

New Value, Fresh Start

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Abstract: In this article, the author enters into the debate about the desirability of the "new value" exception to Bankruptcy Law's absolute priority rule. After a description of the theory's origins, the author rejects the formal and textual argument that the exception did not survive the enactment of the Bankruptcy Code, as well as rejecting the arguments that the exception

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serves no useful function under the voting procedures of the Code, and that it wrongly confers a post-reorganization option-like value to equityholders on account of their pre-petition claims. The author proceeds to argue that the new value exception is necessary because fair new equity auctions would be rare in the reorganization context, because the quasi-option characteristics of the ability to file a reorganization plan using the new value exception provide socially desirable incentives to business owners, and because the new value exception is consistent with, and promotes, the fresh start policy. Moreover, providing the fresh start through the new value exception is preferable compared to its current provision through the rejection of injunctive obligations not to compete. The conclusion sketches the reorganization process toward which the law should move.

I. INTRODUCTION

Reorganization law is at the center of a maelstrom of conflicting interests. Courts and academics have divided over a fundamental rule, whether equityholders may purchase the reorganized firm's equity over a creditor's objection. Currently—although subject to renewed but false doubts—the old equityholders can purchase equity in the reorganized firm over the objection of creditors according to the "new value" exception to the "absolute priority rule." The exception has even taken the limelight of a clash between Ronald Perelman and Carl Icahn.¹

This short article reexamines the "new value" exception. The suggested interpretation—motivated by the economic ramifications of the fresh start policy, the dynamics of auctions for equity stakes under the conditions of the reorganization process, and the need for an incentive for good management of failed and of failing firms—would not only

¹ See Floyd Norris, *Two Financiers Cross Swords over Marvel*, N.Y. Times, December 28, 1996, page 39; Laura Jereski and John Lippman, *Marvel Plans Expansion Despite Filing for Chapter 11, Perelman-Icahn Battle*, Wall St. J., Dec. 30, 1996, page B5.

preserve the existing “new value” exception, but would expand it in cases influenced by the fresh start policy.

The “new value” exception is the topic where the most crucial developments in bankruptcy law are impending. The area is of crucial importance because innumerable reorganization plans that are contested—that must be “crammed down” over the objection of creditors—rely on the “new value” exception. A change is imminent because a split has appeared among Circuit Courts in this subject, and the Supreme Court has been interested, but has declined to resolve the issue.² Moreover, the new value exception is likely to be a focus of the Bankruptcy Review Commission.³

Reorganization plans that require cram-down may not be the rule but they are very frequent. In the case of an insolvent firm, one with debts exceeding its value, a dissenting class of creditors must either be paid its claim in full or receive the firm’s residual value, according to § 1129(b)(2) of the Bankruptcy Code.⁴ This apparently entitles the most junior “in-the-money”⁵ creditors to become the sole equityholders in the reorganized firm, since that would be the only way to provide them with the firm’s residual value. Otherwise, only if the firm is solidly solvent will it be able to provide the creditors with debt of a value equivalent to their claim. But if the other creditors prefer that the current managers (and shareholders) remain with the firm, the only way to achieve their participation is to have them purchase new equity in the reorganized firm. The only way to purchase new equity over the junior creditors’ disagreement is through a plan of reorganization that uses the “new value” exception. Such a plan would give the dissenting creditors the residual

² See notes 6-8 and accompanying text, below.

³ The Bankruptcy Review Commission was established by §§ 601-610 of the Bankruptcy Reform Act of 1994, Pub.L. 103-394, 108 Stat. 4106, 4147-50 (1994) to study amendments in the Bankruptcy Code.

⁴ 11 U.S.C. § 1129(b)(2) (1996). All citations to sections correspond to sections of the Bankruptcy Code unless otherwise noted. Moreover, all Bankruptcy Code sections correspond to the same sections of title 11 of the United States Code; their extensive citation in the form of 11 U.S.C. § __ will also be omitted from now on.

⁵ The terms “in-the-money” and “out-of-the-money” indicate whether a creditor of a particular seniority would be getting any of the firm’s value if that value were to be distributed strictly in accordance with the absolute priority rule. Thus, the most junior in-the-money creditors are the creditors with the lowest seniority that would receive any value; more senior creditors would be paid in full, more junior ones would get no value.

value of the old firm in the form of debt securities, while selling equity in the reorganized firm to the old equityholders.

The split over this issue among Federal Circuit Courts of Appeal is sharp and clear. The Seventh Circuit went out of its way to provide a lengthy opinion full of dicta against the new value exception. It is clear from Judge Easterbrook's *First Bank*⁶ opinion that had the Court had the opportunity, it would have held that the new value exception has not survived the adoption of the Bankruptcy Code in 1978. Soon after *First Bank*, Judge Easterbrook's possible ideological opposite, Judge Reinhardt, wrote a long opinion, *Bonner Mall*,⁷ supporting the new value exception. Other Circuits gradually have chosen or will have to choose sides.⁸ The Supreme Court refused to resolve this split, despite having apparently been tempted. *Bonner Mall* was granted certiorari, but then the Court refused to vacate the opinion after the case was settled.⁹ Obviously, the Court's silence cannot not last.

The academic discussion on the topic of the new value exception is voluminous but undecided.¹⁰ It looks as if economic analysis divides

⁶ *Kham & Nate's Shoes No. 2, Inc. v. First Bank*, 908 F.2d 1351 (7th Cir. 1990) ("*First Bank*").

⁷ *In re Bonner Mall Partnership*, 2 F.3d 899 (9th Cir. 1993) ("*Bonner Mall*").

⁸ Courts have split over whether the new value exception, recognized in *Case v. Los Angeles Lumber Prods. Co.*, 208 U.S. 106, 121 (1939), survived the enactment of the Bankruptcy Code in 1978. Compare, e.g., *Bonner Mall*, 2 F.3d at 907 (recognizing and applying the new value exception); *Ahlers v. Norwest Bank Worthington (In re Ahlers)*, 794 F.2d 388, 402 (8th Cir. 1986) (applying the exception), rev'd, 485 U.S. 197, 203 n.3 (1988) (refusing to decide); and *Teamsters Nat'l Freight Indus. Negotiating Comm. v. U.S. Truck Co. (In re U.S. Truck Co.)*, 800 F.2d 581, 588 (6th Cir. 1986) (applying the exception), with, e.g., *Phoenix Mut. Life Ins. Co. v. Greystone III Joint Venture*, 995 F.2d 1274, 1282 (5th Cir. 1991) (finding no exception), opinion withdrawn in relevant part, 995 F.2d 1284 (5th Cir.) (per curiam), cert. denied, 113 S. Ct. 72 (1992); and *In re Drimmel*, 135 B.R. 410, 415-16 (D. Kan. 1991) (no exception), aff'd sub nom. *Unruh v. Rushville State Bank*, 987 F.2d 1506, 1509-10 (10th Cir. 1993) (refusing to decide).

⁹ Motion to vacate denied, dismissed, *U.S. Bancorp Mortgage Co. v. Bonner Mall Partnership*, ___ U.S. ___, 130 L. Ed. 2d 233, 1994 U.S. LEXIS 7982, 115 S. Ct. 386 (1994).

¹⁰ Mark E. MacDonald, Sally A. Schreiber, and Mark E. MacDonald, Jr., *Confirmation By Cramdown Through The New Value Exception In Single Asset Cases*, 1 Am. Bankr. Inst. L. Rev. 65 (1993) (favoring the uncertainty for promoting negotiations; favoring the exception for single asset cases!); 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 (1992) (the new value exception promotes loss spreading by forcing negotiations between creditors and the debtor); Sara A. Austin, *New Value Exception: (Wanted) Dead or*

the authors. Those rejecting the new value exception use economic arguments,¹¹ and those who embrace the new value exception argue on fairness and justice grounds. This article bridges the chasm by showing that the new value exception is eminently desirable from an economic standpoint. The economic arguments used against it are hasty and shallow.

Part II traces the new value exception by looking at the foundation of the absolute priority rule. Junior claimants, such as the equityholders, may not receive any of the failed firm's value unless all creditors with seniority over them have been satisfied. This creates a huge incentive on small creditors to dissent from reorganization proposals. The response was the new value exception: to allow the equity to participate in exchange for a new contribution to the reorganized enterprise. The two set the stage for the dispute: Is the new value exception still desirable?

Part III describes and rebuts the arguments against the new value exception. Neither have the dynamics of the reorganization process as amended by the Bankruptcy Code rendered the new value exception unnecessary, nor do equityholders in practice receive the "call option" which would violate absolute priority. Moreover, the option-value surplus that, allegedly, the new value exception bestows to the old equityholders, is shown to be an inseparable component of equityholding and to be present in every reorganization, regardless of new value.

Alive — Viability of the new value Exception to the Absolute Priority Rule Under Bankruptcy Code § 1129(b)(2), 96 DICK. L. REV. 189, 193-95 (1992) (exception did not survive but should be legislatively made available to small businesses only); James J. White, *Absolute Priority and New Value*, 8 COOLEY L. REV. 1 (1991) (efficiency and moral arguments do not justify the new value exception); Richard L. Epling, *The New Value Exception: Is There a Practical, Workable Solution?*, 8 BANKR. DEV. J. 335 (1991) (arguing for auctions and ending the exclusivity period upon proposal of a new value plan); Note, *A Rule Unvanquished: The New Value Exception to the Absolute Priority Rule*, 89 MICH. L. REV. 2301 (1991) (exception survived the Code); David A. Skeel, *The Uncertain State of an Unstated Rule: Bankruptcy's Contribution Rule Doctrine After Ahlers*, 63 AM. BANKR. L.J. 221 (1989); John D. Ayer, *Rethinking Absolute Priority After Ahlers*, 87 MICH. L. REV. 963 (1989). The commentators' approaches are summarized in James H. Franklin et al., *Survey Absolute Priority and the Continued Vitality of the "New Value Exception,"* 1 J. BANKR. L. & PRAC. 591, 627-31 (1992).

¹¹ Douglas Baird and Thomas Jackson, *Negotiating After the Fall and the Contours of the Absolute Priority Doctrine*, 55 U. CHI. L. REV. 738 (1988); White, *supra*, note 10.

Part IV argues in favor of the new value exception. Mandated auctions of the new equity in a setting fraught with information inequalities are likely to lead to insider-trading-like abuses. The few actual auctions that have been ordered illustrate vividly the difficulties and are examples of a process to avoid. The option-like attributes that a new-value plan has for owners during the reorganization provides them with desirable incentives in running the firm during, as well as before, bankruptcy. Finally, the new-value exception promotes the fresh-start policy. But currently the fresh start of small entrepreneurs is primarily promoted through the rejection of their injunctive obligations not to compete. The new value exception serves both the fresh start and the interests of the economy better than the rejection of obligations not to compete.

Part V concludes this paper by indicating that using the new value exception to provide small entrepreneurs with a fresh start must not prevent the economic forces from working. The goal of the leniency that bankruptcy law shows to individuals must be to soften the blows of economic evolution, not to prevent it. At the same time, however, the legislative refinement of the new value exception is impracticable at this stage. Its use in the context where a fresh start is desired is wholly different from its use when the owners of the business are solvent. The evolution of these two, in essence, separate new value exceptions should be left to the hands of the equity powers of the courts. The direction toward which reorganization law should move is easy to see and would replace the pointless disputes surrounding § 1129 with substantive incentives on the debtor and the creditors to show their ability to run the reorganized firm.

II. THE NEW VALUE EXCEPTION TO ABSOLUTE PRIORITY

The concept of absolute priority flows from the idea that the many different stakeholders in a firm have different rankings, depending on whether they are secured, ordinary, or subordinated creditors, or, finally, equityholders. Although commentators recommend bending the absolute priority doctrine so that secured creditors share perhaps a fraction of their claim with ordinary tort creditors,¹² such proposals are

¹² Lucian A. Bebchuck and Jesse Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L. J. 857, (1995), for example, argue that secured credit is

far from adoption, and they amend without eliminating the concept of creditors' rank. Creditors' different ranks imply that some must be satisfied before others. If the rank of creditors is violated when the firm's value is being distributed, their priority, and the absolute priority rule, is violated.

The absolute priority rule as a doctrine of U.S. reorganization law traces back to *Boyd*.¹³ A junior creditor, Boyd, was ignored in a reorganization in which the old equityholders retained a stake in the corporation. This was a violation of the junior creditor's absolute priority—i.e., his right to be satisfied before the old equityholders received any of the failed firm's value—and Boyd's claim survived against the reorganized entity.

The respect that the absolute priority rule receives is the focus of the differences between two approaches to the policy and the interpretation of bankruptcy law. The lawyer-economists start with respect for the debt contract, and with aversion for the forum shopping which is caused by giving creditors lesser rights in bankruptcy than they have in state-law foreclosures.¹⁴ Critics who favor reorganization at the

overused because it has the negative externality of bypassing tort creditors. They claim that an arrangement by which secured creditors share with tort creditors will restore the incentives to their optimal level with the beneficial result that, when ordinary debt with restrictive covenants better suits a financing project, it will not be underused.

¹³ *Northern Pacific Railway Co. v. Boyd*, 228 U.S. 482 (1913). The facts of the case are confused by two railroad failures (of Coer D' Alene Railway and Navigation Co., "Coer", and of Northern Pacific Railroad), an intervening fraudulent transfer and the transfer of the claim at bar to Boyd. Boyd's transferor's claim regarded labor and materials provided to Coer in 1886. The fraudulent transfer ensued, and took the form we would recognize today as a leveraged buyout by N.P. Railroad, but it is not relevant to the holding. The over-leveraged Coer failed, and was bought in foreclosure by N.P. Railway, a successor of N.P. Railroad. The foreclosure proceeds were exhausted before junior creditors like Boyd were paid. Boyd turned against the N.P. Railway as both a successor of the transferee of the fraudulent transfer, and as a successor of Coer's shareholder (N.P. Railroad, in both guises) and it is under the latter theory that Boyd was vindicated; i.e., Coer's shareholder received value before Boyd in violation of the absolute priority rule. The new firm issued securities reflecting a market valuation of \$245 million, while only \$61 million was the winning bid at the foreclosure; Coer's secured debt was \$157 million. The Court notes that the foreclosure was in effect a reorganization of Coer in which the senior creditors and the equityholders split the value of the firm, while dissenting junior creditors were not paid in full: "[I]f ... a single creditor was not paid, or provided for in the reorganization, he could assert his superior rights against the old stockholders in the property transferred to the new company."

¹⁴ See, e.g., THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 21-27 ("When bankruptcy is activated for a rule change that benefits one particular class [of

creditors' expense see bankruptcy law as a limitation to creditors' rights,¹⁵ a limitation intending to promote a social policy of preserving firms' going-concern value and economic activity, even if that is not the wealth-maximizing choice. They could support this choice with various redistribution arguments for softening the impact of changes in the economy which hit the neediest hardest.

The proponents of absolute priority consider deviations from it costly. Firms that are prevented by the Bankruptcy Code from committing to their lenders' desire for absolute priority are forced to borrow at higher interest rates than they otherwise would. This costlier borrowing consists of a pointless increase in the costs of production, and a drag on productivity. Proponents of a less strict priority scheme would argue that the reallocation of resources associated with liquidations is costly and painful in the short-term, despite its long-term benefits. A more gradual reallocation should achieve the same goal without as much of the community-wide pain, a pain which is often an externality to the parties of the debt contract.

But the logical clarity of the absolute priority doctrine is deceptive. Creditors' priority to the liquidation proceeds rarely leads to liquidation. Creditors often have no interest in dismantling the debtor firm. Its assets may be best employed at their current use, and its going-concern value may be greater than the sum of the liquidation values of its assets. Unlike other purely financial instruments, however, such as options or futures, debt comes with important control rights. If it is not repaid, in theory creditors have the right to foreclose: to force a sale of the debtor's assets and to be satisfied from the proceeds. But after debtors "stay" creditors through a bankruptcy filing, foreclosures are prevented (unless ordered by the bankruptcy court). The reorganization possibilities of Chapter 11 imply that creditors will receive claims against the reorganized firm, meaning new debt or new equity. The concept of absolute priority implies that if the firm's value does not exceed the old firm's debt, the old equityholders will be eliminated, and the most junior

stakeholders], the net effect may be harmful to owners as a group" at 26); see also Thomas H. Jackson, *Translating Assets and Liabilities to the Bankruptcy Forum*, 14 J. LEGAL STUDIES 73 (1985).

¹⁵ See, e.g., Elizabeth Warren, *A Theory of Absolute Priority*, 1991 ANN. SURV. AM. L. 9; 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 (1992), *supra* note 10.

in-the-money creditors will receive the equity of the reorganized firm. But even if some—relatively unusual—creditors accept to have their debt converted into equity, most creditors will not want to assume management of the failed firm. Managers must be found to run the firm, and they must be compensated. Equity securities make for excellent compensation because of the low cost with which they can be provided to the managers, and because of the incentives they provide to their holders. The shareholder-managers of the failed firm offer expertise, experience, and knowledge of the firm. They also happen to be available. But if, as old equityholders, they receive equity in the reorganized firm, the absolute priority rule is broken, since some junior creditor will be found who has not been not paid in full.

