *Los Angeles Lumber*:[50]

> It is, of course, clear that there are circumstances under which stockholders may participate in a plan of reorganization of an insolvent debtor. This Court . . . indicated as much in *Northern Pacific Ry. Co. v. Boyd* . . . and *Kansas City Terminal Ry. Co. v. Central Union Trust Co.* . . . . Especially in the latter case 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. But if these conditions are not satisfied the stockholder's participation would run afoul of the ruling of this Court in *Kansas City Terminal Ry. Co. v. Central Union Trust Co.* . . . .
>
> . . . [W]e believe that to accord "the creditor his full right of priority against the corporate assets" where the debtor is insolvent, the stockholder's participation must be based on a contribution in money or in

[49] Professor LoPucki has made the following observations:

> Debtors' attorneys quickly discovered means of circumventing the absolute priority rule, most employing variations of one basic scheme. The debtor asserts that it has insufficient cash to continue operations and cannot raise the necessary cash by borrowing. (The assertion is usually true, although the owners may have maneuvered the debtor into that position deliberately.) The debtor then proposes to obtain the necessary working capital by sale of an interest in the business to "new investors." In fact the new investors are either the shareholders themselves or others who are associated with the shareholders in some manner. The new investment is contingent upon confirmation of a plan which pays unsecured creditors less than the full amount of their claims and gives ownership and control to the new investors. The bankruptcy courts generally hold that the absolute priority rule does not apply in these circumstances because the shareholders are retaining their ownership on account of the new investment and not "on account of (their) junior . . . interest."

LYNN M. LOPUCKI, STRATEGIES FOR CREDITORS IN BANKRUPTCY PROCEEDINGS 415 (1985).

[50] 308 U.S. 106.

money's worth, reasonably equivalent in view of all the circumstances to the participation of the stockholder.[51]

When the absolute priority rule was codified in the Bankruptcy Code in 1978,[52] it contained no reference to a new capital exception, and a number of courts have questioned whether the new capital exception survived that enactment.[53] In *Norwest Bank Worthington v. Ahlers*,[54] the United States, as amicus curiae, urged the Supreme Court to rule that the Bankruptcy Code had extinguished the new capital exception to the absolute priority rule.[55] The Court declined to reach this question, finding that its resolution was not essential to the dispute before it, since the capital contribution in the plan under review was not adequate under the *Los Angeles Lumber* standard. The Seventh and Tenth Circuit Courts of Appeals have similarly avoided reaching the question whether the new capital exception remains viable by determining that the particular capital contributions under review were inadequate.[56]

In *In re Greystone III Joint Venture*,[57] the Fifth Circuit initially held that Congress had eliminated the new capital exception by codifying a strict absolute priority rule.[58] However, on rehearing, the panel withdrew the portion of its opinion that dealt with the new capital exception.[59] A dissent[60] hinted that the withdrawal was prompted by the intervening decision in *Dewsnup v. Timm*,[61] in which the Supreme Court (in a somewhat different context)[62] expressed a reluc-

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[51] *Id.* at 121-22 (citations omitted) (footnote omitted).

[52] *See* 11 U.S.C. § 1129(b) (1988).

[53] *E.g., In re* Bryson Properties, XVIII, 961 F.2d 496, 503 (4th Cir.) ("[T]he courts are divided as to whether codification of the absolute priority rule in § 1129(b)(2)(B)(ii) tolled a death knell for the [new capital] exception.") (footnote omitted), *cert. denied*, 113 S. Ct. 191 (1992); Kham & Nate's Shoes No. 2, Inc. v. First Bank, 908 F.2d 1351, 1361 (7th Cir. 1990) ("Whether the 'new value exception' to the absolute priority rule survived the codification of that rule in 1978 is a question open in this circuit.").

[54] 485 U.S. 197 (1988).

[55] *Id.* at 203-04 n.3.

[56] *In re* Woodbrook Assocs., 19 F.3d 312, 320 (7th Cir. 1994) ("[W]e follow our prior decisions and again reserve ruling on the viability of the new value precept until another day."); Unruh v. Rushville State Bank, 987 F.2d 1506, 1510 (10th Cir. 1993) ("[W]e hold that as in *Ahlers*, this case does not require us to reach the issue of whether the 'new value exception' continues to exist.").

[57] 995 F.2d 1274 (5th Cir. 1991), *cert. denied*, 113 S. Ct. 72 (1992).

[58] *Id.* at 1283.

[59] *Id.* at 1284.

[60] *Id.* at 1285. *See also* Michael J. Thomerson, *The Status of the New Value Exception to the Absolute Priority Rule After* Norwest Bank Worthington v. Ahlers, 97 COM. L.J. 457, 469-70 (1992) (stating that *Ahlers* dissent and a commentator believe withdrawal was due at least in part to the decision in Dewsnup v. Timm, 112 S. Ct. 773 (1992)).

[61] 112 S. Ct. 773 (1992).

[62] *Dewsnup* was concerned with whether a debtor in a Chapter 7 liquidation proceeding could strip down a creditor's lien on real property to the value of the collateral.

tance to interpret the Bankruptcy Code as effecting a major change from pre-Code practice unless there was some legislative history to support the change.[63]

The Ninth Circuit relied in part on *Dewsnup* in *In re Bonner Mall Partnership*[64] to conclude that the new value exception had not been abolished by the failure of Congress explicitly to enact it in the Bankruptcy Code.[65] The Ninth Circuit also reasoned that permitting former owners to receive stock in a reorganized corporation did not violate the absolute priority rule if their receipt of stock was not "on account of" their prior ownership interests, but rather given in return for their contributions of new value.[66] The Supreme Court granted certiorari in *Bonner Mall*[67] to resolve the issue it failed to reach in *Ahlers*.[68] Before the Court could decide the issue, however, the parties settled the case, rendering it moot.[69]

Although the *Bonner Mall* settlement prevented the Court from addressing the new value exception's survival, this issue will surely come back to the Court again.[70] When it does, the Court should recognize the exception, because an insolvent corporation's former owners are often the only feasible source of new capital, and their contributions should be encouraged, rather than barred. In addition, the Court should require the form and amount of the capital contributions to be sufficient to fulfill the purpose of the Chapter 11 reorganization process by restoring financial health to the reorganized company.

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63 112 S. Ct. at 779.

64 2 F.3d 899 (9th Cir. 1993), *cert. granted*, 114 S. Ct. 681, *dimissed as moot*, 115 S. Ct. 386 (1994) (denying motion to vacate court of appeals decision after the case becomes moot by voluntary settlement).

65 *Id.* at 912-13.

66 *Id.* at 908-09. *See also* Elizabeth Warren, *A Theory of Absolute Priority*, 1991 ANN. SURV. AM. L. 9, 39 ("By its own language, the absolute priority rule limits old equity's participation in the post-reorganization business only to the extent that old equity claims a share of the estate based on its pre-bankruptcy equitable ownership. The Code does not prohibit old equity from becoming a post-petition financer of the business or a post-plan owner of the business.").

