

REVISITING *203 North LaSalle* TWO YEARS LATER

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Can a Chapter 11 plan be confirmed over the objection of an unsecured class if the unsecured class is not paid in full and old equity obtains an equity stake in the reorganized debtor in exchange for a contribution of new value? Phrased differently, is there a “new value” corollary to the Code’s “absolute priority” rule?

In May of 1999 the Supreme Court issued its decision in *Bank of America National Trust & Savings Ass’n v. 203 North LaSalle Street Partnership*, 526 U.S. 434, 119 S.Ct. 1411, 143 L.Ed.2d 607 (1999). Unfortunately, like many of the Court’s recent bankruptcy decisions, the Court raised more questions than it answered.¹ Although billed in advance as a case that would answer the question of whether the new value corollary to the absolute priority rule survived the enactment of the Code, the Court abdicated its duty and sidestepped that question. The Court left us with the unhelpful observation that, “The upshot of [the legislative] history does nothing to disparage the *possibility apparent in the statutory text*, that the absolute priority rule now on the books as subsection (b)(2)(B)(ii) *may* carry a new value corollary.” *Id.* 119 S.Ct. at 1419 (emphasis added).

Turning next to the statutory language, the Court similarly failed to decide the meaning of the critical phrase “on account of such junior claim” in the context of a new value plan. While the Court did make clear that the phrase means “because of” rather than “in exchange for” or “in satisfaction of” (*id.* at 1420), it declined to specify the degree of causation that would trigger the absolute priority rule. Is any degree of causation between the junior holder’s prior interest and the property retained sufficient, or does the rule merely prevent the junior holder from obtaining property at a bargain price²? The Court tells us, “Which of these positions is ultimately entitled

• ¹ Other recent examples of this trend are the *Rash* and *Hartford* opinions. In *Rash* the text of the Court’s opinion adopted a “replacement value” standard for the valuation of collateral in a Chapter 13 cram down context, but the footnotes muddied the water sufficiently to deprive that standard of any real meaning. See *Associates Commercial Corp. v. Rash*, 520 U.S. 953, 117 S.Ct. 1879 (1997). Similarly in *Hartford* the text of the opinion clearly established that only the trustee could bring an action to surcharge collateral under 506(c). However, the footnotes then took away what the text granted by stating that the Court was not deciding whether the bankruptcy court could authorize other parties to bring such motions. See *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 530 U.S. 1, 120 S.Ct. 1942 (2000).

² The Court phrases this in various ways. In the text it suggests that sufficient causation would exist to disqualify the plan if the junior holder obtains the new property “at a price that failed to provide the greatest possible addition to the bankruptcy estate, and it would always come at a price too low when the equity holders obtained or preserved an ownership interest for less than someone else would have paid.” *Id.* at 1421. However, in the footnote, the Court suggests that “[e]ven when old equity would pay its top dollar and that figure was as high as anyone else would pay, the price might still be too low unless the old equity holders paid more than anyone else would pay” *Id.* at 1421, n. 26.

to prevail is not to be decided here” *Id.* at 1422.

However, although the Court did not decide which view was correct, the remainder of the decision proceeds on the assumption that the “bargain” rule applies. Is the Court tipping its hand and suggesting that the bargain rule is the correct rule, or is it merely analyzing the plan before it under the most liberal rule in order to establish that the plan could satisfy neither standard?

As of mid-February, Westlaw lists 44 reported decisions that cite *203 North LaSalle*. The great majority of those opinions cite the case for propositions other than its new value analysis. Only a few of the reported decisions contain a significant analysis or discussion of the case. These decisions suggest that the Court’s refusal to reject the new value corollary is being interpreted as affirming its continued viability. Further, the lower courts appear to be applying the bargain rule as the minimum standard that must be met by a new value plan.

In *203 North LaSalle*, the Supreme Court’s concern that old equity might not be paying top dollar for the equity interest that it retained or received in the reorganized debtor was based on old equity’s “exclusive opportunity” to buy the equity. It was this exclusive opportunity to buy (and to set the price) that was the “property” that was being received “on account of” the former equity interest. The two significant issues that appear in the post-*203 North LaSalle* opinions are: (1) does the absolute priority rule prohibit old equity from obtaining *any* exclusive opportunities; and (2) does *203 North LaSalle* require an open auction of equity?

Taking the second question first, can a new value plan be confirmed if it contains no auction mechanism? In *203 North LaSalle* the Court noted both that the debtor had the exclusive opportunity to propose a plan and that the plan it proposed not contain an auction mechanism. The Court stated, “Hence it is that the exclusiveness of the opportunity with its protection against the market’s scrutiny of the purchase price by means of competing bids or even competing plan proposals, renders the partners’ right [to acquire the equity interest] a property interest extended ‘on account of’ the old equity position and therefore subject to an unpaid senior creditor class’s objection.” *203 North LaSalle*, 119 S.Ct. at 1411.