The new value exception, however, did not arise in a setting of multiple layers of debt. The dissent of a tiny minority of even a single class of creditors would hold up reorganizations if we were to adhere to the absolute priority rule. Creditors' contractual rights implied that they must all consent to the amendment of their debt's terms in a reorganization. Creditors who challenged this unanimity requirement triggered a Supreme Court opinion by the Justice who, to this day, is the most respected bankruptcy thinker ever on the Court. In *Case v. Los Angeles Lumber* Justice Douglas stated the new value exception: The old equity can participate in the reorganized firm despite the fact that dissenting claims are not satisfied, provided the old equity purchases its participation with consideration of “money or money’s worth,” “reasonably equivalent to the value received,” “substantial,” and “necessary for a successful reorganization.”¹⁶ The new value exception

¹⁶ *Case v. Los Angeles Lumber Products*, 308 U.S. 106 (1939). The debtor corporation's only asset was L.A. Shipbuilding and Drydock Corp., which had under a million dollars of assets securing over \$4 million of debt to bondholders. In 1930 the debtor and 97% in value of the bondholders entered into a restructuring agreement according to which the old shareholders put new value into the enterprise and in exchange were released from liability and received new common stock. Nevertheless, the debtor failed again and went into reorganization in 1937. The 1937 plan created only two classes of securities, common and preferred stock. The bondholders received most of the preferred (some would be sold to raise working capital) and the original shareholders got the common. The going concern value was \$830,000, of which \$811,000 would be received by the bondholders, approximately 25% of their claims. Almost 93% of the bondholders (in value) consented to the plan, as did virtually 100% of the old equity. But the old equityholders received their new equity stake without tangible contribution of new value. Dissenting bondholders claimed that this type of reorganization was not within the “fair and equitable” requirement of the old Bankruptcy Act.

was a solution—narrow, vague and unstructured as it may be—to the hold-out powers of the creditors.

The facts of *Los Angeles Lumber* had a simplicity, however, which has been alleged to narrow its holding. There was only one class of creditors, and 97% (in value) of those agreed with the 1930 reorganization. Despite that the few dissenters looked as if they were holding up the reorganization, according to absolute priority they were entitled to do so unless the new equity participation was purchased using adequate consideration. But in this setting the equity purchase is not an exception to the absolute priority rule. Nothing is received by the old equity on account of its pre-reorganization position.

One might argue that without the new value exception, the old equityholders could not have participated in the 1930 reorganization of *Los Angeles Lumber*. Selling equity securities to the old managers would have to take place after the reorganization was complete. This would imply that creditors would have received the firm's residual value and have become shareholders. But the same result could be achieved by having the reorganized firm merge with a shell corporation formed by the old equityholders where, according to the merger agreement, the reorganized firm's shareholders (the old debtholders) would exchange their shares for debt in the merged corporation.¹⁷ A group with majority—i.e., the creditors who support the reorganization plan—could implement this transaction.

That a single class of creditors accepted in its vast majority the 1930 new-value-based restructuring in *Los Angeles Lumber* should support the new value exception. The idea that creditors' contractual rights could be changed by the bankruptcy court over their objection was radical at that time. Indeed, if the court were searching for a case in which the creditors who dissented to having their contractual rights changed by the reorganization were obviously abusive, one would hardly

The Court agreed, and Justice Douglas stated the conditions under which equity may participate in reorganizations, a rule that has since been followed as the new value exception. Although the Court acquiesced to the 1930 new-value-based reorganization, modern opponents of the new-value exception consider it nothing but dicta, since the new-value exception was not instrumental to the invalidation of the 1937 reorganization.

¹⁷ See, e.g., Del. Gen. Corp. L. § 251(b) (“The [merger] agreement shall state... the manner of converting the shares of each [merging corporation] into shares *or other securities*...[of the resulting corporation]...”; emphasis added).

design a case different than the 1930 reorganization of Los Angeles Lumber: That so vast a majority of the single class of creditors were willing to accept the alteration shows the unreasonableness of the dissenters. The new Bankruptcy Code, however, prevents small minorities of single classes from holding up reorganizations by dissenting to plans that are generally acceptable to creditors. Voting by classes has replaced unanimity as the condition to restructuring creditors' claims in a reorganization. This has led some to argue that since the *Los Angeles Lumber* facts would not need the new value exception to ratify a plan, that the validity of its holding has been diminished.

Since the substance of the new value exception is that creditors' objections to a plan will be overridden if the new equity is purchased for tangible consideration of equal value ("reasonably equivalent" "money or money's worth"), dissenting creditors should have no qualms about the new value exception. But that would only be true in a perfect world, one where firms that should be liquidated are obvious, and are liquidated without delay, where the valuation of the reorganized firm is precise and persuasive, and where the valuation of the new-value consideration is easy and accurate.

The imperfections and inaccuracies that burden courts, combined with the control that debtors-in-possession have in the reorganization process and the strategic power that follows it, imply that reorganizations will occur where the senior creditors may desire to give management a fraction of their share. Perhaps the advantages that managers enjoy allow them to receive more than is necessary to compensate and motivate them. Perhaps senior creditors and equityholders conspire to reduce the claim of junior creditors. Such fears, essentially, have led to a move for eliminating the new value exception. The clearest expression of this movement is Judge Easterbrook's *First Bank* opinion, which maintains that the new value exception is nothing but dicta; that, in any case, it did not survive the enactment of the Bankruptcy Code; and that it is undesirable as a policy matter. Those are the new doubts that *First Bank* cast upon the new value exception. The next section shows they are unfounded.

III. NEW DOUBTS

Opponents of the new value exception argue that it was eliminated by the passage of the Bankruptcy Code. As a formalistic argument, this obviously has no weight. Numerous other judicially created bankruptcy rules survived the Code's adoption.¹⁸ The Supreme Court has even stated that it will not accept "silent abrogation" by the Code of pre-Code bankruptcy common law.¹⁹ Neither is the elimination argument correct as a matter of legislative intent, since Congress' action—at the obvious urging of the banking lobby—was to refuse to expand the new value exception.²⁰ But the falsity of the textual and

¹⁸ Examples abound, particularly in the fundamental rules of bankruptcy, one of which is the new value exception. Examples are the principle that a bankruptcy reason is necessary to change nonbankruptcy entitlements, *Buttner v. United States*, 440 U.S. 48 (1979); the inalienability of post-bankruptcy earnings, *Local Loan Co. v. Hunt*, 292 U.S. 234 (1934); the principle that undersecured and unsecured creditors do not receive interest during the bankruptcy, *Sexton v. Dreyfus*, 219 U.S. 339 (1911) (Holmes, J.); the principle that constructive trusts will be scrutinized, *Cunningham v. Brown*, 265 U.S. 1 (1924); or the concept that torts of the estate during the bankruptcy produce liabilities with the priority of administrative expenses, *Reading Co. v. Brown*, 391 U.S. 471 (1968); as well as the peculiar interpretation of avoidable liens by Justice Holmes in *Moore v. Bay*, 284 U.S. 4 (1931). Nobody thinks that the passage of the Bankruptcy Code puts these principles in question, and neither should its passage put the new value exception in doubt.

¹⁹ *Kelly v. Robinson*, 479 U.S. 36, 47 (1986), *Dewsnup v. Timm*, 502 U.S. 410, 419, 112 S.Ct. 773, 779 (1992) (“[T]his Court has been reluctant to .. effect a major change in pre-Code practice that is not the subject of at least some discussion in the legislative history”); *Pennsylvania Welfare Dept. v. Davenport*, 495 U.S. 552, 563 (1990) (“we will not read the Bankruptcy Code to erode past bankruptcy practice absent a clear indication that Congress intended such a departure”).

²⁰ The proposed expansion of the new value exception would allow its use even if the consideration that would be used to purchase the new equity were intangible. This would eliminate the “money or money’s worth” requirement of *Case v. Los Angeles Lumber*. To quote from *In re Bjolmes Realty*, see *infra* note 70 and accompanying text:

Some of the decisions rejecting the fresh contribution exception claim support from the rejection by Congress of the Bankruptcy Commission's proposal to modify the absolute priority rule... This is a curious use of legislative history. The Commission proposed that the fresh contribution exception be modified to recognize a contribution of the types of intangibles rejected in *Los Angeles Lumber*... Rejection of a watered-down version of the exception is no indication of an intent to reject the exception itself.

134 Bankr. 1000 at 1008 (Bankr. D. Mass. 1991) (citations omitted). See also *In re Pullman Construction Industries, Inc.*, 107 Bankr. 909 at 947 (Bankr. N.D. Ill. 1990) (with further citations).

historical arguments of its opponents is irrelevant for the desirability of the new value exception, which is the true issue.²¹ The claim that the Code should be interpreted to eliminate the new value exception is supported by the argument that circumstances where that exception was necessary have been resolved by the reorganization provisions of the Code's Chapter 11 and, therefore, that the new value exception no longer has any role.

A. The Continued Functionality of the New Value Exception

The new value exception, argue its opponents, only served a function under the Bankruptcy Act of 1896, which required unanimous support of reorganization plans which changed creditors' rights. The Code's innovations use majority voting, and the hold-out problem that the new value exception resolved under the Act no longer exists.

The pertinent innovation of the Code is the reduction of creditors' "hold-out" powers. But for the Code, any creditor can block a reorganization that needs this creditor's forbearance. Consider the typical example of a firm with three large unsecured creditors, each owed \$130,000, and one small unsecured creditor, who is owed \$10,000. The firm's assets are worth \$200,000 in liquidation, which implies a payout of 50 cents on each of the \$400,000 of claims. Were the firm to be reorganized, its discounted future earnings make it worth \$100,000 more. The pro-rata division of the going-concern surplus implies creditors should receive 75 cents on the dollar (\$300,000 of going-concern value distributed to \$400,000 of claims). But the small creditor can threaten to "hold out" from the reorganization by refusing to replace his existing claim with one that gives to the firm the leeway to stay as a going concern. The small cost of his stubbornness (which costs \$2,500 to this creditor if he forces liquidation and receives 50¢/\$ compared to

Obviously, refusing to expand is the opposite of eliminating by refusing to ratify. Indeed the legislative history could and should be read to support a flexible interpretation of the new value exception as the one this article will propose.

²¹ Spurious textual and historical arguments may cast doubt on their makers' integrity, but that is only true if those makers consider textual and original intent arguments something more than pawns to reach the substantively desirable interpretation. But we know that Judge Frank Easterbrook, the author of *First Bank*, is no textualist or original-intentist despite his assertions to the contrary. Hence the analysis must move to its proper object, the substantive merit of the new value exception.

75¢) makes his threat credible and the other creditors, in fear of losing the bulk of the going-concern surplus, may agree to satisfy his claim in full.

The Code eliminates the unanimity problem by adopting a voting procedure for the "confirmation" of reorganization plans in bankruptcy. Plans can be confirmed despite objections. Two means of overcoming creditor objections are provided by the Code, affirmative vote or cramdown.

The Code's voting method uses both a head count and a dollar-weighted vote. Each class of creditors that is "impaired"²² must approve a plan by simple majority, and by a two-thirds majority by amount. As a result, small minority creditors who object to plans cannot block them. The 3% of creditors who objected to the plan in *Los Angeles Lumber* would be powerless. We are urged, therefore, to believe that since the new value exception would not be necessary to avoid their threat, it should no longer exist.

The Code's voting, however, does not eliminate hold-outs. Voting is to be done by classes, but across impaired classes there must be unanimity. Thus, a single class can still block a reorganization. The Code eliminates the hold-out power of small creditors, but not that of small classes.

Take the classic example of the enterprise that has a layered financial structure, with secured debt, then two classes of junior debt and equity.²³ If neither the liquidation nor the (higher²⁴) going-concern value

²² A class of creditors is impaired if it neither receives the full value of its claim in cash, nor is its claim cured from defaults and restored to its pre-bankruptcy terms, § 1124.

²³ Consider, for example, that the debtor has two unsecured creditors, one for \$65,000 who agrees with the proposed plan, and one for \$35,000, who dissents from the proposed plan. Although both can be put in the same class, the debtor would not do that because that class would not vote in favor of the plan by either the required simple by-head or the two-thirds-by-amount majority. Hence, the best alternative for the debtor is to find reasons to separate them into two classes and hope for a cram-down over the smaller creditor's objection. Provided that separate classification is not gerrymandering, strategic separate classification of claims of this type does not offend bankruptcy policy; see, e.g., *In re U.S. Truck Co., Inc.*, 800 F.2d 581 (6th Cir. 1986) (the plan separated the claim of the Teamsters Union from those of other unsecured creditors in separate classes; this enabled the other unsecured creditors' acceptance of the plan to serve the requirement of § 1129(a)(10) that at least one impaired class accepts the plan; this did not constitute improper classification); *In re Jersey City Medical Center*, 817 F.2d 1055, 1060-61 (3rd Cir. 1987) (separate classification

of the enterprise covers the claim of the junior debtholders, the equityholders should not receive any value in either liquidation or reorganization. A reorganization will capture the going-concern surplus, but it may be desirable or expedient to keep the old management (the old equityholders) by issuing them equity in the reorganized firm. Both classes of junior creditors will be impaired under any plan, since their rights will not be reinstated according to the terms of the original loans. Any one of the two classes can "hold-out." Intuitively, only the smaller class will have a credible threat: Instead of sharing the going-concern surplus with the other junior creditors and the equityholders, they would rather take their liquidation share in cash. They might graciously accept a little bit more if the others desire so much to reorganize.

Granted, the Bankruptcy Code has made provisions for dissenting classes. A plan can be confirmed over the dissent of some classes, as long as the conditions of § 1129(b) are met. Those conditions, however, include the absolute priority rule as specified in § 1129(b)(2). The dissenting classes must receive all the going-concern value before the equityholders receive any value. Each class has full hold-out power, and can block even a plan in which the going-concern surplus is not given to the old equityholders, but the equityholders truly purchase their new equity for new value. Hence, the new value exception is still necessary. The argument that it expired with the unanimity requirement is hasty.

That the new value exception is still necessary becomes obvious because restructurings that are not possible under the Code's voting and cramdown rules are possible as two-step transactions after completion of a reorganization without the old equity. Take the example of the insolvent firm with two creditors, only the smaller of which objects to the old equityholders' participation. The Code's classify-and-vote scheme

permitted for claims of physicians, medical malpractice victims, employee benefit plan participants, and trade creditors).

²⁴ For reorganization to make economic sense, the going-concern value of the enterprise must be greater than its liquidation value. Otherwise, society should gain by liquidating and bankruptcy law would be changing the substantive outcome akin to forum shopping: the owners would liquidate the firm if it were debt-free. Moreover, unless the going-concern value of a firm in reorganization is greater than its liquidation value, no reorganization plan will be able to satisfy the "best interest of the creditors" test of § 1129(a)(7) which requires that each objecting creditor receives at least as much as in liquidation.

fails regardless of classification: If the two are in the same class, the smaller creditor's dissent prevents the acceptance of the plan by vote. If the two are placed in different classes, the dissenting class would receive full protection of the absolute priority rule and, without the new value exception, would block the sale of new equity to the old equityholders.

A simple post-bankruptcy transaction restores the failed plan's result illustrating that the new value exception is just a device to eliminate several steps of a complex transaction. After the creditors receive all the equity in the reorganized firm, the larger creditor now controls the corporation. Shares will now be issued to the old equityholders since this measure has the support of the new majority.²⁵ The consenting and dissenting old creditors' shares can be repurchased for debt through a merger with a corporation of the old equityholders, where the old creditors exchange their shares in the reorganized firm for debt in the merged corporation.²⁶ The new value exception simply obviates the need for the extra transactions the parties would have had to orchestrate to achieve the same result.²⁷ Thus, claims that the new value exception

²⁵ The minority will not be able to avoid the dilution of its stake; i.e., the reduction of its percentage of ownership, which anti-dilution provisions granting "preemptive rights" are designed to avoid. The "preemptive rights" provisions of most corporate statutes have been made optional. The dissenting minority will not be able to avoid the dilution of its stake when new equity is issued to the old equityholders, regardless of whether the reorganized firm is chartered in a state which only grants anti-dilution protection by election in the corporate charter (because the majority will not include such a provision), or in a state which grants anti-dilution protection by default (in which case the majority will impose a charter provision opting out of this protection). An example of a statute requiring the corporation to opt-into preemptive rights is Del. G.C.L. § 102(b)(3). An opt-out example is Ill. Bus. Corp. Act § 24.

²⁶ See *supra*, note 17.