67 U.S. Bancorp Mortgage Co. v. Bonner Mall Partnership, 114 S. Ct. 681 (1994).

68 The question for which the Supreme Court originally granted review was: "Did new value exception to absolute priority rule survive enactment of 1978 Bankruptcy Reform Act, permitting debtor in Chapter 11 bankruptcy case to confirm nonconsensual plan of reorganization that allows debtor's equityholders to retain ownership of reorganized debtor while paying objecting creditors less than full amount of their claims?" 62 U.S.L.W. 3441 (Jan. 11, 1994).

69 After the settlement, the creditor who objected to the reorganization plan moved to vacate the Ninth Circuit's decision. U.S. Bancorp Mortgage Co. v. Bonnner Mall Partnership, 114 S. Ct. 1367 (1994). In a unanimous opinion, the Supreme Court denied the motion. U.S. Bancorp Mortgage Co. v. Bonner Mall Partnership, 115 S. Ct. 386, 393-94 (1994).

70 *See In re* Bonner Mall Partnership, 2 F.3d 899, 901 (9th Cir. 1993) ("The question will in all probability ultimately be decided by the Supreme Court."), *cert. granted*, 114 S. Ct. 681 (1994).

VI. The Form of the New Capital Contribution

Although the Supreme Court refused to resolve the issue of the new capital exception's existence in *Norwest Bank Worthington v. Ahlers*,[71] it did rule on the form required for a capital contribution if the exception were to be recognized. Following *Los Angeles Lumber*,[72] the Supreme Court held that capital contributions would have to be in the form of "money or money's worth" if they were to come within a new capital exception to the absolute priority rule.

In *Los Angeles Lumber*, the reorganization plan called for contributions from the reorganizing corporation's former shareholders that consisted merely of their "financial standing and influence in the community" and their providing "continuity of management."[73] While appearing to recognize the new capital exception, the Court held that these intangibles were not adequate consideration for the issuance of stock in the reorganized corporation, saying: "On the facts of this case they cannot possibly be translated into money's worth reasonably equivalent to the participation accorded the old stockholders. They have no place in the asset column of the balance sheet of the new company. They reflect merely vague hopes or possibilities."[74]

The reorganization plan in *Ahlers* called for "yearly contributions of labor, experience, and expertise"[75] from the owners of a farm. As in *Los Angeles Lumber*, the Supreme Court decided that these contributions of future services were not sufficient to justify an exception from the absolute priority rule. It reasoned:

> Viewed from the time of approval of the plan, respondents' promise of future services is intangible, inalienable, and, in all likelihood, unenforceable. It "has no place in the asset column of the balance sheet of the new [entity]." *Los Angeles Lumber*, 308 U.S. at 122-23. Unlike "money or money's worth," a promise of future services cannot be exchanged in any market for something of value to the creditors *today*. In fact, no decision of this Court or any Court of Appeals, other than the decision below, has ever found a promise to contribute future labor, management, or expertise sufficient to qualify for the *Los Angeles Lumber* exception to the absolute priority rule.[76]

The form of contribution analyzed by the Seventh Circuit in *Kham & Nate's Shoes No. 2, Inc. v. First Bank*[77] was a shareholder guarantee of a loan to the reorganizing corporation.[78] The plan of reorganization provided for the corporation's former shareholders to

[71] 485 U.S. 197 (1988).
[72] 308 U.S. 106 (1939).
[73] *Id.* at 122.
[74] *Id.* at 122-23 (footnote omitted).
[75] 485 U.S. at 201.
[76] *Id.* at 204 (emphasis in original) (brackets in original) (footnote omitted).
[77] 908 F.2d 1351 (7th Cir. 1990).
[78] *Id.* at 1362-63.

retain ownership of the corporation in return for their guaranteeing new loans to finance the reorganization. Relying on *Ahlers* and *Los Angeles Lumber*, the Seventh Circuit ruled that the guarantees could not constitute new value for purposes of satisfying a new capital exception to the absolute priority rule.[79] Judge Easterbrook's opinion for the court pointed out that guarantees are not balance-sheet assets; instead, they are intangible, inalienable, and unenforceable, because there is no way for a corporation to prevent shareholders from revoking their guarantees or rendering them valueless by disposing of their assets.[80] It also noted that if the shareholders were organizing a new corporation in Illinois, they could not issue stock to themselves in return for guarantees of loans, because Illinois law restricts the consideration for new shares to money, property, or past services.[81] The court also distinguished its own earlier decision, *In re Potter Material Service, Inc.*,[82] on the ground that the shareholder in that case had contributed cash in addition to guaranteeing a substantial loan, while the guarantees were the only contributions that the shareholders in *Kham & Nate's Shoes* were making.[83]

The Seventh Circuit made a useful comparison in the *Kham & Nate's Shoes* decision between the form of new capital contributions in the corporate reorganization context and the form of capital contributions required as consideration for the issuance of stock under general corporate law. For many years, the trend in corporate law has been toward increasing liberalization of the form of allowed capital contributions. Cash was at first the only form of consideration allowed for the purchase of shares, but early in the history of corporations, property regarded as "money's worth" became an acceptable substitute for cash. After 1850, services that had already been performed were recognized as a permissible form of consideration.[84] This was the scheme of the Model Business Corporation Act in 1969:

> The consideration for the issuance of shares may be paid, in whole or in part, in money, in other property, tangible or intangible, or in labor or services performed for the corporation . . . .
>
> Neither promissory notes nor future services shall constitute payment or part payment for the issuance of shares of a corporation.[85]

The Revised Model Business Corporation Act adopted in 1984 broadened the allowable consideration to "any tangible or intangible property or benefit to the corporation, including cash, promissory notes,

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79 *Id.* at 1362.

80 *Id.* at 1362-63.

81 *Id.* at 1362.

82 781 F.2d 99 (7th Cir. 1986).

83 908 F.2d at 1362.

84 1 MODEL BUSINESS CORP. ACT ANN. § 6.21 history (3d ed. 1989); 1 MODEL BUSINESS CORP. ACT ANN. § 19 comment (2d ed. 1971).