Two of the reported decisions interpret this language to provide two *alternative* avenues to confirm a new value plan. *Either* the debtor can terminate exclusivity *or* the plan can provide for an auction of the equity. *In re Davis*, 262 B.R. 791, 793 (Bankr. D. Ariz. 2001); *In re CGE Shattuck, LLC*, 1999 WL 33457789 (Bankr. D.N.H. 1999). In contrast, the case of *In re Situation Management Systems, Inc.*, 252 B.R. 859, 863 (Bankr. D. Mass. 2000), arguably stands for the proposition that a new value plan must *both* include an auction mechanism *and* that exclusivity be terminated. In *Situation Management*, the Court held that proposing a new value plan that contained an auction mechanism was grounds for terminating exclusivity. The Court’s reasoned that, by including an auction mechanism whereby any party could bid, the debtor had forfeited its exclusive right to propose a plan. This reasoning appears suspect since there is far more to the exclusive right to propose a plan than the single question of who will own the equity in the reorganized debtor. To what extent does the case instead represent a view that exclusivity *per se* violates the absolute priority rule in a new value context because the exclusive right to determine how the equity interest will be distributed is a “property interest extended on account of” old equity?

This is the question addressed in the case of *In re Global Ocean Carriers, Ltd.*, 251 B.R. 31 (Bankr. D. Del. 2000). There the proposed plan gave the stock in the reorganized debtor to a company owned by the daughter of the debtor's controlling shareholder. Although neither the daughter nor her company were existing shareholders of the debtor, the Court interpreted *203 North LaSalle* to treat the right to determine who will own the reorganized debtor as "property." The Court found that the absolute priority rule was violated "by allowing the existing controlling shareholder to determine, without the benefit of public auction or competing plans, who will own the equity . . . and how much they will pay for the privilege." *Id.* at 49. *Global Oceans* represents an extremely expansive interpretation of *203 North LaSalle* under which the exclusive right to propose a plan by itself could violate the absolute priority rule.

This view was firmly rejected by the Third Circuit Court of Appeals in the case of *In re PWS Holding Corp.*, 228 F.3d 224 (3d Cir. 2000). The plan in *PWS* proposed to release certain avoidance action claims that the debtor had against junior equity holders. The Court easily rejected the argument that the absolute priority rule was violated by the debtor's exclusive opportunity to determine how to dispose of the property interest represented by the released claims. The Court reasoned, "[T]o read *203 North LaSalle* so broadly would be to undermine the express statutory provision for exclusivity in §1121(b)" *Id.* at 239, n. 11. To similar effect is the case of *In re Zenith Electronics*, 241 B.R. 92 (Bankr. D. Del. 1999), where the Court found that *203 North LaSalle* did not "eliminate the concept of exclusivity contained in section 1121(b) and the broad powers of the debtor to propose a plan *in whatever format it desires.*" *Id.* at 106 (emphasis added).

The view that emerges from these cases is that *203 North LaSalle* has not eliminated the new value corollary to the absolute priority rule. If anything, it may have made it easier to confirm such plans by setting clear and easy to satisfy requirements. Note that the new value corollary already required that the new value be a fair price for the equity interest received. That determination had been the province of the Bankruptcy Judge. If all that *203 North LaSalle* requires is that the plan replace the Bankruptcy Judge's determination of a fair price with an auction or an opportunity for competing plans, then the opinion adds little to what was already required and may significantly reduce the protections that prevent the old equity from obtaining a bargain.

The practical impediments to proposing competing plans and the likelihood that creditors and non-insiders may be unwilling to bid at an auction of equity may, in many cases, make the new value plan very attractive to old equity. For example, in the *203 North LaSalle* case old equity's desire to retain its ownership interest was driven by tax consequences, and not by the intrinsic value of the retained equity. The old equity proposed to pay \$4,100,000 for the retained equity interest in order to avoid \$20,000,000 in personal tax liabilities that would arise if the Bank foreclosed. *203 North LaSalle*, 119 S.Ct. at 1414. Since the negative tax consequences that the old equity wished to avoid were personal to them, it seems likely that an open auction might have allowed old equity to preserve its stake in the debtor for less than the price required by the plan that was rejected by the Supreme Court. What is the auction value of the equity stake in an entity whose only asset is fully encumbered? Further, doesn't the auction device

answer the question of whether the price paid is a fair one, without running the risk that a Bankruptcy Judge may require more?

Although *203 North LaSalle* may have more bark than bite, a few of the reported decisions involve attempts to avoid its rule by using a “straw.” For example, in *Global Ocean* the equity interest was to be held by a company owned by the daughter of the controlling shareholder. There the Court did not have to directly address the “straw” issue because of its view (probably wrong under *PWS*) that the controlling shareholder’s power to design the plan violated the absolute priority rule. The two cases that address the issue head-on come to conflicting conclusions. In the *CGE Shattuck* case the equity was to be held by a new entity that had been created by and was owned by only one of the old equity holders. Without an extensive discussion and without a determination that the entity was a mere straw, the Court held that the new entity would be treated the same as old equity for *203 North LaSalle* purposes. Contrast this with the case of *Beal Bank, S.S.B. v. Waters Edge Ltd. Partnership*, 248 B.R. 668, 680 (D. Mass. 2000). In *Beal Bank*, the Court refused to apply *203 North LaSalle* when an insider (the son in law of the debtor’s shareholder) was to receive the equity in the reorganized debtor by way of a private sale. The Court did, however, indicate that the insider could not be a mere straw.