²⁷ State laws protect minority shareholders in mergers. Bankruptcy law should not deny this protection to the dissenting debtholders. Dissenting shareholders, for example, may have appraisal rights under state law; see, e.g., Del. G.C.L. § 262 ("Any [dissenting] stockholder ... shall be entitled to an appraisal ... of the fair value of his shares") as well as "fair dealing" protection in cases where the interests of the decision makers are in conflict, *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983) (in presence of conflicts of interests, the acquirer must show the transaction was fair to the minority). While the support of the plan by the majority of the creditors may well imply that a merger would be successful, in contrast stripping the dissenting debtholders of their appraisal and fair-dealing rights constitutes a substantive departure from state law. Unless this is supported by bankruptcy policy, it should not be sanctioned, *Buttner v. United States*, 440 U.S. 48 (1979) (state law rights are preserved in bankruptcy unless bankruptcy policy argues otherwise). Granted, if the appraisal rights place a cash drain on the corporation which precludes its surviving the reorganization, that may be

leads to inefficiency become marginal, since the identical outcomes would take place without it. Indeed, a cynic may even suspect the legal profession for turning against the new value exception in order to create the additional business of the two-step transaction. The opponents of the new value exception must now recall their aversion to forum shopping. Without the new value exception, a firm's bankruptcy could preclude this transaction.²⁸ To avoid the distortions of forum shopping, the new value exception must be maintained.

The policy-based arguments against the new value exception, however, continue. Its opponents think that it confers value to equityholders. They claim that equityholders receive this value due to their pre-bankruptcy claims, which is a direct contravention of bankruptcy policy; i.e., the absolute priority rule. Despite the obvious circularity of this argument, it merits scrutiny. If the new value exception were not to give this option-value to equityholders, it would not really be an exception from absolute priority. Because it does, the features and the operation of the option must be studied to determine its desirability. That it highlights the exceptional nature of the exception should not persuade with respect to merits of policy.

B. The New Value Exception as an Option

The operation of the new value option is analyzed in three sections. The first one explains how the new value plan creates a valuable option for the equityholders. Next comes an analysis of the option in practice. Debtors obviously try to take advantage of it, but bankruptcy courts hardly ever let them have it according to the sample of cases produced by the simple search of part B below. But the resistance of the courts to the option-like features of new value plans does not determine the normative question. To determine that, a third section

sufficient to show that the minority's appraisal rights jeopardize the collective interests of the creditors, if those are promoted best through a reorganization.

²⁸ If the gains to the reorganized firm from the transaction (the out of bankruptcy merger with the managers' corporation) do not exceed the costs of the two step transaction, the merger will not take place. This, which is the likeliest outcome given the financial straights in which firms in bankruptcy will be, is clearly suboptimal from the perspective of social welfare. Even in those cases where the gains exceed the increased costs, there will be waste: the higher cost of the transaction to achieve the same result that the new value exception would.

looks at the option-value features of general equity ownership. The realization that equityholders enjoy option value outside bankruptcy further clarifies that the option-value objection is irrelevant to the public policy concerns: the enjoyment of option value is a consequence of ownership, not an exceptional appearance due to the new value exception as is made obvious by the fact the option-value surplus is conferred to equityholders by plans that do not use the new value exception.

1. OPTIONS AND NEW VALUE PLANS

Equityholders who can choose whether to purchase equity in the reorganized firm according to a reorganization plan, are alleged to receive a valuable option on account of their pre-bankruptcy claims. The option consists of the right to buy the reorganized firm's equity. This is considered to be an option because the old equityholders may have the power to avoid this transaction. Equityholders can indeed recant an obligation under a new-value plan by modifying the plan before it is confirmed.²⁹ Therefore, the equityholders have a true option: They will only exercise their option to purchase shares in the reorganized firm if they determine, when they must commit to buying them, that they are worth more than the consideration. The next paragraphs explain how new value plans function as options.

The new-value plan places equityholders in a position equivalent to that of holders of "call options" that trade in the securities and options exchanges. A call option gives its holder the right, but not the obligation, to purchase a given amount of the "underlying" stock at the "strike" price at the "expiration" time. The call option that equityholders get by virtue of the new-value exception has as a strike price the new value which the

²⁹ The confirmation of the plan makes it binding on all involved entities, § 1141(a). Before confirmation the proponent of the plan may modify it, § 1127(a). Modification allows reconsideration of votes, § 1127(d). Effectively, therefore, the equityholders who find their plan disadvantageous, can amend it in their favor at the expense of losing votes in the plan's favor. But since the equityholders do not want the old plan confirmed, they manage, either by amendment, or by loss of votes, or both, to avoid obligations under the old plan.

plan requires, and expires on the confirmation of the plan. Its differences from an option that would trade publicly are marginal.³⁰

Call options have greater value than the excess of the current market price over the strike price. The right to buy IBM for \$100 in 3 months while it now trades at \$110 is worth more than \$10 because the owner of the stock faces greater risks than the holder of the call option: the danger that IBM will be worth less than \$100 in 3 months. Indeed, as daily trading shows, call options have value even if their strike price is significantly higher than the current market price for the underlying stock. The price of the stock contains the greater uncertainty that adverse future events may reduce its value. This is a risk against which the holder of the call is protected, while at the same time receiving in full the security's potential appreciation. This is the extra value, what can be called the "option-value surplus," of the call option that the new value exception

³⁰ Granted, trading options in organized exchanges is different than buying equity in reorganized firms with new value contributions. Options exchanges interpose an elaborate clearing and settlement system between the parties so that all contracts are identical regardless of the participants' identity. One's good reputation for timely payment, and one's creditworthiness, which may be very relevant in ordinary transactions, are ignored in options' exchanges because the exchange enforces timely settlement, and its clearing-house effectively guarantees all obligations. This allows parties to ignore the fact that even in ordinary options' trading, the time of commitment and the time of settlement are different. Since, by contrast, bankruptcy law does not perform this function, some deviations may appear. Uncreditworthy equityholders may take advantage of adverse price moves from the time of irrevocability of the plan till the time of their contribution. The plan, for example, asks for a new value contribution of \$100,000 to bring the going-concern value of the enterprise to \$500,000. Creditors' claims against the reorganized firm are \$400,000. On the date of irrevocability (confirmation), the equityholders conclude that the firm is worth more than \$400,000, or it will be worth more than \$500,000 with the new value. They commit to contribute it in the ten days Rule 8002 effectively gives them (Fed. R. Bankr. Proc. 8002; 10-day appeal period), by which time the firm's value has dropped to \$300,000, and is in danger of falling even further if the equityholders delay their contribution. Creditors turn against the equityholders for their contribution, but the equityholders may be credit-proof. Those differences, given the circumstances surrounding the reorganization, may be quite relevant. Options sold through exchanges will cost less to their grantors (the "option writers" or sellers) than the same quasi-option sold to equityholders through the reorganization plan costs creditors. But this drawback is not unique to the new value exception. Any purchaser of the new equity through a plan will have more leeway after committing than they would if they were exercising an exchange-traded option. To the extent the old equityholders present special risks as [new-value] purchasers of the reorganized firm's equity, those should be taken into account when the plan is being negotiated, and the different possible outside bids are being considered. These marginal and remediable differences do not make the case against the new value exception.

allegedly wrongly bestows on equityholders who can repudiate plans. But before we can conclude that new value plans give equityholders the probabilistic windfall that the option-value surplus represents (because it reflects the probability that the option will turn out to be a good deal), we must examine whether the bankruptcy courts can prevent the windfall. The most obvious ways to eliminate the option-value surplus are (1) to adjust the amount of new-value contribution and the payout to the most junior in-the-money creditors to the value of the firm as of the contribution date, (2) to charge equityholders for the option-value they buy from the creditors, or (3) to have the equityholders commit to the contribution.³¹ So obvious are these adjustments as to undermine the credibility of the option-value objection to the new value exception. If the option-value surplus was the true concern of the critics, these adjustments would have been suggested. That they were not, questions either their goals or their analysis. But this article will not argue for these adjustments. The option-like feature of new-value plans is not only consistent with the absolute priority rule, but it is also desirable for its incentive effects as will be argued later.³² First, however, it is reassuring to see that bankruptcy courts do not let equityholders get away with their new value plans, as a quick look at the cases shows.

2. OPTIONS AND BANKRUPTCY COURTS

A sense of the treatment new value plans receive might be gleaned by looking at a cross-section of reported decisions of bankruptcy courts. Using reported court opinions to draw statistical inferences is highly debatable and contentious, even more so than looking at litigated cases.³³ Biases come in not only in the selection of parties,

³¹ The last alternative runs the risk of creating an option in the hands of the creditors if their vote regarding the plan comes much after the equityholders' commitment. Then creditors would only vote for the plan if the value of the firm has declined. This probably precludes the practical application of this alternative, although remedies are conceivable, such as conditioning the commitment of the equityholders on a vote by the most junior creditors within a very short period of time.

³² See *infra* text accompanying notes 79-84.

³³ See, e.g., Priest & Klein, *The Selection of Disputes for Litigation*, 13 J. LEGAL STUD. 1 (1984); Wittman, *Dispute Resolution, Bargaining, and the Reduction of Cases for Trial: Study of the Generation of Biased and Unbiased Data*, 17 J. LEGAL STUD. 313 (1988); Stanley & Coursey, *Empirical Evidence on the Selection Hypothesis and the Decision to*

settlements, and disputes, but also the courts' subjective decision of which cases merit full opinions and, since this sample is based on a word search, what words to use and how much text to devote to the subject of the new value exception. This sample, therefore, is neither the universe of new value decisions nor even a representative random sample of it. The dearth, however, of confirmed new value plans in this group of cases is striking and the courts' treatment of new value plans is very informative. Moreover, it is not so much the proportion of new value plans that are denied confirmation (about 90%) which is striking, but the creativity courts use in rejecting them.

To reduce the number of irrelevant cases, a relatively narrow search was performed. The Lexis database of opinions by bankruptcy courts (library "BKRTCY," file "BANKR") was searched on January 6, 1997, for all opinions which mention either "new value" or "new contribution" within four words from "plan." Of the 67 cases that this search produced, 13 were irrelevant, leaving 54 relevant cases. Only one of these is not a confirmation case, but it makes sufficient reference to a confirmed new value plan to be included.³⁴ The opinions date from January 10, 1986, to September 18, 1996. The early years are underrepresented since there is only one 1986 case, no cases from 1987, one from 1988, two from 1989 (plus 1 irrelevant), and an irrelevant one from 1990. Subsequent years produce more cases, 1991 having six, 1992 eleven,³⁵ 1993 nine (and 2 irrelevant), 1994 thirteen (1 irrelevant), 1995 nine (3 irrelevant), and three cases³⁶ (plus 3 irrelevant) being produced in 1996. The composition of the debtors also changes these years. The 1986 and 1988 cases regard individual debtors. Of the two 1989 cases, one features a debtor with a rental real property as its only substantial asset ("single-asset debtor") and the other features individuals. All six 1991 opinions are about single asset debtors. Of the eleven 1992 cases, five are of single-asset debtors, and four of individuals. The remaining two must be categorized as "other." One

Litigate or Settle, 19 J. LEGAL STUD. 145 (1990); Eisenberg, *Testing the Selection Effect: A New Theoretical Framework with Empirical Tests*, 19 J. LEGAL STUD. 337, 338 (1990).

³⁴ *In re Mission Heights Investors L.P.*, 202 Bankr. 131 (Bankr. D. Ariz. 1996), where a limited partner who chose not to participate in a new value reorganization attempts to join it. The original plan was confirmed on May 24, 1992, hence this is a 1992 confirmation.

³⁵ Including *Mission Heights*, *supra*, note 34.

³⁶ Excluding *Mission Heights*, *supra*, note 34.

regards a hotel owner-operator and the other a microbrewery. The nine 1993 cases show one individual, five single-asset, and three “other:” a hotel owner-operator, a condominium association, and a nonprofit hospital. Year 1994 has thirteen cases, nine single-asset, three individual debtors, and one owner-operator of a storage facility. Similarly, 1995 brings us five single-asset debtors, three individuals, and a fur coat designer-manufacturer-retailer. One single asset debtor and two other—an airbag distributor that had ceased operations and a roping machine manufacturer—close the sample as the 1996 cases.

We should be aware of individual and single-asset debtors since their bankruptcies may involve particular concerns. The remaining cases one might have expected to be firms running normal businesses. Several turn out to be very similar to single-asset debtors, firms that probably borrowed on the basis of the value of their real estate during the boom and face the bust. Those are two hotel owner-operators and one lessor of storage space. These bring the total of real-estate-based debtors to 35 (or 65% of the 54 cases in the sample). One more debtor owns a single real estate asset, but the debtor is a condominium association and the asset is not marketable (the common grounds of the association) making this case unique. Only five apparently conventional firms are left as debtors, firms that have a product and provide employment. The airbag distributor, however, had ceased operations and has no remaining employees, leaving four truly conventional firms.³⁷ One of these had its new-value plan confirmed. This 25% confirmation rate must be compared with the confirmation of two individuals’ plans out of fourteen (14%) and two real-estate-based debtors out of 36 (6%; including the condominium association).

The most remarkable of the decisions that confirm new value plans regards the hospital, *In re Whittaker Memorial Hospital Association, Inc.*³⁸ Whittaker was a nonprofit hospital serving a minority community, it should have clearly remained as a going concern, and persistent attempts to sell it produced a single bid, lower than the hospital’s liquidation value. The undersecured mortgagee, the

³⁷ It is interesting to note that all these, except for the nonprofit hospital the ownership of which is abstract, were family owned firms, while several of the real-estate-based debtors were not.

³⁸ 149 Bankr. 812 (Bankr. E. Va. 1993). The two quotes that follow are from page 816 of the opinion.

Department of Housing and Urban Development, objected to the confirmation of the plan claiming it violated the absolute priority rule. Although the plan satisfied none of the requirements for the application of the new value exception, the court overruled the objection: The plan gave the controlling group of the hospital “nothing but problems and great anguish ahead.” “Certainly not a favored position over HUD.” There is no indication that the HUD was ready to takeover the hospital’s management, while the current management’s efforts to streamline operations had met with success. *Whittaker* shows the length to which bankruptcy courts will go to use their equity powers in favor of good-faith and able owner-managers.

The opinions which confirm new value plans do not discuss the details of the exception or its application. This may also indicate a bias in the selection of this sample of cases, namely that judicial opinions confirming new value plans discuss the exception less than rejecting opinions and that, therefore, the former will tend to be underrepresented in samples derived from word searches. Speculating on the causes of the relatively taciturn nature of confirming opinions is pointless. Decisions finding contributions sufficient may be unremarkable and may tend not to become signed opinions, or a bias against publicizing them may exist if debtors will then use them to make reaching future rejecting decisions harder. It should not surprise, perhaps, that a significant fraction of the confirmations this search brought to the surface are of atypical plans, like the no-new-value plan of *Whittaker Memorial Hospital* or the almost expressly inadequate plan of *In re Woodscape L.P.*³⁹ where a \$150,000 contribution was enough to buy the equity in a \$6.1 million overleveraged single-asset case. But that opinion’s almost frustrated remark in favor of the plan captures crucial advantages of the new value exception:

[T]he solution [to the plethora of single-asset filings in this recession] is not to make every reorganization ... into a liquidation by denying equity holders the right of participation... Refusing to permit [them] an opportunity to invest destroys any incentive which might exist for capital contribution. Without fresh

³⁹ 134 Bankr. 165 (Bankr. D. Mary. 1991).

capital infusion, little hope exists for reorganizing deflated assets in a bad market.⁴⁰

First, the new value exception preserves incentives. It does not only preserve the expressly mentioned incentives to invest in order to change the use of assets and accelerate the adjustment to the change in use that the real-estate crash may demand, but it also preserves the incentives for generally advantageous management, as well as the incentives to invest and manage before the bankruptcy filing. This point, however, will be analyzed later. The second point is unique to a recession like the one of the early nineties real-estate. The rarity of real-estate crashes must not detract from the importance of this function. When a speculative bubble in prices crashes, lenders who have used as collateral such assets will become undersecured (as asset prices fall) and will want to foreclose and liquidate their collateral before prices drop further. But forced liquidations would aggravate the crash. In a stock market crash, the same dynamic of a panic is created when, as prices fall, the stocks that secure “margin” debt are automatically liquidated by the lending brokerage firms, further depressing prices and aggravating the vicious cycle of the crash. A real-estate crash would be identical. The downturn that reduces rents and values leaves owners unable to make debt payments, which leads to foreclosures by lenders, which further depress prices and so on. Bankruptcy courts can break this vicious cycle by confirming some, no more than a small fraction, of the new value plans that reach them.⁴¹ Secured lenders as a group are favored by such a practice because the higher real-estate prices would imply more valuable collateral and fewer foreclosures. As crashes are not unique to the real estate market, neither should this function of the new value exception be restricted to real-estate-based debtors.

⁴⁰ 134 Bankr. at 177.

⁴¹ The pattern we see in this sample does not refute this hypothesis. The only two plans of real-estate-based debtors that were confirmed were in 1991 and 1992, early in the recession (*Woodscape* and *Mission Heights*, supra note 34). Real-estate-based debtors’ new-value plans increased in frequency; but as the recession subsided, none were confirmed. The following table illustrates the evolution of real-estate-based debtors’ plans in absolute numbers and as a fraction of each year’s plans in the sample:

	'86-'88	'89	'90	'91	'92	'93	'94	'95	'96
Number:	0	1	-	6	6	7	10	5	1
As Fraction:	0%	50%	-	100%	55%	55%	77%	55%	33%

The crash-mitigating justification of the new value exception that *Woodscape* presents would be sufficient to show that the exception is desirable and to resist attempts for its eradication. But many more benefits of the new value exception will be discussed later, which will show that the exception should not simply stay in reserve till the next crash. First, however, we should look into the rich material provided by the opinions which decline to confirm new value plans.