85 1 MODEL BUSINESS CORP. ACT ANN. § 19 (2d ed. 1971).

services performed, contracts for services to be performed, or other securities of the corporation."[86] The Official Comment explains:

> Section 6.21(b) specifically validates contracts for future services (including promoters' services), promissory notes, or "any tangible or intangible property or benefit to the corporation," as consideration for the present issue of shares. The term "benefit" should be broadly construed to include, for example, a reduction of a liability, a release of a claim, or benefits obtained by a corporation by contribution of its shares to a charitable organization or as a prize in a promotion. In the realities of commercial life, there is sometimes a need for the issuance of shares for contract rights or such intangible property or benefits. And, as a matter of business economics, contracts for future services, promissory notes, and intangible property or benefits often have value that is as real as the value of tangible property or past services, the only types of property that many older statutes permit as consideration for shares. Thus, only business judgment should determine what kind of property should be obtained for shares, and a determination by the directors meeting the requirements of section 8.30 to accept a specific kind of valuable property for shares should be accepted and not circumscribed by artificial or arbitrary rules.[87]

The Supreme Court's insistence in *Los Angeles Lumber* and *Ahlers* that new capital contributions must be "money or money's worth" appears to be out of step with the liberal trend reflected in the Revised Model Business Corporation Act. On the other hand, this may well be justified in the peculiar context of Chapter 11, where a debtor is seeking confirmation of a reorganization plan over the objection of at least one impaired class of creditors.[88] A corporation that has already experienced insolvency is inherently riskier than the average corporation, and so its creditors may be entitled to greater solicitude from the bankruptcy court, which may properly require more tangible forms of new capital to make up the equity cushion.

Nonetheless, it would be a mistake to construe the *Los Angeles Lumber* and *Ahlers* cases so rigidly as to exclude all forms of intangible property. For example, if allowed as consideration for new shares under the applicable state corporate law,[89] a promise of future serv-

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[86] 1 MODEL BUSINESS CORP. ACT ANN. § 6.21 (3d ed. 1989).

[87] *Id.* § 6.21 official comment.

[88] *Cf. Kham & Nate's Shoes*, 908 F.2d at 1362 ("Promises inadequate to support the issuance of shares under state law are also inadequate to support the issuance of shares by a bankruptcy judge over the protest of creditors, the real owners of the firm.").

[89] *Cf.* Butner v. United States, 440 U.S. 48, 55 (1979) ("Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding. Uniform treatment of property interests by both state and federal courts within a State serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving 'a windfall merely by reason of the happenstance of bankruptcy.' ") (citation omitted).

ices might appropriately be allowed as a new capital contribution,[90] particularly if arrangements (such as placing the shares in escrow)[91] could be made to assure that the promised services are forthcoming. Similarly, had Illinois law permitted a guarantee to constitute allowable consideration for the issuance of new shares, and had there been some way to quantify the guarantee's value to the reorganizing corporation, *Kham & Nate's Shoes* might have come out differently.

VII. THE AMOUNT OF THE NEW CAPITAL CONTRIBUTION

Although there has been considerable concern expressed in the cases about the source and form of a new capital contribution in a plan of reorganization, there has been relatively little analysis of the amount of new capital necessary to finance a reorganization. In *Case v. Los Angeles Lumber Products Co.*,[92] the Supreme Court stated that "the stockholder's 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."[93] Because the shareholders' contribution in that case was not "in money or in money's worth," it was not in the proper form, and the Court did not need to decide whether it was "reasonably equivalent" to the value of the equity the shareholders were to receive under the plan. Thus, the Court's statement concerning the magnitude of the new capital contribution was not part of its holding. Nevertheless, numerous courts have adhered to the Supreme Court's dictum that the new capital contribution must be reasonably equivalent to the value of the interests in the reorganized corporation that the contributing shareholders will receive.[94]

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[90] Most states continue to follow Section 19 of the Model Business Corporation Act (1969) and prohibit the issuance of shares in exchange for promises of future services. *See* 1 MODEL BUSINESS CORP. ACT ANN. § 6.21 annot. at 370-71 (3d ed. 1989); *see also, e.g.*, COLO. REV. STAT. § 7-4-105(2) (1986) ("The promise of future services shall not constitute payment or part payment for shares of a corporation."); N.Y. BUS. CORP. LAW § 504(b) (McKinney 1986) ("Neither obligations of the subscriber for future payments nor future services shall constitute payment or part payment for shares of a corporation.").

[91] *See* 1 MODEL BUSINESS CORP. ACT ANN. § 6.21(e) (3d ed. 1989), which provides:

> The corporation may place in escrow shares issued for a contract for future services or benefits or a promissory note, or make other arrangements to restrict the transfer of the shares, and may credit distributions in respect of the shares against their purchase price, until the services are performed, the note is paid, or the benefits received. If the services are not performed, the note is not paid, or the benefits are not received, the shares escrowed or restricted and the distributions credited may be cancelled in whole or part.

The escrow arrangements should include protection against the possibility of the corporation's waiving the escrow terms to the detriment of creditors.

[92] 308 U.S. 106 (1939).

[93] *Id.* at 122.

[94] *See, e.g.*, *In re* Stegall, 865 F.2d 140, 141 (7th Cir. 1989) ("[T]here is a judge-made exception to the absolute priority rule: the debtor can retain an interest in the bankrupt estate ahead of his creditors to the extent that he puts new capital into the estate. So if he contributes $50,000

The Seventh Circuit's opinion in *Potter*[95] illustrates how the *Los Angeles Lumber* standard has been applied. Under the proposed plan of reorganization, all stock in the insolvent corporation was to be canceled, the unsecured creditors were to receive three percent of their allowed claims, and the sole shareholder was to be issued all the stock in the reorganized corporation in return for: (1) contributing $14,800 to the corporation to fund the payments to the unsecured creditors, (2) paying the allowed compensation to the debtor's attorneys in an amount estimated at $20,000, and (3) renewing a personal guarantee of a $600,000 loan to the debtor. The bankruptcy court confirmed the debtor's plan over the objection of the unsecured creditors on the ground that the shareholder's contribution was substantial and exceeded the going concern value of the firm, which the court concluded was between $10,000 and $15,000.[96] No explanation was offered regarding how the bankruptcy court determined the corporation's going concern value, but the Seventh Circuit affirmed because there was no showing that the bankruptcy court's determination was erroneous.[97]

While most commentators have accepted the *Los Angeles Lumber* standard uncritically,[98] John Ayer[99] and Bruce Markell[100] have pointed out that it is fundamentally unsound. The problem with the standard is that it will always be satisfied whenever the corporation's pre-reorganization going concern value is allocated entirely to its creditors, as is required under the absolute priority rule.[101] As Professor Markell notes, rather than placing limits on the new capital exception to the absolute priority rule, the *Los Angeles Lumber* standard "merely rephrases the . . . rule."[102]

in cash to the bankrupt enterprise, he can retain an interest worth $50,000 . . . ."); *In re* Ashton, 107 B.R. 670, 674 (Bankr. D.N.D. 1989) ("[T]o retain property to the exclusion of the unsecureds the contribution must at least equal the interest being retained."); *In re* Aztec Co., 107 B.R. 585, 588 (Bankr. M.D. Tenn. 1989) (finding that the new capital exception was satisfied because the "new investment is far in excess of the value of the interests that the venturers will retain in the debtor"); *In re* Yasparro, 100 B.R. 91, 99 (Bankr. M.D. Fla. 1989) ("[T]he contribution must be reasonably equivalent to the value of the interest to be retained. This is self-explanatory.").