Debtors, of course, try very hard to reap the option-value surplus the new value exception may give them. The extreme is, perhaps, *In re Applied Safety, Inc.*⁴² The debtor had an exclusive distribution contract which had been renegotiated and allegedly breached by the manufacturer. Applied Safety would have been the exclusive distributor of airbags manufactured by Breed for retro-fitting into older cars. A subsequent “termination” agreement allowed Breed to sell airbags to others subject to a \$30-per-airbag fee to Applied Safety. Applied Safety has ceased operations and Breed claims the fee agreement was fraudulent and refuses to honor it. Breed is the largest creditor with claims for payment for airbags it delivered. The reorganization plan is that on its effective date, in the year 2000, equityholders of Applied Safety would contribute \$16,000 and use the \$30-per-airbag claim against Breed to offset Breed’s claim and pay every creditor in full. The plan was effectively contingent on two conditions, Applied Safety prevailing on its contractual dispute, and on Breed selling enough airbags that accumulated owed fees would be enough to make the plan a profitable proposition for the equityholders of Applied Safety. This is the purest attempt to take advantage of the option-like features of the new value exception. Let us posit some probabilities for the contingencies and see, hypothetically, what value would confirmation of this plan bestow on equityholders. Suppose that Breed had a good case and would win with 80% probability. Suppose also that in the four years to the effective date, the probability that Breed would sell enough airbags to make the plan profitable would be 15%. Say that Breed’s sales would exceed the plan’s break-even point by at most 5000 airbags which would be a 1% likelihood, while selling an extra 4000 would be a 2% likelihood, 3000 a 3% one, 2000 a 4%, and 1000 a 5% one (for a sum of 15%). Starting with the fact that a 1% chance at \$150,000 (\$30 times 5000) is worth

⁴² 200 Bankr. 576 (Bankr. E.D. Penn. 1996).

\$1500, after adding all five possible sales outcomes and then taking the 20% of that figure to compensate for Applied Safety's odds of winning its contract dispute, produces an option value of \$2,100.

The lengths to which debtors' equityholders went to increase their option value surplus is not always apparent in the plan. A lot of planning goes toward creating a justification for the separate classification of the secured creditor's deficiency claim and to prevent the secured creditor from buying all other unsecured creditors' claims (which secured creditors do in order to prevent the existence of an accepting impaired class, required by § 1129(a)(10) for cramdown). Equityholders, for example, arrange for their allies to buy some claims and accept the plan, as in *Principal Mutual Life Insurance v. Lakeside Associates*.⁴³ Equityholders using top tier law firms have attempted to shed the appearance of the single-asset creditor and to create ostensibly operating debt by buying office equipment on credit with express or implied understandings with the sellers not to transfer those claims to the secured creditor and to accept the new value plan, as in *In re Dollar Associates, Inc.*⁴⁴ Such attempts blatantly rely on a formalistic, mechanical application of bankruptcy law which is unknown in the United States. What is worrisome is that law firms with the reputation of Gibson, Dun & Crutcher, that represented Dollar Associates, believe such attempts are worth trying instead exposing the law firm to risk of liability for malpractice, abuse of process, and contempt for treating the most equity-oriented courts of this legal system like "bots" (the derogatory term that has developed for internet automata).

The courts in this sample of opinions match equityholders' determination by declining to confirm virtually every real-estate based debtor's new value plan, 94% of them in this sample. The structure of the new value exception limits courts' display of creativity to the traditional elements of the exception. Nevertheless, when all else fails, courts do not hesitate to reject new value plans as "simply not fair and equitable"⁴⁵ or because the "plan does not further the recognized reorganization goals of preserving jobs and going concern value, and preventing the shrinkage of economic activity resulting from the

⁴³ 194 Bankr. 797 (Bankr. E.D. Va. 1996).

⁴⁴ 172 Bankr. 945 (Bankr. N.D. Cal. 1994).

⁴⁵ *In re Dean*, 166 Bankr. 949 (Bankr. D.N. Mex. 1994) (single asset case).

liquidation of a going business.”⁴⁶ Thus, the *Dollar Associates* opinion seems to imply that confirmation of a new value plan is, at its very essence, motivated by the fundamental goals of reorganization law, the preservation of going-concern value and productivity. A plan that fails to deliver on either does not justify any departure from a strict concept of absolute priority.

The stern attitude of the courts caused by the deluge of new value plans due to the real-estate recession had the unfortunate side-effect of leading courts to adopt tougher express standards for new value plans. Thus, a line of cases is favorably disposed toward a new way of testing the substantial nature of the new contribution in cases involving closely held debtors. The new value should be substantial only if it represents the equityholders’ best efforts and it gives unsecured creditors a substantial return.⁴⁷ Thus, the equityholders should inject most of their available wealth for the plan to represent their best efforts and this injection must produce a significant payout to the unsecured creditors. This proposal obviously heightens the hurdle new value plans must overcome. Beyond the retributive features of this proposal (preventing equityholders’ diversification, forcing a significant payout to potentially out-of-the-money creditors), its further defects will become obvious after the reorganization treatment of injunctive obligations is analyzed in section IVC2; see also note 99 and accompanying text.

⁴⁶ *In re Dollar Associates*, 172 Bankr. 945 at __ (Bankr. N.D. Cal. 1994). The new value was in cash so it satisfied the “in money or money’s worth” requirement, was one million dollars so as not to fail easily neither the “substantial” nor the “reasonably equivalent” requirements, would be used to fund structural reinforcements that were necessary—although they could be made by any owner—as as to meet the “necessary” requirement. *Dollar Associates* has probably the only plan in the sample that would invest the new value in the firm instead of using it to pay unsecured creditors. Since nothing other than the practice of “buying” unsecured creditors’ acceptances—necessary per § 1129(a)(10)—requires this distribution of the new value, it is surprising that more plans do not invest the new value. Note that one of the narrowings of the new value exception, however, does suggest that investing instead of distributing the new value would reduce the odds of confirmation. A line of cases suggests that a new contribution is substantial only if, among others, it leads to a significant payout to unsecured creditors, see note 47 and accompanying text, *infra*, as well as text accompanying note 99.

⁴⁷ See, e.g., *In re Haskell-Dawes, Inc.*, 199 Bankr. 867 (Bankr. E.D. Penn., 1996) (with further citations); *In re Capital Center Equities*, 144 Bankr. 262 (Bankr. E.D. Penn., 1992).

Another questionable narrowing of the new value exception appears in *In re Baxter and Baxter, Inc.*⁴⁸ which prohibits sales of equity to outsiders by virtue of the new value exception. The perversity of this unjustified restriction is underlined by the doublespeak of the case, since the source for the suspicion of this new value plan was the sale of the equity to the equityholder's spouse, hardly an outsider. The consequences of this haphazard additional hurdle have already appeared. The restriction on outside financing of *Baxter* sank the plans in two later cases in this sample which should have been close calls. The equityholders of *In re Gramercy Twins Associates*⁴⁹ had found an outside investor willing to inject \$950,000 for a preferred equity stake in the firm. The plan offered the secured creditor a realistic 85% loan-to-value ratio with profit sharing and options to increase the interest rate. *In re Fur Creations by Variale*⁵⁰ combined the narrowing of *Baxter* with the best-efforts/substantial-return-to-unsecured-creditors line of cases. The new value plan, which might have saved a family's true operating business, failed because the 2.5¢/\$ it proposed to pay to the unsecured creditors was not substantial and for other reasons, including that the new contribution would have come from the children of the current owner.

A further habitual strictness is the exacting interpretation of the "money or money's worth" requirement to mean cash paid on the effective date of the plan. While this correctly precludes the confirmation of many single-asset plans that are long on hope and short of cash (and prospects), it has also gotten squarely in the way of confirming new value plans of individuals who are willing to exchange post-petition income and exempt assets for retaining non-exempt assets. This was the only reason that the plan failed in *In re Bolton*,⁵¹ as well as contributing to plan rejections in five other individuals' cases.⁵² While one may suspect that individuals who can use generous exemptions can then use the new value exception to force their creditors into allowing them to keep non-exempt

⁴⁸ 172 Bankr. 198 (Bankr. S.D.N.Y. 1994).

⁴⁹ 187 Bankr. 112 (Bankr. S.D.N.Y. 1995).

⁵⁰ 188 Bankr. 754 (Bankr. S.D.N.Y. 1995).

⁵¹ 188 Bankr. 913 (Bankr. D. Vt. 1995).

⁵² *In re Kovalchick*, 1995 Bankr. Lexis 296 (Bankr. E.D. Penn. 1995); *In re Rocha*, 179 Bankr. 305 (Bankr. M.D. Fla. 1995); *In re Short*, 173 Bankr. 946 (Bankr. E.D. Okla. 1994); *In re Eitemiller*, 149 Bankr. 626 (Bankr. D. Idaho 1993).

assets, there is little reason for not allowing good-faith debtors some flexibility when the technically enumerated exemptions do not match an individual's situation.

What surprises, when we look at all these different interpretations that bankruptcy courts use to prevent the confirmation of new value plans, is why, if the problem with the new value exception is the option-value surplus, the courts so rarely use the requirement which directly eliminates the option. One of the requirements of *Los Angeles Lumber* is that the new contribution must be "reasonably equivalent" to the value that will be received according to the plan. When this is tested as of the confirmation of the plan (or as of its effective date if the plan provides for more than the ten days to effectiveness implied by Fed. R. Bankr. Proc. 8002), then the equityholders never get a bargain, hence there is no valuable option. Out of this entire sample (excluding individuals' cases), only ten rejections include the "not reasonably equivalent" in their justifications for not confirming.⁵³ Of these, in five opinions the "reasonable equivalence" is the only element of the new value exception that the plan fails. This frequency should be contrasted with the prediction of the option-value argument that no new value plan ever offers reasonably equivalent value unless that is determined ex post.

The paucity of the failures for "reasonable equivalence" (and the consequent variability of means that courts use to reject new value plans) does not indicate an error but the healthy fermentation of an imperfect rule in the common law environment. An outright adoption of the option-value argument would have led to auctions of the reorganized firms' shares, which, as section IVA explains below, are likely to be ineffective and prove to be so in practice. The new value exception is one more rule the workings of which and the purpose of which we do not completely grasp. Courts apply the exception intuitively. When a consensus on the rule's function will emerge, then its application as well as the rhetoric

⁵³ *In re Haskell-Dawes*, 199 Bankr. 267 (Bankr. E.D. Penn. 1996); *In re Fur Creations by Variale*, 188 Bankr. 754 (Bankr. S.D.N.Y. 1995); *In re BMW I, Ltd.*, 168 Bankr. 731 (Bankr. W. Okl. 1994) (need auction to determine reasonable price for new equity); *In re Wynnefield Manor Associates, L. P.*, 163 Bankr. 53 (Bankr. E.D. Penn. 1993); *In re One Times Square Associates, L. P.*, 159 Bankr. 695 (Bankr. S.D.N.Y. 1993); *In re S.A.B.T.C. Townhouse Association*, 152 Bankr. 1005 (Bankr. M.D. Fla. 1993); *In re Creekside Landing*, 140 Bankr. 713 (Bankr. M.D. Tenn. 1992); *In re SLC Ltd V*, 137 Bankr. 847 (Bankr. D. Utah 1992); *In re Pullman Construction Industries, Inc.*, 107 Bankr. 909 (Bankr. N.D. Ill. 1989).

behind it can be streamlined and made consistent. Until then, we observe the common law's process of chaotic evolution.⁵⁴

The richness of the rejections of new value plans is such that their discussion may never end. It must come to a halt, however, so that we can turn our attention to the general option-value surplus accruing to equity ownership.

3. OPTIONS AND EQUITY OWNERSHIP

It is easiest to see that simply owning the equity of a firm may lead to the opportunity for a bargain—that equity ownership contains an option—by assuming there is no new value exception and even positing an instantaneous process of foreclosure upon default. Ignore also any other opportunities for profit that may accrue to the owners by virtue of being at the helm of a project and make the equityholder a passive investor. Encumber this hypothetical firm with enough debt to make it marginally insolvent. Accountants, who determine the equity's position by subtracting debt from assets, would say this firm has “zero equity.” But this equityholder's position has an expected value much more than zero because the value of the firm may increase again.

Consider the objection that in a world of instantaneous foreclosures, holders of zero-equity positions are doomed. That is clearly false. For the foreclosure to occur, the firm must fail to meet a debt payment. Since zero-equity ownership has value, the owner may have a sufficient interest in preventing the foreclosure that she may satisfy the debt service shortfall by her other funds. By making the debt payments the owner keeps the opportunity for a turnaround, however unlikely. The equityholder effectively, has the option of keeping the gains from future appreciation by meeting the debt service shortfall. Since the equityholder can foresee having this ability even while the firm is solvent, the equity of solvent firms is also worth more than the accounting calculation of their equity position. Equityholders own a valuable option regardless of the firm's solvency.

However unstructured this option appears, it is concrete enough for option theorists to calculate its value in a method akin to the pricing of call options using the Black-Scholes-Merton formula. In a recent article,

⁵⁴ See also Nicholas L. Georgakopoulos, *Predictability and Legal Evolution*, forthcoming INT'L REVIEW OF L. & ECON (1997) {verify by publication time}.

three finance professors derived a general formula for calculating the value of the equity including its option to keep the project by making the debt payments.⁵⁵ The resulting figure of the true value of the equity compared to its accounting value reminds of the traditional figure comparing the value of the call option according to Black-Scholes-Merton to the cash that would be received by exercising it. The following figure compares two option-values of equity (one assuming the owner can inject cash to meet the debt payments of the insolvent firm) to its accounting value.

Value of Owning a Project that May Have Negative Equity

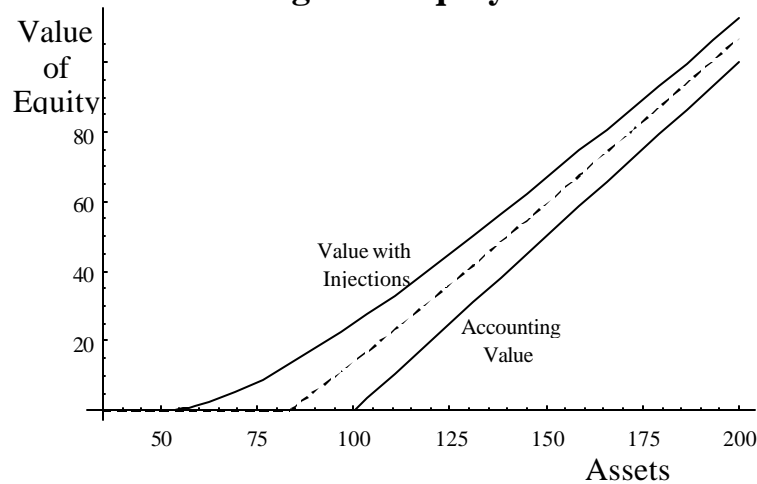


Figure 1: This figure illustrates the value of owning the equity in a firm given that the owner can choose to make some debt payments to avoid default (heavy solid line “Value with Injections”) and contrasts it with the value of the equity in a project that is liquidated as soon as its revenues do not meet its debt payments (dashing line) and the accounting value of the equity (light solid line). Note that both equity values have increasing slope, since safe

⁵⁵ Cornell, Logstaff, and Schwartz, *Throwing Good Money after Bad? Cash Infusions and Distressed Real Estate*, 24 REAL ESTATE ECON. 23 (1996). The value of the equity (S) depends on the value of the firm’s assets (V), their volatility in annual standard deviation as a percentage of price (σ), the project’s earnings as a percentage of value (δ), the debt (F), its interest rate (m), and the risk-free rate (r). The value of the equity in a project where the owner can inject cash, provided that the assets’ value is greater than $A=F/(1-1/g)$ in order for the injections to be worthwhile, is $S=-(1/g)A^{1-g}V^g+V-F$, where

$$g = \frac{-(r-\delta-\sigma^2/2)-\sqrt{(r-\delta-\sigma^2/2)^2+2r\sigma^2}}{\sigma^2}$$

The value of the equity without infusions is $S=(mF/\delta)^g(F-(mF/\delta))V^g+V-F$. The maturity of the firm’s debt does not appear in this model because the model assumes perpetual debt. The closer the maturity is, the smaller the value of the equity.

capitalization is to the debtholder's advantage in both cases. Both are asymptotic to the equity's accounting value. The option-value of the equity becomes zero in the case without new value injections when asset values drop to the point where the project has insufficient cash flow to service its debt. With cash injection, the value of the equity becomes zero when new injections are no longer worthwhile (the option is path-dependent). The values used were debt of \$100 with fixed 5% interest, the assets bring revenues of 6%, the risk-free rate is 5%, and the standard deviation of the project's value is 20%. At the asset value of \$100 where the accounting value of the equity is zero, the equity is worth over \$13 without the possibility of injections and \$25 with it. Realizing that owning a firm with negative equity has value should also suggest that reorganizations need not produce balance-sheet solvent firms as is universally the practice, but only firms with solvent cash-flows.

The potential gain by satisfying creditors and keeping the project's ownership is not the only option associated with equityholding. Perhaps it is the cleanest since it depends strictly on financing—making the debt payments to hold the liquidating creditors at bay. In actuality, the involvement with a project will tend to network the owner with other businesses and to present opportunities for other potentially profitable deals (which render the above calculation a minimum). A typical example appears in an old but still leading opinion which defines partners' fiduciary obligations, *Meinhard v. Salmon*.⁵⁶ The dispute regarded what would be called today an option: an offer which the controlling partner received and accepted in his own name, appropriating it. Justice Cardozo, using his striking and continuously cited prose, gave the opportunity to the partnership.⁵⁷ The opportunity consisted of an offer to develop an entire city block at the corner of 5th Avenue and 42^d Street in Manhattan during the late 1920's. It came to the manager of one of the numerous buildings on that block, who was also the only visible partner of the partnership that had the lapsing 20-year lease on the building and

⁵⁶ 249 N.Y. 458, 164 N.E. 545 (1928).

⁵⁷ "Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty... Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior... Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court." *Id.* The frequency with which *Meinhard* is cited is striking. Chief Judge Richard Posner reports 653 citations to it by other opinions compared to 827 citations to Cardozo's most famous and older case, *MacPherson v. Buick Motor Co.*, 217 N.Y. 382, 111 N.E. 1050 (1916). RICHARD POSNER, *CARDOZO: A STUDY IN REPUTATION*, 103 (1990). By January 1997 *Meinhard*'s 21% lag had been reduced to under 11%, with 840 citations to *MacPherson*'s 941. The "punctilio of honor" language had been quoted by 390 opinions (plus 3 that use "punctillio"). Fifty of those do not also cite *Meinhard*, which shows the memorability of the quote and that the previous count understates its popularity.

that had renovated and managed it for that duration. It is interesting to note that for the first few years of the original lease, the venture had operated at a loss. The above figure shows that the partners were not irrational for keeping the project alive.

Thinking about the option-value components of equity ownership also leads to the realization that the option-value surplus is not a result of the new value exception. Regardless how much new capital will be contributed, the variability of the old firm's value does not change.⁵⁸ The option-value surplus is a result of the firm's variability, and is independent of the new value contribution. Indeed, even a plan that does not use the new value exception offers the same option-value surplus to the old equityholders, and offers it at a lower out-of-pocket cost.

A simple example clarifies how the option surplus is irrelevant to the new value contribution. Suppose the firm has a total expected value of \$100, and its volatility is such that in a year, when confirmation is anticipated, there is an equal (50%) chance that it will be worth either \$95 or \$105. Creditors have claims of \$99, so that the firm is marginally solvent and the old equity might be able to survive reorganization without the new value exception.⁵⁹ Compare two alternative plans, the first of which calls for no new value, and the second of which calls for new value of \$15. Under the former plan, the firm's possible values are either \$105 or \$95. The equityholders receive \$6 half the time, otherwise nothing. This is a \$3 option-value surplus at the time they propose the plan. Under the \$15 plan, the values of the firm will be either \$120 or \$95 (since the plan will be amended on the eve of confirmation if the bad outcome materializes). For \$15, the equityholders receive \$21 half the time. Because they net \$6 half the time, this plan too offers a \$3 option-value surplus.

If we think that equityholders should pay for their option-value surplus, why shouldn't these equityholders of marginally solvent debtors pay for the probabilistic value they receive? The example also shows that

⁵⁸ If a more variable asset is contributed, such as a plant that the parent of the failed firm proposes to contribute as new value, its variability will never work against the plan's proponent. If the parent determines the plant to have appreciated in value, the parent will amend the plan accordingly. This erodes the option-value surplus that consideration of variable value might have restored.

⁵⁹ A solvent balance-sheet does not preclude bankruptcy since the firm may not have the cash flow to service its debt.

the smaller the new-value contribution, the larger the option-value surplus as a fraction of the contribution. But then, according to the option-value argument, the most egregious violation of absolute priority is a plan with little or no new value contribution, where the old equity stays in place with minimal participation because the firm's assets barely cover its debts. Were the opponents of the new value exception fighting an actual war with such backfiring ammunition, the outcome would be much clearer.

Since, regardless of bankruptcy rules, equity ownership implies an option-value surplus, the argument that bankruptcy law must not give equityholders any option-value surplus cannot be made. If this analysis demystified, as it intended, the option-value argument, we can now turn to the substance of the question. What shape should the new value exception take?

IV. OLD BENEFITS

Not only do the attacks against the new value exception lack merit, but very sound arguments exist in its favor. The new-value exception is beneficial: It resolves severe problems associated with auctioning hard-to-value equity, it provides incentives for good management during, as well as before, the bankruptcy, and it solves problems of the fresh start policy as it applies to family-owned firms. To the extent that these collide with the current interpretation of the new value exception, they should be taken into account by the evolutionary process of the bankruptcy common law.

A. Problems with New Equity Auctions

The alternative to selling the reorganized firm's equity to the old equityholders is to find other buyers. Effectively, if new capital must be raised, the new equity will be sold at an auction. Opponents of the new value exception regard auctions as so superior to the ordinary court-supervised confirmation of a new-value plan, that they suggest mandating them if new equity is to be issued. Auctions are seen as leading to the elimination of valuation errors, as bringing higher prices for the reorganized equity and, consequently, as leading to better-capitalized firms and safer debt. Mandatory auctions, however, are not the

panaceas they are purported to be. Not only are their theoretical merits overstated, but a glance at their application reveals an almost sinister nature. The following paragraphs discuss these two points.

1. THE THEORETICAL DRAWBACKS OF MANDATORY AUCTIONS FOR NEW EQUITY

The source of the problems with selling firms' equity is that it is extraordinarily difficult to price. Valuations depend on estimates of future profitability and on the firm's future risk. Given the size of the uncertainties, the soft unverifiable information that the old equityholders have is likely to provide a very substantial advantage. This informational advantage is not unique in the reorganization setting. Multiple aspects of the regulation of corporations' activities are motivated by this inequality of information: insider trading rules,⁶⁰ disclosure obligations,⁶¹ takeover and defensive tactics law,⁶² and so on.

The informational imbalance may be exacerbated in the context of reorganized firms. Reorganized firms tend to have more debt, and to fail with greater frequency than their non-reorganized counterparts.⁶³ The result is that an ordinarily almost irrelevant insight into a firm's prospects may influence valuation substantially.

⁶⁰ See Nicholas L. Georgakopoulos, *Insider Trading as a Transactional Cost: A Market Microstructure Justification and Optimization of Insider Trading Regulation*, 26 CONN. L. REV. 1 (1993).

⁶¹ See Nicholas L. Georgakopoulos, *Why Should Disclosure Rules Subsidize Informed Traders?*, 16 INT'L REV. L. & ECON. 417 (1996).

⁶² Case law offers an express understanding of the concept that managers who do not share information evenly with all bidders can manipulate takeover outcomes in *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261 (Del. 1989). Articles on defensive tactics are plentiful. Some examples are Ronald J. Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 STAN. L. REV. 51 (1982); Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers: A Reply and Extension*, 35 STAN. L. REV. 23 (1982); John C. Coffee, Jr., *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145 (1984); Dale A. Oesterle, *The Negotiation Model of Tender Offer Defenses and the Delaware Supreme Court*, 72 CORNELL L. REV. 117 (1986); Ronald J. Gilson & Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247 (1989); Joel Seligman, *The New Corporate Law*, 59 BROOK. L. REV. 1 (1993).

⁶³ See Stuart C. Gilson, *Transactions Costs and Capital Structure Choice: Evidence from Financially Distressed Firms*, Harvard Business School working paper, forthcoming J. FIN. (1996).

Consider the example where management knows that the reorganized firm's prospects have a slightly different uncertainty than those of other comparable firms. Suppose that the present value of the two possible outcomes of the firm's operation are \$85 and \$115, a variation of 15% around its average performance of \$100, instead of the industry's usual variation of $\pm 20\%$. Risk-neutral investors would consider this difference irrelevant in well-capitalized firms. If this firm will emerge from Chapter 11 with 90% debt, however, the management would pay for its equity only up to \$12.50, while outsiders would be bidding erroneously up to \$15.⁶⁴

Imbalances of information lead to some further problems. High bids by outsiders may cease to be indications of greater use and efficiency; they may simply be erroneous overvaluations. Moreover, outsiders, in fear of the insiders' superior information may shun the auction preventing the dependability of its outcome.

First, falsely high bids are undesirable regardless of the apparently safe capitalization which they provide. They consist of a direct waste of resources which, if not corrected by a voluntary sale or redeployment of the assets to their most valuable use, will come to waste the bankruptcy system's resources again when the firm fails. While it is certainly not within the purview of bankruptcy policy to prevent valuation errors, neither is it sound policy to invite them.

Outsiders' apprehension toward auctions also reduces their effectiveness. One of the alleged advantages of auctions is that they will relieve courts of the burden of evaluating the equity in new-value plans. But the discouraging of outside bids implies that the courts must continue to evaluate the new equity. If outsiders systematically underbid, the old equityholders will systematically receive the new equity at a bargain price. The auction process cannot be relied upon to provide fair valuations, as the following example illustrates:

Suppose outside bidders can determine the discounted value of the firm's average performance, but cannot determine whether this firm is

⁶⁴ Management figures the equity is worth nothing if the bad outcome materializes (because \$90 of debt would exhaust the \$85 of assets), but worth \$25 in the good outcome (because \$115 of assets exceed \$90 of debt by \$25). Outsiders, by contrast, believe the equity would be worth \$30 in the latter case. The example assumes the two outcomes are equally probable (50%). This simplification does not detract from the general conclusion that differences in volatility influence the valuation of leveraged firms.

riskier or less risky than others (as long as that difference is small). To continue with the previous example's type of uncertainty, they cannot tell if the firm falls within the plus or minus 20% of the industry, or is within 15%, or 25% of the average. A firm with \$100 average value of assets over the two outcomes and \$90 of debt will have equity that is worth different amounts to risk-neutral buyers. A 20% variation implies \$15 value, 15% implies \$12.50, and 25% implies a value for the equity of \$17.50.⁶⁵ Since outsiders cannot verify the variability of this firm's outcomes, they will not trust statements that it is 25%. Moreover, if they bid the average value of this equity, \$15, they will never get a fair deal; they will be the winning bidders only when the equity is worth \$12.50, never when it is worth \$17.50. Knowing this, the managers and old equityholders need never bid the full \$17.50, even when that is the value of the equity. Not only does the auction not prevent underbids, it effectively leads to them.

Auctions, however, may occasionally be useful in the reorganization setting. Although arguments suggesting that equity auctions would be desirable in most reorganizations are implausible, nothing argues auctions never work. Auctions may facilitate some reorganizations and obstacles to their use must be removed.⁶⁶ But mandating auctions for the firm's equity in every reorganization is clearly excessive.

⁶⁵ The three scenarios imply the firm ends up with assets (1) worth \$80 or \$120 in the $\pm 20\%$ case, (2) worth \$85 or \$115 in the $\pm 15\%$ case, or (3) worth \$75 or \$125 in the $\pm 25\%$ case. In all cases, the \$90 of debt exhaust assets if the bad outcome materializes. Since the two outcomes are expected with equal 50% probability, risk-neutral equityholders value each scenario at 50% of the payoff in each one's good outcome. The $\pm 20\%$ scenario, for example, has equityholders receiving \$30 net of debt in the good outcome: \$120 of assets burdened by \$90 of debt. They would value the equity at \$15.

⁶⁶ The most significant obstacle to auctions is securities regulation, which imposes S.E.C. registration for every public offering of securities. The Bankruptcy Code's exemption, § 1125, is not available for sales to outsiders, see *infra*, note 69. A bankruptcy "safe harbor" which would secure the exemption from registration—or, more likely, would relax the strict liability scheme of securities regulation—with respect to invitations to bid in reorganizations, would be of great help. Successful use of the expanded exemption, however, should not lead to the conclusion that mandated auctions are desirable. Even if we find that outside equity purchasers succeed and, therefore, conclude that the expanded exemption does not expose investors to risks they cannot handle, auctions still must not be mandatory. The successes of auctions will come from situations where auctions can be conducted. New value plans should still take care of those situations where outside bidders cannot compete against insiders. Buyers of securities in reorganizations also run the risk of being considered underwriters and be liable

Mandating auctions in every reorganization also invites numerous potential abuses in those circumstances where information cannot be shared evenly. Debtors-in-possession who in fact underpay for their equity in the new firm (because of no other high bidders) will appear as unassailable purchasers for full value. Debtors who are not interested in participating in the reorganized firm will, nevertheless, to a large extent control the access that third parties would have to the information, and the ease with which they would gather their information. Their cooperation and strategic behavior would be of great interest to creditors and competing bidders. It is not coincidental that the same scholars who favored unrestricted insider trading⁶⁷ before it was conclusively shown to be socially undesirable in both theoretical and empirical work,⁶⁸ support the position that equity in the reorganized firm must be sold at auction. Mandating auctions, in essence, would mandate insider trading in reorganizations. The same unrealistically perfect markets are necessary for both proposals to work.

2. AUCTIONS IN PRACTICE

It is interesting to note that auctions have been ordered in bankruptcy settings, although they are only open to bidders who already have a relationship with the debtor, in order to use the exemption from the registration securities laws require. The exemption is provided by the

when they sell, but if they do not buy with a view to a distribution—as will be the rule—then they will tend to fit within the exemptions of § 1145.

⁶⁷ Judge Frank H. Easterbrook, for example, the author of the *First Bank* opinion, *supra* note 6, has defended repeatedly the right to trade on inside information. See Frank H. Easterbrook, *Insider Trading as an Agency Problem*, in *PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS* (John W. Pratt and Richard J. Zeckhauser, eds., 1985); and *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 S. CT. REV. 309.

⁶⁸ A formal proof of the necessity for insider trading regulation is offered in Nicholas L. Georgakopoulos, *Insider Trading as a Transactional Cost: A Market Microstructure Justification and Optimization of Insider Trading Regulation*, 26 CONN. L. REV. 1 (1993) (the profits of informed traders are a cost of trading for life-cycle uninformed traders; insider trading rules impose competition which reduces the profits and the cost, with little delay of price accuracy). The empirical proof consists of the calculation of the same implicit transaction cost burdening life-cycle uninformed traders even when the insiders trade legitimately. See H. Nejat Seyhun, *Insiders' Profits, Costs of Trading, and Market Efficiency*, 16 J. FIN. ECON. 189 (1986).

“safe harbor” of § 1125.⁶⁹ The fact pattern of the few auction cases is that when the old equityholders propose a plan that relies on the new-value exception, the objecting creditor argues that confirmation should depend on an auction to avoid the equityholders receiving the new equity for less than fair value. Let us examine the example of the first case to order an auction, *In re Bjolmes Realty*.⁷⁰

Bjolmes' single asset was an apartment building, bought in 1985 for \$410,000, worth during the 1991 reorganization about \$250,000. The building had been refinanced in 1988 with a \$380,000 secured 2-year loan, on which \$410,000 was due, giving the secured creditor (the FDIC) a \$250,000 secured claim, and a \$160,000 unsecured one.⁷¹ Other unsecured creditors were owed \$7,000. The plan proposed that the old equityholders buy the equity for \$17,000 new value in cash, which would be used to pay about 10 cents for every unsecured creditors' dollar. The court conditioned confirmation of the plan on an

⁶⁹ The exemption that § 1125 provides is limited to the securities issued by the reorganization plan to those voting on the plan. This obviously does not include outside solicitations. Invitations to bid must be shielded by one of the ordinary exemptions. A likely one, assuming a small number of savvy bidders, is the “private offering” exemption. The private offering exemption to the registration provisions of the Securities Act of 1933 is founded on its § 4(2), 15 U.S.C. § 77d. The limits of the private offering exemption are judicially defined and quite vague; see generally, *S.E.C. v. Ralston Purina*, 346 U.S. 119 (1953) (large corporation could not use the private offering exemption to sell its securities to all its employees). The Securities and Exchange Commission has promulgated rules intended to provide more clarity to issuers; see, e.g., Regulation D, S.E.C. Rules 501 *et seq.*, 17 C.F.R. § 230.501 *et seq.* (1996). No rule exists that would ease the scrutiny on a general solicitation to bid on equity securities issued by a plan and sold at an auction run under the bankruptcy process. The Bankruptcy Court's oversight ought to provide grounds for some relaxation of the strict liability of securities regulation, and, therefore, a movement toward liability only for negligent misrepresentations.