95 781 F.2d 99 (7th Cir. 1986).

96 *Id.* at 102.

97 *Id.* at 103-04.

98 *See, e.g.*, John T. Bailey, *The "New Value Exception" in Single-Asset Reorganizations: A Commentary on the* Bjolmes *Auction Procedure and Its Relationship to Chapter 11*, 98 COM. L.J. 50, 53 (1993); Linda J. Rusch, *The New Value Exception to the Absolute Priority Rule in Chapter 11 Reorganizations: What Should the Rule Be?*, 19 PEPP. L. REV. 1311, 1333-35 (1992); Warren, *supra* note 66, at 43.

99 *See* John D. Ayer, *Rethinking Absolute Priority After* Ahlers, 87 MICH. L. REV. 963, 1012-19 (1989).

100 *See* Markell, *supra* note 5.

101 *Id.* at 98 ("[A]ny contribution of money or money's worth permits owners to retain ownership so long as creditors receive property equal to the debtor's reorganization value.").

102 *Id.* at 101.

In order to repair an insolvent corporation's capital structure through the reorganization process, its liabilities must first be written down to the going concern value of the corporation's assets. As a result, the going concern value of the corporation's assets net of its remaining liabilities becomes zero. The going concern value of the corporation's assets net of liabilities cannot be greater than zero, because if it were, the creditors would be entitled to the excess as a result of the absolute priority rule. Indeed, the only justification for reducing the corporation's liabilities in the reorganization process is the fact that they exceed the going concern value of the corporation's assets; if they did not, the creditors would be entitled to have their claims satisfied in full. A contribution of new capital to the reorganizing corporation causes its going concern value net of its liabilities to increase precisely by the amount of the contribution. Since the contribution will always be equivalent to the corporation's going concern value net of liabilities,[103] the amount of the capital contribution that is required in the reorganization process cannot be determined from the corporation's going concern value.[104]

The indeterminacy of the *Los Angeles Lumber* standard may be demonstrated with a numerical example. Consider the balance sheet of a corporation that initially has assets with a going concern value of $1 million and liabilities of $3 million. Writing down the liabilities to $1 million (the going concern value of the assets) would yield a net going concern value of zero. If a shareholder or other investor were to make a capital contribution of $200,000 after the writing down of the liabilities, the going concern value of the corporation's assets after the contribution would be $1.2 million and its net going concern value would be $200,000. This is illustrated below.

Professor Ayer is correct in pointing out that a reorganizing corporation's going concern value net of its liabilities must be zero, but he is mistaken when he goes on to contend that this means there is no basis for a new capital exception to the absolute priority rule.[105] He claims that a rational shareholder would never agree to contribute new capital to an insolvent corporation that is undergoing reorganization, and if one did, the fact that the shareholder was offering to contribute new capital would itself be an "admission" that the reorganizing corporation's net going concern value was really more than zero. If the reorganized corporation did have a positive going

[103] *See id.* at 116 n.278 ("If full reorganization value is to be returned to creditors, then the contribution by the debtor will equal, at least on an accounting basis, the total net worth of the reorganized debtor.").

[104] *See In re* Jartran, Inc., 44 B.R. 331, 379 (Bankr. N.D. Ill. 1984) ("Inasmuch as the shareholders' equity is valueless, any contribution by [a shareholder] will necessarily be equal to or greater than the value of its 100% ownership interest.").

[105] *See supra* note 99.

Before Reorganization

Assets	$1,000,000	Liabilities	$3,000,000
		Equity	–2,000,000
Total	$1,000,000		$1,000,000

After Reorganization

Assets	$1,000,000	Liabilities	$1,000,000
Shareholder Contribution	200,000	Equity	200,000
Total	$1,200,000		$1,200,000

concern value, the reorganization plan could not be confirmed unless all the creditors received full payment.[106]

Professor Ayer's latter argument brings to mind the story about the student who tells a finance professor that there is a twenty-dollar bill lying on the ground; the professor responds that if the bill really were there, someone else would already have picked it up.[107] Even though a reorganizing corporation's net going concern value is zero, it may nonetheless offer a profitable investment opportunity for a prior shareholder. Moreover, there may be other reasons (economic as well as noneconomic) for a former shareholder to be willing to pay a premium for continued ownership.[108]

A shareholder's contribution of new capital does not vanish after it is made; instead, it increases the going concern value of the reorganized corporation. Consequently, it is not irrational for an investor to make a capital contribution to a corporation that has a net going concern value of zero. The increase in going concern value resulting from the infusion of new capital may be even larger than the capital contribution, and if that is so, the contributing shareholder will earn a profit from the investment. In addition, over time the active participation of former shareholders may contribute even more to the corporation's

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[106] Professor Ayer writes:

> Given that no one would pay $10 for a company with a net worth of zero, then the offer of a $10 payment has to be taken as an "admission" that the company is worth more than [the amount the court found was the going concern value of the corporation's assets]. But if it is worth more than [the court's finding of the going concern value], then [the creditor's] secured claim is undervalued, and [the creditor] is not being fully compensated on that secured claim. That being the case, cram-down is not available, and the plan may not be confirmed.
>
> The same logic forbids confirmation at any valuation until [the creditor] either (a) consents or (b) receives full value for its claim.

Ayer, *supra* note 99, at 1014.

[107] *See* Martin Shubik, *Corporate Control, Efficient Markets, and the Public Good*, *in* KNIGHTS, RAIDERS, AND TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER 31, 33 (John C. Coffee, Jr. et al. eds., 1988).

[108] *See* Markell, *supra* note 5, at 100 (tax benefits, sentimentality); Warren, *supra* note 66, at 21-22 (continued employment, "psychic income," and connection to other businesses).

going concern value, particularly if they are involved in the corporation's management or operations.

Professor Ayer concludes that because the size of the new capital contribution cannot be determined from the corporation's going concern value, there is no basis for a new capital exception to the absolute priority rule.[109] His conclusion does not follow, though, because there may be other criteria by which courts may determine the appropriate size for the new capital contribution.

One requirement that a number of courts have imposed is that the new capital contribution must be necessary to the reorganization.[110] By definition, an insolvent corporation needs new capital in order for its solvency to be restored. Because this requirement will always be satisfied, it does not provide any guidance as to the amount of the capital contribution that will be sufficient for reorganization.

Another criterion that several courts have applied is that a new capital contribution must be "substantial."[111] For example, the Seventh Circuit said in *Potter* that "[t]he new capital investment must (1) represent a substantial contribution and (2) equal or exceed the value of the retained interest in the corporation."[112] The court failed to specify any standard for evaluating whether a capital contribution is substantial, however; it merely ruled that the bankruptcy court's finding of a substantial contribution was not erroneous.[113]

109 Ayer, *supra* note 99, at 1012 (1989) (stating that "new value may have been an illusion all along—or less dramatically, there may never have been an adequate doctrinal basis for the new value rule").