⁷⁰ 134 Bankr. 1000 (Bankr. D. Mass., 1991). Other cases that order auctions are *In re Homestead Partners, Ltd.*, 197 Bankr. 706 (Bankr. N.D. Ga., June 25, 1996) (favoring an auction among claimants—to avoid violating the securities laws—as opposed to terminating the exclusivity period upon submission of the new value plan); *In re ROPT, L.P.*, 152 Bankr. 406 (Bankr. D. Mass. 1993). They all treat the auction issues in an identical manner to *Bjolmes*. There is no evidence that any auction has ever taken place.

⁷¹ Undersecured creditors can make the § 1111(b) election to have their entire claim treated as secured at the cost of losing their unsecured objecting vote, for what is the unsecured part of their claim. The election usually helps only nonrecourse undersecured creditors. In this as in most cases, the election would not help the secured lender in defeating the plan. For the election, see generally Dale C. Schian, *Section 1111(b)(2): Preserving the In Rem Claim*, 67 AM. BANKR. L. J. 479 (1993).

auction for the new equity in which the equityholders and the creditors were to bid. Creditors were not to bid on credit, as they could do in a foreclosure of the actual building, because they would not be bidding for the building but for the equity of its owner. The amount raised would then be distributed to the unsecured creditors whose claims would be discharged, while the secured claim would survive according to the plan's terms.

The first puzzle *Bjolmes* gives rise to is the use of the auction proceeds. If creditors are bidding while receiving a pro rata fraction of their bid, they are subject to unique incentives. In this example, the FDIC would eventually receive back 96% of its bid, because its unsecured deficiency claim was 96% of all unsecured claims. If this does not sound problematic, remember that the creditors, while being entitled to the going-concern value of the firm, are not entitled to any idiosyncratic value that the asset has for the debtor.⁷² Consider now that the firm's going-concern value was indeed \$250,000, but due to its sentimental value, the debtor's equityholders are willing to pay an additional \$20,000 for it. The equityholders should win an auction with a bid of \$1 (subject to the secured claim which, let us assume for now, is truly worth \$250,000). But the unsecured creditors as a group have a credible threat of bidding much more, since they receive their dollars back. Effectively, the unsecured creditors can force the equityholders to pay the full amount of the surplus of their idiosyncratic valuation. The fallacy lies in allowing the new value contribution to be paid to the old creditors. The contribution is value of the reorganized firm, and it must not be distributed on account of antecedent claims. The new value, as it would in a startup firm issuing securities, must stay with the firm.

⁷² This policy is evident in not only the exemption provisions of § 522(d) and the lien-avoidance provisions of § 522(f)-(h) (which preclude creditors from reaching assets with high idiosyncratic value for this debtor such as family photographs), but also by the Code's legislative history, which notes that exemptions prevent extortionary threats by creditors that they will repossess worthless but costly to replace household goods to obtain repayment. See DOUGLAS G. BAIRD AND THOMAS H. JACKSON, CASES PROBLEMS AND MATERIALS ON BANKRUPTCY 905 (1990). Moreover, large idiosyncratic values can be considered akin to the irrationalities from which bankruptcy law protects. Allowing creditors to extract idiosyncratic value from debtors would contradict the parallel policy of protecting creditors from their errors when they borrow, a protection which is given through the fresh start policy, see *infra*, text accompanying notes 89-93.

The second puzzle of auctions regards the very object of those auctions, which is considered to be 100% of the new equity. As is clear from the fact that debt does not participate in any rise in the firm's value, it is impossible for the surviving secured claim to ever have the same value with the firm, here \$250,000.⁷³ Indeed, no lender ever lends up to a fraction even approaching 100% of their collateral, and it is a commonplace argument that neither should bankruptcy courts force secured creditors to do so by confirming overleveraged plans.⁷⁴ The reorganized firm must emulate the capital structure that a new firm could achieve, and never would voluntary secured debt exceed 90% of the assets (assuming the market provides for such high leverage). This does not mean that the FDIC should only receive a secured claim for \$225,000. The FDIC's secured claim must be converted to claims against the reorganized firm, but no more than the market debt ratio, say 90%, of those should be debt. The balance must be equity in the reorganized firm. After this capital structure has been established, according to which senior creditors receive 100% of the value of the firm in both debt and equity of a realistically capitalized firm, and junior claims are discharged, only then should the issue of new value be considered. New value contributions would stay in the reorganized firm, and the winning bidder would not be bidding for a fixed fraction of the firm, but would receive a share proportional to the secured creditor's equity, depending on the amount of new value. A bid of \$25,000 would receive a 50% stake, \$50,000 would buy a 66.6% stake, \$75,000 would buy 75%, and so on.⁷⁵ This arrangement also emulates the raising of new

⁷³ Consider again that the future value of the firm's assets will be uncertain. Their present value will be the average (discounted) of their future values. Supposing that is \$100. A 100% equity claim to those assets will have the same \$100 value. By contrast, a debt claim, secured by the same assets, can practically never have the same \$100 value because the debt has a ceiling on the claim. A great enough appreciation of the asset will provide the secured creditor with all his claim, and value will be left over for the owner.

⁷⁴ See, e.g., Lynn LoPucki and William Whitford, *Patterns in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 78 CORN. L. REV. 597 (1993); Lucian A. Bebchuck, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775 (1988). But see Stuart Gilson, *Transactions Costs and Capital Structure Choice: Evidence from Financially Distressed Firms*, supra note 63 (chapter 11 reorganizations lead to less debt than out-of-bankruptcy workouts).

⁷⁵ This setting also illustrates the meaning of the notion that the new value must be "necessary" for a successful reorganization. The reorganized firm must need the new-value infusion to stay in operation and preserve its going-concern value. Since the new value is

capital by firms outside bankruptcy. New equity issues are negotiated and the buyer receives shares proportionate to the relative values of the new and the existing equity.

When we realize the mistreatment that the auction proposal undergoes in practice, it is obvious why secured creditors lose when contesting new value plans. Courts do confirm new value plans which distribute the new value to the old creditors. Naturally, as in *Bjolmes*, this bribe buys the support of creditors who might otherwise receive nothing, and the plan can now be confirmed, having been supported by an impaired class as required by § 1129(a)(10). In this setting, it is not the new value exception that offends the absolute priority rule, but rather using it to pay out-of-the-money creditors. But that objection is never raised. Secured creditors only complain about the new value exception or the separate classification of their unsecured claim.⁷⁶

Despite their mistreatment, auctions, if done properly, are an important tool in the reorganization process. But, before an auction is conducted, not only must the reorganized firm have a reasonable capital structure and the new value be retained by the reorganized firm, but also outsiders must be allowed to bid.

For the creditors to receive the going-concern surplus of the failed firm, the winning bidder must compete against another who also perceives the firm's going-concern value. In an auction without outsiders,

mostly used in practice to "buy" the out-of-the-money creditors' vote for the plan and since that vote is necessary because one class must accept the plan per § 1129(a)(10), it is always perversely necessary for the reorganization, as the following paragraphs of the text explain. Given the abuse that the new value idea has received in its application, it is no surprise that it receives strong opposition. The new value is, of course, necessary, only if it consists of, or if it is converted into, items without which the firm is not viable, such as new equipment or necessary services. The irony of the fact that "necessity" is judged by the legal requirements for a reorganization should not go unappreciated. The requirement of § 1129(a)(10) that one class must accept the plan appears increasingly questionable, since not only the junior creditors acceptance is "bought" to strip down the secured claims, but also the secured may agree to a plan that will not hurt them if by stripping down the claims of the unsecured creditors it makes foreclosure less likely, as, e.g., *In re Capital Center Equities*, 144 Bankr. 262 (Bankr. E.D. Penn. 1992) (mortgagee was fully secured and supported the plan, which would have paid the unsecured creditors 10¢/\$).

⁷⁶ Separate classification is necessary if the secured creditors' unsecured claim, which they will vote against the plan, does not allow the other unsecured creditors to reach the necessary majorities. Other unsecured creditors, of course, receive the new value and favor the plan.

however, the former equityholders may well be the only bidder interested in running the firm. The creditors will tend to be in the business of lending to, not running, firms. This composition of the pool of bidders ensures that the equityholders will underpay for their interest. The *Bjolmes* example can also illustrate the fallacy of no outside bidders. Suppose that the firm has a going-concern value of \$250,000, a liquidation value of \$230,000, and the industry norm for a reasonable capitalization is 90% debt. The secured creditor receives a secured claim of \$225,000 and an equity stake—say 25 common shares each corresponding to \$1,000 of shareholder equity—to provide the balance up to the \$250,000 going-concern value. Suppose that the firm requires new equipment to remain in business, which costs \$20,000, and which will bring the going-concern value to \$300,000, but will only increase the liquidation value by the same \$20,000 it costs (to \$250,000). The terms of the auction provide that the first \$20,000 cash proceeds will be used to purchase this equipment. A reasonable bidder will certainly bid more than \$20,000, since the stake being auctioned appears to be worth \$50,000 (it brings the going-concern value of the firm from \$250,000 to \$300,000). A good use to which additional cash can be put without offending the reorganization process is to buy back the secured creditor's equity stake, assuming it is worth \$25,000.⁷⁷ In a competitive environment, the above auction should raise \$50,000. The secured creditor will sell its entire equity stake for \$25,000, and there will be \$5,000 left. Bidders who realize that bids above \$45,000 will enable this buyout and render the bidder into the owner of 100%, should be willing to bid up to \$75,000, producing a \$55,000 surplus and an even better capitalized firm.⁷⁸

⁷⁷ It would not be appropriate to distribute this surplus to the unsecured creditors because it is not value of the failed firm but of the new one. If we were to insist on replicating non-bankruptcy distributions inside bankruptcy, this value should go to the entity that created it, whether that is the investment bankers, the debtor-in-possession, or any other party. This would also provide the appropriate incentives for its production. See also note 78.

⁷⁸ Which of course means that more than \$75,000 will be bid now that the firm will be worth \$355,000. No end to this bidding appears, since the winning bidder bids, effectively, on credit past the \$45,000 point. This is because the buyer can refund to himself in the form of a dividend any amount bid beyond \$45,000. This is unlikely to become a problem in practice, where expenses and fees may drain this surplus. Perhaps the optimal fee to the brokers and investment bankers for finding additional buyers is this surplus or a large fraction of it, particularly since their commission must be lower or even zero when only the necessary capital, here \$20,000, is raised (see also note 77). If the problem persists, the plan can state

Notice, by contrast, that a creditor who wishes to liquidate will only bid up to \$20,000 for the equity. In the liquidator's eyes, \$20,000 is the value of the equipment, and that is the increase of value that it brings to the firm (from a liquidation value of \$230,000 to a liquidation value of \$250,000). But the contribution of this asset increases the going-concern value of the firm by \$50,000 and should, therefore, correspond to a 2/3 equity stake. If no outsiders participate in the auction, however, the only bidder who appreciates the firm's going-concern value may well be the old equityholder. If so, the equityholder will receive the new equity by bidding slightly over \$20,000, and will be receiving at least a \$50,000 value: the 2/3 majority stake in a firm worth \$300,000 with debt of \$225,000. The secured creditor, who in a competitive auction open to outsiders would even get rid of its onerous minority equity position, will be forced to stay as an unwilling minority equityholder.

Proper auctions must include outsiders; must retain the new value for the firm; and firms must be reasonably leveraged. Current auctions satisfy none of these requirements, so they are not even proper as alternatives, let alone as mandated procedures.

The movement against the new value exception fails for more reasons than that the alternative, auctions, is currently unworkable. New value plans offer direct benefits. The next section explains the desirable incentives produced by the potential to file a new value plan, before the subsequent section analyzes the advantages of using new value plans to reduce the costs of providing a fresh start.

B. New Value Plans as Incentives

In every firm and every industry, managers receive options as part of their compensation packages. Options are used routinely because of two desirable motivating effects. They provide managers with the incentive to increase the firm's value, and they reduce managerial risk-aversion.

Managers who own options have the incentive to increase the firm's value. Managers' options give them the right to buy the firm's stock at a specified price. Increases of the firm's value increase directly

additional capital investments that can be made with the surplus. Since these must be decreasingly attractive, an end should appear in the bidding.

the value of management's options, giving them the incentive to increase it.

The value of managers' options also depends on the variability of the firm's value, which is the volatility of its stock. The greater the volatility, the greater the value of the options. By being strongly correlated with the stock's volatility, they increase in value as the variability of the firm's future outcomes increases. Managers tend to be by nature risk-averse because all their human capital is invested with the firm.⁷⁹ Owning options gives managers an interest in the variability of the firm's outcomes. Managers are induced to take risks. Ideally, their risk-tolerance would reach the risk-neutrality of investors, who are diversified and, therefore, would rather not see any of their firms avoid some on-average beneficial project because of its dangers.⁸⁰ Empirical research verifies the superiority of options against stock grants as motivating compensation schemes.⁸¹

But if in the context of bankruptcy there is an absolute bar to distributions to old claimants for the duration of the reorganization,⁸² then

⁷⁹ Meaning that, because their prospective salaries in the employment market depend on their current firm's success, they want to avoid its ruin lest they lose their sustenance salary. Consider the following example of a CEO choosing among two investment alternatives for the firm's \$100 of total assets: A gamble with a 50% chance of success which will turn the assets into either \$85 or \$125 (a \$105 expected value) and a safe investment that will produce \$102. After the firm has the \$102 result the C.E.O. can maintain his lifestyle but not if firm value fell to \$85 on this C.E.O.'s "watch." Therefore, our C.E.O. may well avoid the risk and its rewards.

⁸⁰ For a very readable introduction to risk and its control through diversification, see RONALD GILSON AND BERNARD BLACK, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* (1995), primarily chapter 3. For an interesting application of diversification to eliminate grade shopping biases in law school, see Nicholas L. Georgakopoulos, *Relative Rank: A Remedy for Subjective Absolute Grades*, 29 CONN. L. REV. ___ (1997).

⁸¹ See William W. Stammerjohan, *CEO Compensation and Subsequent Firm Performance: An Empirical Investigation*, Miss. St. U. Working Paper, March 1996 (verify). See also, Richard A. Lambert & David F. Larcker, *Executive Compensation, Corporate Decision Making, and Shareholder Wealth: A Review of the Evidence*, in *EXECUTIVE COMPENSATION: A STRATEGIC GUIDE FOR THE '90S* (Fred K. Foulkes ed. 1993) p. 98 at 109-10 (options increase risk-taking unless they are far in the money). The quasi-option of the new value plan, of course, is at the money, not in the money.

⁸² *Official Committee of Equity Security Holders v. Mabey*, 832 F.2d 299 (4th Cir. 1987) cert. denied, 485 U.S. 962 (1988) (the estate was not allowed fund time-sensitive medical procedures to cure infertile tort victims before the end of the reorganization, even though this would be to all creditors' advantage since the procedures were expected to cost less than their uncured beneficiaries' expected distribution).

it may not be possible to motivate the debtor-in-possession through the actual issuing of options. It is desirable to provide the managers with the appropriate motivations by including options in their compensation, regardless who ends up as an owner of the firm after the reorganization. The quasi-option character that the reorganization plan has for the proposed equityholders achieves this simply and effectively.⁸³

Any reorganization plan presents quasi-option characteristics from the perspective of its proposed equityholders. If, at the time of confirmation, the firm's value does not exceed that of the reorganized debt, equityholders are, in essence, no worse off than they would be if they had no equity. If the plan provides for participation of the old equityholders upon a contribution of new value, then the equityholder's option is to recant the plan, if the firm with their contribution does not exceed the value of reorganized debt plus the contribution.⁸⁴

Thus, for the duration of the reorganization, the plan is the simplest and most effective way to provide management with an incentive to run the firm well. Their inchoate rights under the plan mean that they will benefit from an increase in the value of the firm, and their option-like character reduces managerial risk-aversion.⁸⁵

One could object that equityholders always have the incentive to prefer risky projects, very much as the debtholders prefer that they are avoided. Debtors-in-possession do not need the risk-taking inducement of the option-like new-value plan. The limited liability of the corporation gives shareholders limited downside risk. This phenomenon appears at firms that are close to solvency. If the firm's value is close to what it owes its creditors, risky projects do not expose shareholders to risk. If

⁸³ *In re Pullman Construction Industries, Inc.*, 107 Bankr. 909 at 914 (Bankr. N.D. Ill. 1990), provides an explicit acknowledgment of this effect. Senior employees of the debtor stayed during the reorganization, stopped its decline, and led it to success for only the prospect of becoming minority shareholders through the anticipated new value plan. The plan was not confirmed.

⁸⁴ See *supra*, note 29 and accompanying text.

⁸⁵ In a pure new-value plan, in which the old equityholders would contribute the new value on top of the junior creditors' claim instead of purchasing their claim to the residual (see *supra* text accompanying notes 32-58), the equityholders receive an option on 100% of the firm's equity, which may exceed what is necessary to motivate them. Nothing precludes the court from adjusting the plan so as to reduce the size of the equityholders' option by, for example, also letting junior creditors receive equity, as suggested above, notes 77-78 and accompanying text.

the project fails, the de-valuation it will cause hurts the creditors only. But if the project succeeds, the shareholders will enjoy all the gains. Thus, when presented with two projects of comparable value for the firm, equityholders of firms that are near insolvency will prefer the riskier. They may prefer the riskier project even if it is not superior to the safe one. As Chancellor Allen has explained in *Credit Lyonnais*,⁸⁶ insolvency places equityholders in a position where they prefer inferior projects, provided they are riskier than the alternative. In *Credit Lyonnais*, the shift in risk-preferences was such that insolvency was held to trigger a shift in the beneficiaries of directors' fiduciary duties. Directors, who in solvent corporations must promote only shareholders' interests, must also protect creditors' interests when the firm is at the verge of insolvency. Since debtors-in-possession are the old equityholders, and since a firm undergoing a reorganization in Chapter 11 tends to be insolvent, there is no shortage of incentives to undertake risky projects. Therefore, we are urged to conclude, debtors-in-possession need no additional inducements to take risks.

But this objection ignores the fact that equityholders only prefer the more uncertain projects if they offer the possibility of solvency. If a firm is far from being solvent, which is the rule in reorganization proceedings invoking the new value exception, then such projects are likely not to exist. The equityholders' stake in the firm does not depend in any way on its performance and, accordingly, debtors-in-possession have no incentives to make the right managerial decisions. They reacquire, however, their motivation, as soon as it is possible for a plan to offer new equity to them in exchange for new value. The better the firm is run, the more will their new equity will be worth. The more variable the firm's projects are, the greater the prospects that the new-value plan will offer them a bargain. It is not necessary that the new value plan exist; its potential existence motivates. Therefore, the new value exception motivates. Not only are managers motivated, but they are also nudged away from their natural risk-aversion.

Notice that even if creditors will not end up receiving equity under the plan, or if they are undiversified and, therefore, risk-averse, firms still should be run by risk-neutral management during the

⁸⁶ *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.* 1991 Del. Ch. LEXIS 215 (Del. Ch., 1991).

reorganization. Society has a diversified stake in all firms, not only as the taxing authority, but also as the beneficiary of increased economic activity. Were bankruptcy law to cultivate the natural risk-aversion of managers, fewer opportunities would be pursued, and economic growth would be slower. Although the population of firms in reorganization is relatively small, there is no reason for society to give up on the goal of risk-neutral management with respect to those firms.

The incentives that the possibility of filing a new value plan provides are not only felt after the bankruptcy filing. The possibility of filing a new value plan also influences not just the decision to file but also the owners' conduct leading to the filing. It is intuitive that the more desperate and disenfranchised the owners, the more desperate will their actions be, and the smaller the likelihood of a display of the good faith that may influence an equity court's attitudes on ambiguous issues such as the confirmation of a new value plan. In all the cases that the simple search of section III B2 identified, none had indications of the equityholders being vindictive. By contrast, what should surprise was their good faith. The persistent rejection of new value plans in that set of cases may have led to lender vindictiveness reminiscent of taking their debtors to a debtors' prison. How else can we justify the rejection by creditors of individuals' plans that provided creditors with post-petition earnings? We should admire our bankruptcy system which provided enough incentives for no owner misbehavior in all those cases and which led owners like the Picciolos to mortgage their residences and personally provide much of the labor to turn a fire-ravaged building into "the jewel of Bay Ridge"⁸⁷ and employees like those of Pullman Construction to stay and turn the business around.⁸⁸ Instead of concern about the harsh and perhaps deceitful treatment of such individuals, we see a movement in case-law and commentary that would reduce their incentives for such exemplary conduct by eradicating the new value exception.

C. Family Businesses and the Fresh-Start

The financial health of family-owned businesses is intertwined with that of their owners. While little concern may be wasted on the poor

⁸⁷ *In re 8315 Fourth Avenue Corp.*, 172 Bankr. 725 at 727 (Bankr. E.D.N.Y. 1994).

⁸⁸ See *supra*, note 83.

luck of the millions of shareholders in reorganizations of such mass tortfeasors as A.H. Robbins or Johns-Manville, the failure of a family firm triggers a particular concern of bankruptcy law: that individual debtors must receive a fresh start so that they have the incentive to earn a livelihood after the case is over and so that their potential contribution to society is not wasted. The fresh-start policy guarantees to every individual who files for bankruptcy that if all (non-exempt) assets are surrendered, all (dischargeable) debts will be wiped out, so that the individual can start over with a clean slate.

The comparative neglect that the fresh-start policy receives in the academic debate is misleading. Writers universally accept the fresh start policy, and are attracted by the intricacies of the rest of bankruptcy law. It is only natural that most bankruptcy research will focus on other aspects. The reexamination of the fresh-start policy under the microscope of modern economic analysis of law identifies a host of justifications for it. The principal reasons can only be restated briefly.⁸⁹

Borrowing by individuals is associated with a negative externality that causes debtors to underestimate the cost of their financial failure. If social programs or even compassionate relatives or friends will provide the debtor's sustenance in the case of his failure, the debtor does not suffer all the costs of failure. The compassion of the social environment provides, effectively, an insurance scheme with the usual distortions of incentives. One tendency will be for the least creditworthy to borrow excessively and rely more heavily on the social safety net (the "adverse selection" problem). Moreover, the debtor's behavior will be influenced after borrowing. The industrious borrower, realizing that failure is not as costly as anticipated, will have fewer incentives to maintain his efforts (the "moral hazard" problem). The fresh start policy places the cost of a borrower's failure on his lenders, because they can no longer recover the balance of their loan. Placing the cost of failure on lenders not only provides them with the incentive to charge borrowers for the cost of their failure (in the form of higher interest rates) but also the incentive to counteract both the adverse selection and the moral hazard problems by

⁸⁹ For the complete analysis and further citations see THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 225 *et seq.* (1986); Thomas H. Jackson, *The Fresh-Start Policy in Bankruptcy Law*, 96 HARV. L. REV. 1393 (1985).

filtering out the uncreditworthy borrowers, and by monitoring the performance of existing borrowers.

The fresh start also prevents idleness and pauperism by failed debtors. If the borrower's income were to be used to satisfy insurmountable old debt, the debtor has little incentive to work and produce that income. The fresh start returns this incentive to the failed debtor, and restores a productive member into society.

The fresh start is also supported by theories relying on errors, or irrational decision-making by borrowers. We all tend to be overoptimistic, argue decision theorists.⁹⁰ Therefore, borrowers would underestimate the cost of their failure even if they felt its full consequences. The fresh start saves them from themselves by having lenders filter debtors for viability. Individuals may also be subject to compulsive borrowing, shooting for one more chance at success. Again, borrowers are given the incentive to stop such borrowing. Finally, borrowers may fail to promote their lifetime interests by failing to provide for their future and borrowing at their future's expense. Again, lenders constricted by the fresh start policy avoid such lending.

But the fresh start policy applies to individuals and not firms. Businesses that fail complete the circle of economic development. In this world of limited resources, deploying resources effectively is essential. Businesses that produce uneconomic goods are wasteful, and if their owners will not voluntarily redeploy their assets to socially more desirable uses, financial ruin and bankruptcy will ensure that the assets will be put to better use.

When considering the fresh start of small entrepreneurs, it is important to take into account all the means that the bankruptcy system uses to provide the fresh start. In addition to the traditional discharge of debts, we see emerging the possibility to retain equity in the family business by means of the new value exception, and the rejection of injunctive obligations not to compete. These two newer means of promoting the fresh start have the potential of operating cumulatively. Small entrepreneurs may have injunctive obligations not to compete; a typical example will be franchisees. Franchising contracts routinely prohibit the franchisee from operating a similar business in the same area for some time after the termination of the relation with the franchisor. If a

⁹⁰ See cites collected in Jackson, *supra* note 89.

franchisee fails, both the new value exception and the rejection of his obligation not to compete will be available and one of the two may be superfluous. Franchisees could be allowed to retain equity in the old business, or to compete by starting a new business. The issue becomes the comparison of rejection and the new value exception as means for providing the fresh start. The objective is to find if one will tend to be superior and under what conditions. By examining the rejection of noncompete obligations, which turns out to be a very costly interference with economic evolution, the superiority of the new value exception becomes obvious. All the benefits of the fresh start can be received without rejecting injunctive obligations, but first, an introduction to the rejection of injunctive obligations is necessary.

Debtors in bankruptcy have the right to “reject” unperformed (“executory”) contracts, so as to convert the other side of such contracts into ordinary creditors for the claim that arises from the breach which the rejection caused. This is to the advantage of the debtor’s estate when the contract is advantageous to the other side. If the prices for the goods the debtor has agreed to sell have risen, rejection allows the debtor to sell them at the higher market price, and pay a few cents on the dollar to the original buyer for the injury (which is having to buy these at the higher market price). Rejection is supposed to be a breach that leads to money damages. Debtors cannot reacquire rights by rejecting—rights against the exercise of which, but for their bankruptcy, injunctions would be issued by state courts. Thus, a debtor who has provided an exclusive license cannot start selling more licenses once in bankruptcy by virtue of rejection.⁹¹ Similarly, debtors who have signed clauses not to compete in employment contracts cannot simply file for bankruptcy and reject the contract in order to take a higher-paying job with their employer’s competitor.⁹² In these contracts the other side has an injunction against

⁹¹ See, for example, *In re Richmond Metal Finishers, Inc.*, 38 Bankr. 341 (E.D. Va. 1984), which found that a licensing agreement could not be repudiated by the licensor through rejection. This result was legislatively confirmed with § 365(n) after the appeals court erroneously reversed, *Lubrizol Enterprises v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985), cert. denied, 475 U.S. 1057 (1986).

⁹² See, for example, *In re Carrere*, 64 Bankr. 156 (Bankr. C.D. Cal. 1986). Actress Tia Carrere had a contract with ABC to perform on the show “General Hospital” which prevented her from accepting a more lucrative contract to perform on the show “A Team.” The Bankruptcy Court did not allow her to reject her injunctive obligation.

such breaches by the debtor, not simply a claim for damages. Injunctions survive the rejection unaffected.

Some injunctive obligations, however, are erased by rejections because they interfere with the debtor's ability to receive a fresh start. Debtors who file for bankruptcy in good faith, truly needing the protection from their creditors that the filing affords them, have been allowed to reject clauses not to compete. Although this interferes with the parties' contractual rights, and the planning of their business affairs, the fresh start policy trumps the arguments that make injunctive obligations not rejectable.

To see this interplay of clauses not to compete and rejection, take the simple example of *Register*.⁹³ A franchisor trained the debtors' to make and sell silk flowers. In exchange for the training and other, perhaps, services which the franchisor provided, the Registers promised not to run a silk flower business in their area for a stated period after the termination of their contractual relationship with the franchisor. The franchisor was also to receive monetary compensation for helping set up the business in the form of participating in the businesses' profits, which is the usual franchising fee. Despite expectations and the Registers' best efforts, the business failed and the Registers filed for bankruptcy protection. The bankruptcy court, realizing that the only source of livelihood for the debtors was the manufacture and sale of silk flowers, allowed them to reject their contract with the franchisor, including their injunctive obligation not to compete, and to start their own silk-flower business.

Franchisors, of course, suffer the economic effects of allowing good-faith debtors to reject clauses not to compete. The Registers' ability to open a silk-flower business means that there is one less location where the franchisor could place a profitable franchise. The calculation that the franchisor makes may not be hard to approximate. Suppose that the franchisor maintains 100 franchises, one of which the Registers run. If each franchisee faces a 1% probability of good-faith bankruptcy every year, the franchisor should expect to lose one franchise a year. If each franchise produces on average profits of \$100 every year for the franchisor, the franchisor's revenues start at \$10,000 but drop by \$100 every year. This presents a return significantly less than the apparent

⁹³ *In re Register*, 95 Bankr. 73 (Bankr. M.D. Tenn.), aff'd, 100 Bankr. 360 (1989).

constant annual \$10,000 this franchising business produces. If clauses not to compete could not be rejected, of course, the failed franchises would be replaced with new ones and the franchisor's income would not drop.

The question lying under the issue of the rejection of obligations not to compete is whether they should be treated similarly to the debtor's indebtedness. The arguments used to support the fresh start policy may also show that good-faith debtors should shed their injunctive obligations. The following section will discuss the application of the arguments for the fresh start on injunctive obligations. Before jumping to the conclusion that injunctive obligations interfering with the debtor's fresh start should be rejected, the subsequent section will explore solutions other than rejection. The flexibility of reorganizations allows changes in the compensation of franchisors, the usual recipients of noncompete promises, which in combination with the new value exception preserve the fresh start without the cost of rejections.

1. THE APPLICATION OF THE FRESH START ARGUMENTS ON INJUNCTIVE OBLIGATIONS

The discharge of an individual's debts restores her incentive to resume her efforts to earn a living. The likely occupation of the debtor after bankruptcy depending on the rejection of a clause not to compete is a crucial step in the application of the fresh-start arguments. The franchisor has provided the debtor with new skills, the price of which included the obligation not to use them against the franchisor's interests, but these skills may provide the debtor's continued employment and survival. By contrast to the debtor with monetary debts, the debtor who has promised not to compete has every incentive to obtain employment in a different line of work. The presumably fewer skills will imply a smaller compensation for the debtor, but the incentives for other employment reduce the concern about the injunctive debtor's livelihood, compared to the concern that drives the fresh start policy, but this reduced concern only counters the general feeling in favor of the failed debtor's survival and the externality-based argument that the debtor underestimated the cost of her failure. Since even if injunctive obligations were not dischargeable, these debtors would tend not to resort to the social safety net for their survival, they would, therefore, tend to suffer the full cost of their failure. There is little reason for shifting that cost to

their "injunctive creditors," who are the beneficiaries of the covenant not to compete. But all other arguments in favor of the fresh start remain in full force.

The fresh start prevents the pauperism and idleness that would result from the elimination of incentives for productivity due to excessive debt. Since the injunctive debtor will have no monetary debts, despite the survival of his injunctive obligation, he will have every incentive to work, but a social asset does become idle: the skills that the franchisee has learned. While the franchisor prefers this idleness because the vacancy in the franchisee's location may be filled by another franchisee who will pay the franchising royalties and fees, society perceives the vacancy as a waste.⁹⁴ The survival through bankruptcy of the injunction against competition exposes society to the same type of cost as pauperism. The debtor's contribution to productivity is greatly reduced.

The arguments for the fresh start that rely on errors (irrationalities) make an even stronger case for the rejection of injunctive obligations. The fresh start counteracts individuals' inherent optimism or adventure-seeking. Prospective franchisees would tend to falsely inflate the attractiveness of the franchising venture. But for the rejection of the injunctive obligation not to compete, the franchisor would be the beneficiary of this systemic miscalculation in a manner similar to how gambling establishments profit from compulsive gambling: overeager franchisees will "buy" their entrepreneurial gambles (the franchises) which they overvalue, by "selling" to the franchisor their obligation not to compete, the cost of which, in their optimism, they underestimate. The rejection of the clause not to compete restores some balance in this relationship the same way that the non-enforceability of gambling debts tries to disfavor the gambling establishments.

⁹⁴ A simple example shows that the franchisor prefers the survival of the injunction. Suppose that the franchise in this location produces some consumer surplus (say \$100). The demand allows the franchisee to have some level of revenues (say \$200), the royalty fee on which is an agreed fraction (usually about 8% of gross sales, here \$16). The franchisor will prefer the injunction's survival, even if the alternative new franchisee is less efficient, producing smaller revenues. The franchisor's royalties of the lower revenues will be preferable to receiving no royalties as in the case of rejection. Society, of course, cares about the sum of consumer and producer surplus, which is invisible, but given the reduced revenues, the consumer surplus is definitely reduced. The inefficiency of the new franchisee implies reduced producer surplus as well.

Just as powerful is the argument based on the failure to promote lifetime interests. Prospective franchisees ignore the burden of the clause not to compete on their future years and gladly buy the entrepreneurial opportunity at a cost to be felt at a much later stage of life. The rejection relieves them from encumbrances too easily undertaken.

The courts, thus, are correct in treating injunctive obligations as rejectable in the context of good-faith bankruptcies. Because family enterprises often operate through a business organization, a closely held corporation and its recent hybrids, Limited Liability Companies and Limited Liability Partnerships (L.L.C. and L.L.P.), the issue arises whether injunctive obligations of the business entities should also be rejectable. One can immediately argue that closely held entities should enjoy the same treatment since they are only "legal fictions," artificial personas behind which are the flesh-and-blood franchisees. Perhaps a formalistic judiciary would have had difficulty applying the fresh start—a policy restricted to individuals—to incorporated entities. The bankruptcy courts have not exhibited any such tendencies. Corporate fronts for individual franchisors routinely reject injunctive obligations not to compete. But while this was a strongly desirable outcome in the individual setting which implicitly takes place under the specter of liquidation, the flexibility that the reorganization provides suggests that perhaps more solutions exist than the two extremes of rejecting or not rejecting the injunctive obligation. The following paragraphs develop such alternatives.