110 *See, e.g.*, *In re* Snyder, 967 F.2d 1126, 1131 (7th Cir. 1992) ("[A]n infusion of new capital must be necessary to the success of the undertaking."); *In re* S.A.B.T.C. Townhouse Ass'n, Inc., 152 B.R. 1005, 1010 (Bankr. M.D. Fla. 1993) ("The second requirement of the 'new value exception' is that the contribution must be necessary to the Debtor's reorganization effort."); *In re* F.A.B. Indus., 147 B.R. 763, 769 (C.D. Cal. 1992) (new value must be "necessary for an effective reorganization"); *In re* Batten, 141 B.R. 899, 908 (Bankr. W.D. La. 1992) ("In order to qualify under the exception, debtors must first show the necessity for the capital infusion."); *In re* Mortgage Inv. Co., 111 B.R. 604, 620 (Bankr. W.D. Tex. 1990) ("The capital infusion exception may only be used in those instances where the capital is *necessary* for the continued operations of the debtor.") (emphasis in original) (footnote omitted).

111 *See, e.g.*, *In re* Snyder, 967 F.2d 1126, 1131 (7th Cir. 1992) ("The requirement that a contribution be substantial is independent of the rule that a contribution must be at least equal to the value of the interest retained."); *In re* F.A.B. Indus., 147 B.R. 763, 769 (C.D. Cal. 1992) (new value must be substantial); *In re* Batten, 141 B.R. 899, 908 (Bankr. W.D. La. 1992) (to qualify under the new value exception the capital "must be substantial"); *In re* SLC Ltd. V, 137 B.R. 847, 855 (Bankr. D. Utah 1992) ("One element courts have applied to valuation is whether the contribution is substantial."); *see also In re* Greystone III Joint Venture, 995 F.2d 1274, 1283 (5sh Cir. 1991) (proposed test for new value exception includes requirement that it be substantial) (withdrawn on rehearing), *cert. denied*, 113 S. Ct. 72 (1992); Markell, *supra* note 5, at 95 n.166 (criticizing the substantiality requirement).

112 *In re* Potter Material Service, Inc., 781 F.2d 99, 101 (7th Cir. 1986).

113 *Id.* at 103.

Some courts[114] and commentators[115] have interpreted this last criterion to mean that the capital contribution must be more than a mere token amount. While it is clear that a capital contribution must be greater than a trifle, this is a feeble standard for assessing the sufficiency of a capital contribution. The primary gauge that courts have used to measure whether a capital contribution is substantial is the amount of prepetition debt that will be discharged under the plan.[116] Comparing the capital contribution to the amount of prepetition debt may have some validity, because the amount of liabilities that the insolvent corporation accumulated in the past may be some indication of its future capital needs.

Rather than dwelling on the debtor's liabilities from the past, though, a bankruptcy court should look to its future prospects. This was the approach taken by Judge Altenberger in *In re Snyder*,[117] where he explained:

> It seems clear that in establishing the exception the Supreme Court was requiring a contribution of new money in an amount essential to the success of the reorganization. So another consideration is whether the . . . cash contribution is sufficient to bring about a successful reorganization. Stated another way, will the contribution give the Debtors the financial strength to complete the Plan?[118]

The most appropriate standard for a new capital contribution is whether it provides an adequate equity cushion.[119] The price that the

114 *See In re* Woodbrook Assocs., 19 F.3d 312, 320 (7th Cir. 1994) ("[T]he proposed token cash infusion does not constitute 'new value' and violates the absolute priority rule."); *In re* Snyder, 967 F.2d 1126, 1131 (7th Cir. 1992) ("Contributions that are merely nominal or 'gratuitous, token cash infusions proposed primarily to "buy" cheap financing,' will not suffice."); *In re* Stegall, 865 F.2d 140, 144 (7th Cir. 1989) (nominal contribution would not be sufficient).

115 *See* Warren, *supra* note 66, at 43 (stating that, to be substantial, the contribution "must be something more than nominal").

116 *See In re* Woodbrook Assocs., 19 F.3d 312, 320 (7th Cir. 1994) (affirming district court decision that the proposed capital contribution was not substantial because it constituted only 3.8% of the total amount of unsecured debt); *In re* Olson, 80 B.R. 935, 937 (Bankr. C.D. Ill. 1987) ("Inasmuch as the application of the exception involves the relationship of the Debtors to the dissenting class, one factor to be considered is the amount of the contribution compared to the amount of unsecured debt due to the dissenting class."); *In re* Pullman Constr. Indus., Inc., 107 B.R. 909, 950 (N.D. Ill. 1989) ("[T]o gauge whether or not the [shareholders'] contribution is 'substantial', the Court must compare the contribution to the total pre-petition claims and the amount of debt to be discharged under the Plan."); *In re* Ruby Debruycker Ranch, Inc., 84 B.R. 187, 190 (Bankr. D. Mont. 1988) ("The cash contributions, while allowing the Debtor [sic] to retain their equity, pales into the 'de minimus' category, even if one were to accept the exceptions of *Case* is [sic] allowable under the absolute priority rule. In other words, the capital contribution must certainly result in a 100% pay out of unsecured creditors, which is not proposed under the Plan."). *But see In re* Snyder, 967 F.2d 1126, 1131 (7th Cir. 1992) ("We cannot say that the determination as to whether an infusion of new capital is 'substantial' will always hinge on a comparison to the total amount of unsecured debt.").

117 105 B.R. 898 (Bankr. C.D. Ill. 1989), *aff'd*, 967 F.2d 1126 (7th Cir. 1992).

118 *Id.* at 903.

119 I am indebted to my colleague M. Thomas Arnold for this insight.

new owners of a reorganized corporation should be required to pay for control following the reorganization is neither the going concern value (which will be zero if the assets are valued correctly and the absolute priority rule is applied) nor the amount of liabilities to be discharged. Instead, the rule should require the new owners to put up a sufficient stake in the enterprise to absorb any future losses that can reasonably be anticipated.[120]

Absolute protection for a corporation's creditors is not attainable. No business is entirely risk-free, and there is always some possibility of future losses to creditors that cannot be eliminated with any finite amount of equity capital. Although creditors cannot expect to receive absolute protection, they can be shielded from most risks of loss through the maintenance of an adequate cushion of equity. An adequate cushion provides owners with appropriate incentives to maximize the long-term value of the corporation, whether the equity cushion comes from outside investors or from former shareholders. The equity cushion needs to be large enough not only to keep the potential conflicts of interest between shareholders and creditors to a minimum, but also to absorb any fluctuations in earnings that can reasonably be anticipated. Otherwise, there is a significant risk of another insolvency, and the reorganization will have been for naught.[121]