2. REORGANIZATION TREATMENT OF INJUNCTIVE OBLIGATIONS

Reorganization, either under Chapter 11 or Chapter 13, allows an infinity of adjustments to the affairs of the debtor. Contracts can be amended, and unusual securities can be issued.⁹⁵ In the context of a reorganization, given the creativity that is possible, the goal of protecting both the fresh start and economic evolution (through protecting the franchisor's interests) should be attainable. This section will discuss some broad avenues along which reorganization plans of closely-held businesses can proceed, whether the business is incorporated or not.

⁹⁵ The issuance of securities is subject to a curious restriction on nonvoting stock per § 1123(a)(6). For some arguments against this restriction see Kenneth Klee, *Adjusting Chapter 11: Fine Tuning the Plan Process*, 69 AM. BANKR. L.J. 551 at 556 (1995).

The two conflicting concerns are the fresh start policy, and the operation of the economic forces that ensure productivity. Here the fresh start policy does not simply argue that the debtor's incentives to work must be reinstated, but that the waste of this debtor's special training must be avoided. The service that the operation of the economic forces would provide is not only that unproductive franchisees should be replaced by productive ones, but also that non-viable businesses (including franchises) should be replaced. The conflict is very pronounced. If an ineffective franchisee is left in operation, the expansion of an economically desirable franchisor will be retarded. Not only would a different franchisee do more business in the same location, but this would also translate into greater profits for the franchisor, properly reflecting the demand for this product and enabling faster expansion. Even if the failure is not the franchisee's, again interference retards economic evolution: The product of this franchise is either not competitive or not sufficiently demanded; resources spent in its production would be employed more productively elsewhere. The bankruptcy legal system's response can be excessive in either direction. Failing to protect franchisees will waste their skills; failing to allow economic forces to work will waste resources generally.

A glance at franchising contracts shows that they provide for a relatively simple set of incentives to the two sides by compensating the franchisor through a flat percentage fee on the franchisee's gross sales: a fee which is usually close to 8%. While limitations to buying their product from the franchisor may provide for additional profits for the franchisor, such terms may also provide quality control; they cannot be considered inherently suspect. The flat percentage fee is often broken into two parts, an advertising fee, and a royalty for the use of the franchisor's trademarks.⁹⁶ The flat percentage fee provides the franchisor the incentive to promote the brand nationally or internationally, while the franchisee faces the incentive to increase sales (to the extent profitable) since the franchising fee imposes a fixed marginal cost.

Despite the simplicity and the effectiveness of fixed percentage franchising contracts, they may become clearly suboptimal from a social perspective in bankruptcy. The simple social goal of maximizing wealth

⁹⁶ See, e.g., *In re Burger-King of Kansas, Inc.*, 99 Bankr. 446 (Bankr. D. Kansas 1989).

that was being pursued by the original franchising contract has been substituted by concerns about the waste of the franchisee's skills. This concern can be promoted by relieving the franchisee of the franchising fees if the franchise performs so poorly that its net income is insufficient for the franchisee's survival. The franchisor would be compensated for this range of lower fees by higher fees in the event that the franchise does better. The attraction of this arrangement for the franchisor is that the franchising relationship continues. Some fees will still be received, and the cost of training and installing a new franchisee in this location has been avoided. The cost for the franchisor is perhaps some increased monitoring and some distortion of the franchisee's incentives from the optimal. That occurs because the fixed marginal cost of franchising has been substituted by an increasing marginal cost, since the franchising fee is now increasing as sales increase. This change is also desirable from the franchisee's perspective, since without it, the rejection of the executory contract would prevent the franchisee from retaining the trademarks of the franchisor; trademarks which attract significant clientele.

The easiest way for the Bankruptcy Court to achieve this rearrangement in the franchising relationship is by amending the provisions of the franchising contract with respect to the franchising fees and royalties. It would be a simple matter to amend the fees and royalties so as to gradually increase from 0%, if the franchise sales are under the franchisee's subsistence level, to in excess of twice the originally agreed-upon fees (to about 16% or more) if the franchise performs handsomely. Of course, this is not the only means to achieve the desired result. Alternative vehicles may include part-ownership of the franchisee by the franchisor, and convertible securities which would allow the franchisor to increase its ownership stake in case of good franchisee performance. The advantages that such arrangements may offer are neither obvious nor general. Their complexity suggests avoiding them unless they fit a particular situation.

The change in the franchising fee alters the franchisee's incentives regarding the quantity of the product he will produce. Ordinarily, competitive businesses increase their production until no more profit remains, until, that is, the marginal profit of producing one more unit of the good equals its marginal cost. The franchising fee influences this calculation. The usual flat-percentage fee adds to all units the same marginal cost, the agreed percentage of their price that must be paid to

the franchisor. An increasing fee means that as production increases, marginal costs increase as well, since additional units may increase profitability and trigger the greater payments to the franchisor. (The opposite is also possible if fees are blindly tied to profits: the franchisee may overexpand to reduce his profits and the franchising fee; but the tying of fees to revenues avoids this pitfall.) The lower output of the franchisee may alert antitrust thinkers, since it suggests higher prices and a reduction in consumer surplus. But that is not the case in the franchising context where each franchisee competes not only with competing producers but also with franchisees of the same franchisor in other locations. The franchisor, of course, may not share society's tolerance for the reduced production incentives, but the franchisor must realize that this is a much less costly method for providing franchisees with the fresh start than letting them reject injunctive obligations.

Changing the fee structure of the franchising agreement is so attractive an alternative to outright rejection of the injunctive obligation that it should not be limited to reorganizations. The bankruptcy court should use its equity powers to produce the same outcome in individuals' liquidation proceedings: deny rejections, but amend franchising fee structures to preserve the debtor's fresh start. Franchisors' position would improve, economic evolution would operate, and franchisees' fresh start would be preserved. Moreover, the effective nondischargeability of injunctive obligations is in harmony with the general policy of promoting financing based on future earning as opposed to current assets. Just as the nondischargeability of student loans is necessary to provide equal access to education regardless of wealth, so does the nondischargeability of obligations not to compete facilitate the equal access to franchisor-financed training.

V. CONCLUSION: RENOVATING THE NEW VALUE EXCEPTION

This article's support for the new value exception is paradoxical: it suggests expanding the new value exception that others find costly in order to reduce its cost. The "money or money's worth" requirement of *Los Angeles Lumber* not only impedes using potential reorganization plans as costless and effective managerial compensation, but also prevents fresh starts unless clauses not to compete are rejected. The requirement that the consideration must be tangible implies that failing

firms will not be run well because owners lose the incentives new value plans give them. This requirement also absolutely precludes the fresh start of the family-owned enterprise. The successful reorganization of family-owned businesses has many more advantages than avoiding rejection of injunctive obligations and reducing the costs of franchising. Free-market competition thrives on, practically requires, the existence of numerous small businesses. Family-owned businesses have repeatedly been considered the object of systematic protection as cornerstones of the society and the economy.⁹⁷

This is not to say, of course, that family-owned businesses should not be allowed to fail. Their failure is an integral part of the economic evolution and development. Repeated failures should not be allowed, but with the new flexibility of family reorganizations, injunctive obligations can be enforced without qualms. Bankruptcy courts must not allow a failure, even if it leads to liquidation, to be cause for rejecting the injunctive obligation not to compete. That a second failure means the end of the franchisee's occupation is also a healthier solution from the perspective of economic evolution. Had the franchisee rejected the franchising contract with its quality control, she may have been able to continue producing goods with artificially lower costs. Thus, the firm would have survived longer while producing uneconomic goods. The

⁹⁷ The fields of law where small businesses receive special protection are innumerable, ranging from antitrust, to discrimination, tax, and environmental law. The entire body of antitrust law, for example, has been considered a protection of small business regardless of efficiency and welfare, see generally *Antitrust Jurisprudence: A Symposium on the Economic, Political and Social Goals of Antitrust Policy*, 125 U. PA. L. REV. 1128 (1977); Kurt A. Strasser, *Antitrust Policy in Agreements for Distributor Exclusivity*, 16 CONN. L. REV. 969 (1984); William C. Page, *Ideological Conflict and the Origins of Antitrust Policy*, 86 TUL. L. REV. 1 (1991); also frequent is the criticism that courts interpret antitrust rules in favor of small business, see generally ROBERT BORK, *THE ANTITRUST PARADOX* (1976); Michael E. DeBow, *The Social Costs of Populist Antitrust: A Public Choice Perspective*, 14 HARV. J.L. & PUB. POL'Y 205 (1991). For the criminal law perspective, see Lionel M. Lavenue, *The Corporation as a Criminal Defendant and Restitution as a Criminal Remedy: Application of the Victim and Witness Protection Act by the Federal Sentencing Guidelines for Corporations*, 18 J. CORP. L. 441, 514-19 (1993). The size limits of anti-discrimination rules have been considered motivated by a desire to protect smaller businesses, see e.g., *Smith v. Capitol City Club*, 850 F. SUPP. 976, 979 (M.D. Ala. 1994); Kendra Samson, *Does Title VII Allow for Liability Against Individual Defendants?*, 84 KY. L.J. 1303 at 1320 (1996). A similar pro-small-business sheen has been attributed to environmental law, see, e.g., Steven J. Groseclose, *Reinventing the Regulatory Agenda: Conclusions from an Empirical Study of EPA's Clean Air Act Rulemaking Progress Projections*, 53 MD. L. REV. 521 (1994).

longer it takes to re-allocate productive assets, the worse for social welfare.

The limitation of requiring tangible consideration to allow the equityholders to purchase equity in the new firm is felt the most in the reorganization of family-owned businesses. The owners' remaining personal wealth, if any, is bound to be illiquid and to be shielded from creditors through exemptions such as the "tools of the trade" exemption.⁹⁸ The only value they can exchange for the new equity is their personal guarantees; but that is exactly what the requirement of tangible consideration sought to avoid: the use of consideration, the valuation of which is difficult and uncertain. Indeed, if we are serious about providing a fresh start without rejecting injunctive obligations, even personal guarantees of debtors unlikely to be able to honor them should be considered enough to support issuing new equity to the family owners of the failed business.

This analysis does not necessarily suggest that the new value exception needs legislative interference. Despite its strength, this support of the new value exception may not even justify its legislative ratification. A legislative pronouncement that the new value exception has survived the Code must necessarily be accompanied by its definition; but we saw that the exception must be flexible. Its thrust must be different when it is used to preserve the fresh start and avoid the rejection of injunctive obligations, and different when it is part of a reorganization that does not involve an individual owner's financial ruin. In the former case, even worthless personal guarantees could satisfy the new value exception; in the latter, the consideration for the new equity, although not necessarily tangible, must have a value equivalent to the new equity. Other requirements that *Los Angeles Lumber* imposes on the new value exception must also be allowed to evolve. Typical are the developments awaiting the requirements that the new value must be necessary for the reorganization, and substantial. Insisting on necessary and substantial contributions prevents use of the new value exception to provide a fresh start. Proposals regarding the interpretation of these terms which would seem to favor the fresh start must be reviewed critically. Consider the idea that the substantial nature of the contribution should be measured

⁹⁸ See § 522 and note 72, *supra*.

relative to the wealth of the old equityholder.⁹⁹ Although this appears to favor the fresh-start use of the new value exception, on closer inspection it does not. Personal guarantees should be acceptable contributions as long as the individual has truly failed financially; but even in that case, exemptions allow some wealth to be retained by the failed debtor, and the nearly worthless personal guarantees could appear insubstantial compared to the retained wealth. If, by contrast, the new value exception is not used in conjunction with an individual's fresh start, then the contribution's substance must be measured objectively compared to the value of the enterprise. If a peppercorn were necessary for the reorganization, the old equity should not be allowed to contribute it and reacquire control of the failed enterprise; but if a realistic capital structure were imposed by the plan, the requirement that the new value be substantial would be unnecessary. A small contribution would only buy a small fraction of the reorganized firm's equity. The old equityholders who contribute a peppercorn will find themselves minority shareholders, the majority being held by the creditors whose debt was converted to equity in order to provide for a realistically leveraged firm.

The puzzle with the new value exception is that it must serve two very different functions: Preserve the fresh start of unlucky entrepreneurs, but prevent the perpetual control of failed firms by inept businesspeople. To allow the first and prevent the second, the new value exception must show two very different faces. A legislative straight-jacket cannot fit both. The courts' equity powers, so important in every other aspect of bankruptcy law, must be relied upon in this area as well.

It is unlikely, of course, that the spirit of these proposals is absolutely impossible to codify. Such an attempt would be quite a departure from the current Code and the *Los Angeles Lumber* shape of the new value exception. The departure is such that an immediate transition is too radical to be advisable. An understanding of the eventual target would be useful, however, so as to serve as one of the possible goals that the evolutionary process of bankruptcy common law could cautiously attempt to approach.

⁹⁹ See Rusch, *The New Value Exception to the Absolute Priority Rule in Chapter 11 Reorganizations: What Should the Rule Be?*, 19 PEPP. L. REV. 1311 (1992), *supra* note 10. Even harsher, of course, is the dual requirement that to be substantial, a contribution must be not only a significant fraction of the equityholders' wealth but also must produce a significant payout to unsecured creditors. See *supra* note 47 and accompanying text.

The foundation of this change, and the most radical departure from the current scheme of Chapter 11, is that the voting of all stakeholders must be replaced so as to emulate the voting of the reorganized firm's shareholders (before the new value contribution). Thus, we should expect a transition toward a regime in which the reorganization must anticipate the reorganized firm's capital structure. After an appraisal of the firm's value as a going concern, the senior creditors would retain the creditor position as far as the usual capital structure in the industry permits. As creditors of the reorganized firm they would not vote. The senior's deficiency claims, and the progressively next most senior creditors would stand to become the shareholders of the reorganized firm until its value is exhausted, and those should be the only ones voting. More junior out-of-the-money stakeholders should be excluded. The resulting vote would approximate the vote of the shareholders of a reorganized firm without the new value contribution, and their vote should determine the new value exception just as their vote would determine whether the reorganized firm would perform the equivalent transaction of merging with a token corporation created by the old equityholders.¹⁰⁰ This scheme would allow negotiated new value contributions that would be unassailable because they would simulate the non-bankruptcy corporate combination that the new value exception mirrors. A transition to such a voting scheme would effectively end concerns about the new value exception and all the problems that § 1129 raises. The egregious single asset cases would not be reorganizable without the secured creditor's consent because the secured creditor would control the vote.

This austere scheme, however, is only advisable for bankruptcies that are neither part of a panic and crash cycle (as was *Woodscape*; supra notes 39-40 and accompanying text), nor bankruptcies that trigger fresh start concerns. For a firm's failure to raise fresh start issues, it must not simply be family owned but the family owners must also be in financial difficulty. Only then is there concern over wasting the debtor's potential contribution to economic life. Nevertheless, courts must show great skepticism when approaching fresh start claims in the context of the new value exception, never forgetting that they would be exceeding the conventional venue of the fresh start which is limited to the discharge of

¹⁰⁰ See supra notes 25-28 and accompanying text.

monetary debts. The leniency of debt discharge is enough to avoid waste by restoring the production incentives in most debtors. Only if the setting of the failed enterprise is such that the individuals will waste their abilities if the enterprise fails—because they cannot employ their skills, as is the case with debtors having obligations not to compete¹⁰¹—will the fresh start concerns argue for allowing the family owner to maintain control over the failed firm by virtue of the new value exception. Therefore, to use the new value exception to assist the fresh start the court must not only be convinced of the good faith failure of a family-owned firm and its owners, but also of the waste of the owners' skills. If either the skills or the waste are not in prospect, there is no reason for the new value exception; but if the court accepts that the fresh start policy argues for continued control of the firm by this debtor, then all the requirements of *Los Angeles Lumber* may be ignored to restore in full the incentives and the ability to produce of unlucky but able entrepreneurs, just as *Whittaker Memorial Hospital* did.¹⁰² Doubtlessly, this test is extraordinarily difficult to apply, but perfect accuracy in its application is clearly unnecessary. That any gains from its application are an improvement over the current scheme is not the only reason to support it. The fresh-start-motivated new value exception provides entrepreneurs a laudable incentive scheme. Since the new value exception will be awarded to entrepreneurs that show that they were not simply unlucky but that they are able and in a unique position to use their abilities through their firms, it gives them an incentive to demonstrate that they will excel. Furthermore, it gives them an incentive to invest in education and in customizing their business, in finding niches, and developing and serving new markets. The entrepreneur must show that she will be missed.

Compared with the elaborate and artificial structure of § 1129, this proposal—difficult as its application may be—is simple and straightforward. The peculiar and questionable activities that § 1129 has given rise to—such as claims trading, impairment negotiations, and classification games—will be substituted with the substantive efforts on

¹⁰¹ This article has focused on the market failure which suggests obligations not to compete will be undertaken too easily, supra text accompanying notes 89-96. While presently this may be the only obvious market failure that wastes debtors' skills, others may appear. The new value exception can then be used to accommodate debtors who suffer from those market errors as well.

¹⁰² See supra, note 38 and accompanying text.

the part of the equityholders to show ability in running the firm and on the part of the creditors to show ability to take control of the firm. Errors are inevitable, but however inaccurate the courts are in applying these rules, they would be a dramatic improvement over the current jumble of activities around § 1129.