To protect the corporation's existing and future creditors from another insolvency, the feasibility requirement in Section 1129(a)(11) of the Bankruptcy Code provides that a bankruptcy court should confirm a reorganization plan only if confirmation "is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor."[122] This requirement has long been a part of the law of bankruptcy reorganizations. Section 221(2) of the former

120 *See Snyder*, 105 B.R. at 904 ("[T]he purpose of requiring a contribution of new capital is to help provide financial strength to complete the plan."); *cf. In re* Bonner Mall Partnership, 2 F.3d 899, 916 n.38 (9th Cir. 1993) ("If old equity contributes a substantial amount of new capital to the business undergoing reorganization, then the risk of a later failure falls more heavily on stockholders than creditors."), *cert. granted*, 114 S. Ct. 681, *dismissed as moot*, 115 S. Ct. 386 (1994); Raymond T. Nimmer, *Negotiated Bankruptcy Reorganization Plans: Absolute Priority and New Value Contributions*, 36 EMORY L.J. 1009, 1051-52 (1987) ("With the contribution, the former owners, undertake a risk of increased loss. In return, they retain control as well as an opportunity to benefit from market and valuation factors."); Warren, *supra* note 66, at 43 ("[The rule that the contribution must be substantial] evidently functions to assure that there is not only a purchase in form, but also in substance—that the DIP [debtor in possession] is putting up something more than a token amount for the control and going-concern value.").

121 *See* E. Merrick Dodd, Jr., *Reorganization Through Bankruptcy: A Remedy for What?*, 48 HARV. L. REV. 1100, 1102 (1935) ("The first essential of a workable reorganization plan is that it shall, so far as is possible, provide the reorganized enterprise with a capital structure and cash resources which will give it a reasonable chance of financial rebirth as a solvent going concern.").

122 11 U.S.C. § 1129(a)(11) (1988). *See* Markell, *supra* note 5, at 116 n.278 (explaining that the feasibility requirement provides a test for whether the capital contribution is sufficient for the reorganized corporation to be able to thrive).

Bankruptcy Act included a similar requirement[123] from which Section 1129(a)(11) was derived.[124] To determine whether a plan satisfies the feasibility standard, courts usually look at whether there is a reasonable prospect that the reorganization plan will succeed.[125] While the adequacy of a debtor's capital structure is often listed as one of the factors used in analyzing a plan's feasibility,[126] the bankruptcy courts have tended to concentrate on the accuracy of the plan's income projections,[127] instead of on the need for the owners of the reorganized corporation to have a significant stake in the enterprise.

The feasibility requirement cannot be satisfied if the reorganized corporation is so thinly capitalized that it is unable to withstand some future losses. An all-equity capital structure would provide the largest possible equity cushion, but most corporations operate satisfactorily with substantial levels of debt.[128] Debt increases risk, but the reorganized corporation obtains offsetting benefits from the tax advantages and leverage that debt financing provides. And subject always to the stability of the expected earnings for the reorganized corporation, the risk of insolvency following reorganization can be held to an acceptable level by maintaining an adequate equity cushion.

A variety of factors may potentially influence a corporation's capital structure. These include the corporation's profitability, the uniqueness of its products, the degree of specialization of its equipment and its employees, and the extent of equity ownership by its manage-

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123 11 U.S.C. § 621 (1976) (repealed 1978) (providing in pertinent part: "[t]he judge shall confirm a plan if satisfied that . . . the plan is fair and equitable, and feasible").

124 S. Rep. No. 989, 95th Cong., 2d Sess. 128 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5914 (stating in pertinent part: "Paragraph (11) requires a determination regarding feasibility of the plan. It is a slight elaboration of the law that has developed in the application of the word 'feasible' in Chapter X of the present Act.").

125 *See, e.g.*, Kane v. Johns-Manville Corp., 843 F.2d 636, 649 (2d Cir. 1988) ("[T]he feasibility standard is whether the plan offers a reasonable assurance of success. Success need not be guaranteed.").

126 *See, e.g.*, *In re* U.S. Truck Co., 800 F.2d 581, 589 (6th Cir. 1986); *In re* Landing Assocs., Ltd., 157 B.R. 791, 819 (Bankr. W.D. Tex. 1993); *In re* Landmark at Plaza Park, Ltd., 7 B.R. 653, 659 (Bankr. D.N.J. 1980).

127 *See, e.g.*, *In re* SM 104 Ltd., 160 B.R. 202, 234-39 (Bankr. S.D. Fla. 1993); *see also* David G. Epstein et al., Bankruptcy 759 (1993):

> How does the debtor establish feasibility? It does so through business projections, and by putting the chief financial officer, accountants, business consultants or other experts on the witness stand to explain why a new and sunny day is dawning. Business projections are inexact at best, and creditors can easily cast doubt on feasibility by challenging the debtor's assumptions and by presenting their own skeptical witnesses.

128 Robert A. Taggart, Jr., *Secular Patterns in the Financing of U.S. Corporations*, *in* Corporate Capital Structures in the United States 13, 16-17 (Benjamin M. Friedman ed., 1985) (noting a dramatic increase in the debt-to-asset ratio for U.S. corporations between 1937 and 1979).

ment.[129] However, the primary factor affecting a corporation's capital structure is generally the volatility of its earnings. A number of studies have shown, for example, that corporations in regulated industries, which tend to have stable earnings, have the highest proportions of debt, while pharmaceutical and electronics manufacturers, which tend to have the most volatile earnings, have the smallest proportions of debt.[130]

In evaluating whether a proposed capital contribution is sufficient to absorb future losses, a bankruptcy court should look at the capital structures of other corporations in the same industry. The volatility of earnings depends on the type of business in which a corporation is engaged, and consequently, corporations in the same industry tend to have similar capital structures.[131] The capital structures of other corporations in the same industry can therefore provide a gauge for measuring the adequacy of the proposed equity cushion in the reorganized corporation.[132]

Surprisingly, when reviewing the adequacy of capital contributions, the courts have generally been oblivious to the need for an equity cushion to provide financial stability in the reorganized corporation. For example, in affirming Judge Altenberger's decision in *In re Snyder*, the Seventh Circuit relied on the disparity between the contribution and the amount of unsecured debt that the corporation had before the reorganization,[133] rather than on whether the reorganized corporation had a suitable capital structure. A comparison of the magnitude of the capital contribution to the unsecured debt is of little use in assessing the adequacy of the contribution, because the fundamental purpose of the reorganization process is to restore a stable capital structure to the corporation, rather than to repay its former creditors. Repaying the former creditors might be a desirable end, but a corporation's shareholders have no such obligation under the lim-

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129 *See* Milton Harris & Artur Raviv, *The Theory of Capital Structure*, 46 J. FIN. 297, 337-40 (1991) (summarizing theoretical and empirical studies of the effect these and other factors have on a corporation's capital structure).

130 *Id.* at 333-35.

131 Michael Bradley et al., *On the Existence of an Optimal Capital Structure: Theory and Evidence*, 39 J. FIN. 857, 869 (1984) ("[A]lmost 54% of the cross-sectional variance in firm leverage ratios can be explained by industrial classification. There is more variation in mean leverage ratios across industries than there is in firm leverage ratios within industries.").

132 *Cf.* Lynn M. LoPucki & William C. Whitford, *Patterns in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 78 CORNELL L. REV. 597, 607-09 (1993) (finding that companies emerging from reorganizations tended to have higher debt to equity ratios than companies of comparable size in the same businesses).

133 The court decided that the proposed capital contribution was insubstantial because it amounted to only 2.7% of the total unsecured debt and 3.3% of what was owed to the principal creditor. *In re Snyder*, 967 F.2d 1126, 1131 (7th Cir. 1992).

ited liability rule.[134] All the creditors are entitled to receive is the going concern value of the corporation's assets, and without a successful reorganization, all they would receive is the liquidation value of the assets. The capital contribution goes not to the creditors, but rather to the reorganized corporation, and so the size of the capital contribution should have nothing to do with the amount of liabilities that are discharged in the reorganization process.

The lack of concern shown by bankruptcy courts for an adequate capital structure is exemplified by *In re Bjolmes Realty Trust*.[135] The debtor was a Massachusetts business trust whose principal asset was a fifteen-unit apartment building. The trust owned the building subject to a $380,000 first mortgage loan, but the building's value had declined to approximately $250,000. Including the unsecured portion of the mortgage, the debtor had about $167,000 of unsecured debts. The debtor's plan of reorganization called for payment of the $250,000 secured claim over a twenty-five-year period at a rate of interest to be set by the court, and payment of a ten percent dividend to the unsecured creditors at the time of confirmation. In addition, the unsecured creditors would receive a second mortgage on the building, which would be paid without interest when the building was sold or refinanced. The source of the ten percent dividend for the unsecured creditors was to be a $17,000 contribution from the trust's former shareholders. In exchange for the $17,000 contribution, the trust's former shareholders would receive all the stock interests in the reorganized trust.[136]

The proposed capital structure of the reorganized trust in *Bjolmes Realty* is obviously defective. Rather than going to create an equity cushion, the capital contribution would be paid immediately to the unsecured creditors. Because the portions of the unsecured claims that were not satisfied would not be discharged upon confirmation, the reorganized trust would remain insolvent under the debtor's proposed plan. Although the unsecured claims would not be payable immediately, they would remain as liabilities secured by the second mortgage on the building. Because the shareholders of the reorganized trust would continue to have negative equity, they would face no downside risk and would not have the appropriate incentives to manage its operations effectively.

The bankruptcy court refused to approve the debtor's plan without two revisions,[137] neither of which addressed the plan's fundamen-

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[134] *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. Chi. L. Rev. 89 (1985).

[135] 134 B.R. 1000 (Bankr. D. Mass. 1991). *See also* Bailey, *supra* note 98, at 65-77 (praising the approach taken in this case).

[136] 134 B.R. at 1001.

[137] *Id.* at 1010-11.

tal defect. Instead of accepting the proposed $17,000 contribution from the trust's former shareholders, the court required an auction to be held among the trust's shareholders and creditors, with the creditors being allowed to bid for the equity in the reorganized trust. All the proceeds from the auction would be used to pay a dividend to the unsecured creditors, however, so there would still be no equity cushion in the reorganized trust. The second revision was to eliminate the second mortgage for the unpaid portion of the unsecured creditor's claims. Although the court's opinion was not explicit, it appears that the unpaid portion of the unsecured creditor's claims was to be discharged upon confirmation. Thus, under the bankruptcy court's plan of reorganization, the reorganized trust would not be insolvent right away. Nevertheless, its capital structure would still be deficient because it would consist entirely of debt.

Another inadequately capitalized plan of reorganization was confirmed by the bankruptcy court in *In re Greystone III Joint Venture*.[138] The debtor owned an office building in Austin, Texas with an appraised value of $5.8 million. Its major creditor held a nonrecourse promissory note secured by a first lien on the building and was owed $9.3 million, which left an unsecured deficiency claim of $3.5 million. The plan provided for the debtor's former partners to contribute $500,000 in return for all the equity interest in the reorganized partnership, and from this contribution approximately $100,000 (or about three cents on the dollar) would be paid to the creditor on account of its deficiency claim.[139] Only $400,000 would remain as an equity cushion.

In contrast to the *Bjolmes Realty* plan, the *Greystone* plan did provide an equity cushion for the reorganized partnership, because a portion of the new capital contribution was to remain in the partnership rather than being immediately paid to creditors. Nevertheless, the reorganized business was too thinly capitalized to satisfy the feasibility requirement of Section 1129.[140] There are a number of factors that affect the size of a real estate loan,[141] but most lenders require a seventy-five percent loan-to-value ratio.[142] An appropriate equity

[138] 102 B.R. 560 (Bankr. W.D. Tex. 1989), *rev'd*, 995 F.2d 1274 (5th Cir. 1991), *cert. denied*, 113 S. Ct. 72 (1992).

[139] 995 F.2d at 1277; 102 B.R. at 561.

[140] *See* 11 U.S.C. § 1129(a)(11) (1988).

[141] In addition to the property's value, lenders normally consider the amount of income and expenses as well as the cash flow from the property in evaluating the size of a loan. *See generally* M.A. HINES, REAL ESTATE DEBT FINANCING 153-68 (1987) (describing criteria used by lenders in making loans); JOHN P. WIEDEMER, REAL ESTATE FINANCE 260-64 (3d ed. 1980) (same).

[142] John B. Levy, *Regulations Prompt Higher Minimum Spreads*, NAT'L REAL EST. INVESTOR, Mar. 1993, at 24 ("Since the beginning of the commercial mortgage business, lenders have imposed a 75% loan-to-value limit as being prudent. This real estate recession has unfortunately shown that even that level of leverage was too aggressive. As a result, a number of survey

cushion for the creditor's secured claim of $5.8 million might therefore have been in the neighborhood of $1.5 million, instead of the $400,000 that was called for in the reorganization plan.

The plan under review in *Bonner Mall*[143] also appears deficient. The *Bonner Mall* debtor's primary asset was a shopping mall in Idaho, which the bankruptcy court valued at $3.2 million. The debtor's principal liability was a loan of $6.6 million, secured by a deed of trust against the mall. The debtor's plan provided for repayment of the secured portion of the loan ($3.2 million) thirty-two months after confirmation, with interest payable monthly in the interim. Unsecured creditors with claims greater than $1,000 would receive a pro rata distribution of 300,000 shares of $1.00 par value preferred stock in the reorganized corporation, convertible to a maximum of 300,000 shares of common stock upon payment of the secured portion of the loan. The debtor's six former partners were to contribute a total of $200,000 and receive two million shares of common stock in return. In addition, the plan called for the partners to subsidize any shortfall in working capital during the first thirty-two months after confirmation of the plan, and for five of the former partners to contribute a collateral trust mortgage on other property as a guarantee of the debts that were assumed by the reorganized corporation.[144]

It should be apparent that this plan would not satisfy the feasibility requirement of Section 1129. Even though the reorganized corporation would not be immediately insolvent, the common shareholder's equity interest would be under water after the issuance of the 300,000 shares of $1.00 par value preferred stock to the corporation's former unsecured creditors. Because the reorganized corporation would have only a $200,000 equity cushion and the preferred shareholders would have a liquidation preference, the common shareholders would not be entitled to any profits until the $100,000 impairment of capital resulting from issuance of the preferred stock was cured. Consequently, there would be a potential conflict of interest between the common and preferred shareholders built into the capital structure of the reorganized corporation. Moreover, the issuance of the preferred shares would be contrary to the stated capital requirements of the applicable Idaho law.[145]

members are now requiring that their commercial mortgages meet a 65% loan-to-value test or less."). *Cf.* FED. RESERVE BULL., Sept. 1993, at A37 (reporting that loan-to-value ratios for mortgages on new homes ranged from 74.8% to 79.5% between 1990 and June 1993).

143 2 F.3d 899 (9th Cir. 1993), *cert. granted*, 114 S. Ct. 681, *dismissed as moot*, 115 S. Ct. 386 (1994) (denying motion to vacate court of appeals decision after the case became moot by voluntary settlement).

144 *Id.* at 905.

145 *See* IDAHO CODE §§ 30-1-18, 30-1-21 (1980) (prohibiting the issuance of shares for less than their par value).

The *Bonner Mall* plan was also deficient because of the size of the equity cushion. Applying the seventy-five percent loan-to-value standard,[146] the equity cushion for the secured creditor's $3.2 million claim should be close to $1 million, rather than the $200,000 provided by the reorganization plan. The plan also called for the former partners to subsidize any shortfall in working capital and to guarantee the payment of the reorganized corporation's debts with a collateral trust mortgage. Depending on the circumstances, these guarantees might have sufficient value to compensate for the lack of a more substantial cash contribution. However, they would not be allowed as consideration for the issuance of new shares under applicable Idaho law[147] and thus should not be considered part of the equity cushion of the reorganized corporation.

When the case reached the Ninth Circuit, the court held that the new value exception to the absolute priority rule had survived the enactment of the Bankruptcy Code, and therefore, the plan was not unconfirmable on account of the source of the capital contribution. The court added that it was unclear whether the plan satisfied all the requirements for the exception, so it remanded the case to the bankruptcy court for a ruling with respect to these requirements.[148] The bankruptcy court never had a chance to rule, however, because while the case was pending before the Supreme Court, the parties reached a settlement and agreed to an alternative reorganization plan, which the bankruptcy court confirmed.[149] In contrast to the previous plan, the plan arrived at by the parties through negotiation expressly provided for an adequate equity cushion. Under the confirmed plan, the former partners would contribute not only guarantees, but also additional real property as collateral upon which the creditor would receive liens. The confirmed plan further provided for the creditor to obtain appraisals for the mall and the other collateral, and that if the appraisals showed that the loan-to-value ratio was more than sixty-five percent, the former partners committed themselves to contribute additional collateral to reduce the loan-to-value ratio to sixty-five percent or less.[150]

Although there may not be any precise formula for determining an ideal capital structure for a reorganized corporation, in many cases

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[146] *See supra* note 142.

[147] *See* IDAHO CONST. art. XI, § 9 ("No corporation shall issue stocks or bonds, except for labor done, services performed, or money or property actually received; and all fictitious increase of stock or indebtedness shall be void."); IDAHO CODE § 30-1-19 (1980) ("The consideration for the issuance of shares may be paid, in whole or in part, in cash, in other property, tangible or intangible, or in labor or services actually performed for the corporation.").

[148] *Bonner Mall*, 2 F.3d at 918.

[149] *See In re* Bonner Mall Partnership, No. 91-00801, 1994 WL 249619, at *1a (E.D. Wash. Mar. 10, 1994) (order confirming Chapter 11 plan).

[150] *See id.* at *18a-19a (third amended plan of reorganization).

a bankruptcy court can be reasonably certain that a capital structure proposed in a plan under review is inadequate. For example, it is clear that a corporation should not be allowed to emerge from the reorganization process with inadequate shareholder equity, as the plans in *Bjolmes Realty* and *Greystone* proposed. For closer cases, the bankruptcy court may need expert testimony from a financial analyst concerning the adequacy of capitalization and possibly also from a lender as to the debtor's ability to borrow the debt specified in the plan from an informed outside source.[151] The court might also require the reorganization plan to include contractual restrictions to prevent the reorganized corporation from paying out the equity cushion in dividends after confirmation.[152]

VIII. Conclusion

The fundamental purpose of a corporate reorganization is to repair an insolvent corporation's capital structure by restoring its equity cushion. The restoration of the equity cushion defuses the conflicts of interest that the insolvency created between the corporation's shareholders and creditors. In deciding whether to confirm a plan of reorganization, bankruptcy courts must evaluate whether the plan provides an adequate equity cushion in the reorganized corporation; otherwise, the fundamental purpose of the reorganization process will have been ignored.

For the most part, bankruptcy judges and lawyers have not paid any attention to the adequacy of equity cushions proposed in reorganization plans. Instead, they have concentrated on whether the capital contributions to finance the reorganization came from the corporation's former shareholders or from outside investors and on whether the capital contributions were tangible property or not. In general, however, the size of the capital contributions is more critical than either its source or form. Perhaps the lack of attention to the size of the equity cushion grew from the misleading dictum in *Los Angeles Lumber*. The Supreme Court's dictum has a superficial validity: capital contributions from former shareholders must be reasonably equivalent to the ownership interests they receive in return. This standard provides inadequate guidance, though, because if the corporation's assets are fairly valued and the absolute priority rule is applied, even a nominal capital contribution would satisfy the *Los Angeles Lumber* standard. A nominal capital contribution is not sufficient for

151 *See In re* Mobile Steel Co., 563 F.2d 692, 703 (5th Cir. 1977) (listing methods for determining the adequacy of capitalization in equitable subordination cases); *see also* LoPucki & Whitford, *supra* note 132, at 607-09 (comparing debt to equity ratios of companies emerging from reorganization with ratios for companies of comparable size in the same business).

152 For an example of a covenant restricting distributions to shareholders, see Bayless Manning & James Hanks, Legal Capital 105-12 (3d ed. 1990).

a successful reorganization, however. The courts should therefore reject the *Los Angeles Lumber* dictum and instead evaluate plans of reorganization according to whether they provide an adequate capital structure for the reorganized corporation.