No. 97-1418

In the Supreme Court of the United States

OCTOBER TERM, 1998

BANK OF AMERICA NATIONAL TRUST AND SAVINGS ASSOCIATION,

Petitioner,

v.

203 NORTH LASALLE STREET PARTNERSHIP,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

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REPLY BRIEF FOR THE PETITIONER

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UPDATED RULE 29.6 STATEMENT

The Rule 29.6 statement contained in the opening brief for the petitioner remains accurate, except that the merger of BankAmerica Corporation and NationsBank Corporation is now scheduled to occur on September 30, 1998.

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REPLY BRIEF FOR THE PETITIONER

The only question before this Court is whether the debtor's pre-petition equity holders "receive[d] or retain[ed] under the plan on account of [their prior equity] interest any property" even though the plan did not provide in full for a dissenting class — the bank's $38.5 million unsecured claim. 11 U.S.C. § 1129(b)(2)(B)(ii). The answer is an unequivocal "yes": under the plan, the debtor's pre-petition equity holders received a recognized property interest — the exclusive opportunity to retain the equity interests in the reorganized debtor through the contribution of new value — as a result of and thus "on account of" being pre-petition equity holders.

In trying to justify the result below, the debtor and its amici focus on their view of bankruptcy policy and misconstrue cases decided more than 70 years ago concerning the meaning of "fair and equitable" — all of which they maintain should somehow be more reflective of congressional intent at the time of the enactment of the Bankruptcy Code than the text Congress enacted in 1978. These arguments are not only mistaken, but irrelevant; congressional intent is best expressed by the statutory language, which does not provide for a new value exception to the absolute priority rule.[1]

The debtor's arguments about the statutory text are unconvincing. The debtor concedes that its pre-petition equity holders "obviously" received "property" under the plan. Resp. Br. 10. But, the debtor argues, "on account of" in Section 1129(b)(2) means proximate cause, not "but-for" cause, and the equity holders' contribution of new

[1] The debtor and its amici contend that prior judicial definitions of "fair and equitable," rather than the elaborate definition of the same phrase in Section 1129(b)(2), should control this case. They invoke in support of that contention the principle that Congress makes its intent specific when it intends to change the interpretation of a judicially created concept. They assert, remarkably, that Congress "*evinced no in[ten]tion to change*" the meaning of the term "fair and equitable," and that "this Court should presume that Congress intended the Bankruptcy Code to incorporate *all aspects* of pre-Code 'fair and equitable' jurisprudence." Org. Br. 19 (emphasis added). We are at a loss to understand what Congress is supposed to do to evince an intent to supplant the judicial interpretation of a previously defined phrase with a different definition, if *defining the term differently in the statute* does not evince such an intent. "[L]egislative history need not confirm the details of changes in the law effected by statutory language before we will interpret that language according to its natural meaning." *Morales* v. *TWA*, 504 U.S. 374, 385 n.2 (1992).

value, not their status as pre-petition equity holders, was *the* proximate cause of their acquisition of equity interests in the reorganized debtor. Resp. Br. 14-16, 19-20. But causation is not an all-or-nothing proposition. Events may have more than one proximate cause. Thus, even if Section 1129 requires proximate causation, it is clear that the debtor's prior owners received property "on account of" their prior interests — being a pre-petition equity holder was one of two indispensable prerequisites to receiving a post-confirmation ownership share. Because one of those proximate causes here is prohibited by Section 1129(b), it is irrelevant that the other cause does not violate the statute.

The 1978 legislative history supports this construction. That history does not even mention the new value exception, let alone endorse it. Instead, the House Report stated that junior classes cannot receive "anything" under the plan until senior classes are "paid in full." H.R. Rep. No. 95-595, at 413.

Here, the bank has not been "paid in full" for the $92 million it lent to the debtor ($93 million with interest). Far from it — the bank ultimately will receive payments with a present value of only about $60 million. Pet. Br. 6, 8.[2] Giving preference to junior interests by affording the debtor's prior owners the exclusive opportunity to control an insolvent debtor is particularly unwarranted here. The bankruptcy court found that the debtor was insolvent on the date of confirmation and will remain insolvent throughout the term of the plan. Pet. Br. 7. And the debtor was in business in the first place only because the bank lent it $92 million, secured by its only substantial asset, 15 floors of a Chicago office building. In return, the debtor promised to repay the loan by January 1995, and, if it did not do so, to allow the bank to foreclose. Pet. App. 103a. But as a result of the plan of reorganization, the bank — which holds more than 99.75% of the debtor's unsecured debt and is by far the debtor's largest creditor — is prevented from foreclosing and will not have anything approaching payment in full.

[2] The debtor's conclusory references to possible payment "in full" (Resp. Br. 4, 6-7) are a pipe dream. The debtor has *never* contested the bankruptcy court's finding that the bank will receive only about 16% of the present value of its $38.5 million unsecured claim. See Pet. Br. 6. This does not begin to satisfy the requirement that the bank receive *on the effective date of the plan* property with a present value equal to the full amount of the bank's unsecured claim, 11 U.S.C. § 1129(b)(2)(B)(i), and is hardly a "windfall" (Resp. Br. 42) — on a present-value basis, more than $30 million of the original loan will never be repaid to the bank.

This is inconsistent with Chapter 11's basic precepts: junior classes may not receive *anything* until senior classes are "'provided for in full,'" and "it is up to the creditors — and not the courts — to accept or reject a reorganization plan which fails to provide them adequate protection or fails to honor the absolute priority rule." *Norwest Bank Worthington* v. *Ahlers*, 485 U.S. 197, 202, 207 (1988).[3] Permitting confirmation of plans like the one in this case over the objections of a dissenting class of unsecured creditors thus turns the priority scheme underlying the Bankruptcy Code on its head and effectively permits the debtor to sell its property to its own insiders without ever having to subject that property to market forces, which is prohibited by the Code.

I. THE PLAIN STATUTORY LANGUAGE DOES NOT INCLUDE A NEW VALUE EXCEPTION

1. The debtor does not dispute that an option to receive an equity interest in a business is "property" within the meaning of the statute. See Pet. Br. 15-16. Instead, the debtor's point seems to be that its prior equity holders were locked in to contribute new capital before the plan was confirmed; from that fact, the debtor somehow concludes that they did not receive the opportunity to own part of the post-petition entity *under* the plan. Resp. Br. 10-11, 22-28; Org. Br. 5-6, 23-25. But there is no textual basis in the statute for concluding that the validity of a new value plan depends on the timing of the prior equity holders' decisions to buy into the new firm. Nor are we aware of cases supporting the debtor's argument — courts typically reject Code interpretations that would permit substantive results to vary depending on the manipulable timing of business decisions. *In re Handy Andy Home Improve. Centers, Inc.*, 144 F.3d 1125, 1128-1129 (7th Cir. 1998). More important, regardless of when prior equity owners committed themselves to invest, they were the *only* persons allowed to contribute new capital to, and become owners of, the post-petition debtor. It is simply not true *under the plan* that there was "an unlimited universe of potential investors." Resp. Br. 23. The whole purpose of the plan was that there be a *limited* universe of potential

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[3] NACM's view (at 9, 12) that Chapter 11 is "largely directed" at unsecured creditors and that the Code "sharply curtails the power" of dissenting senior creditors ignores the facts of this case, where the dissenting claim at issue is the bank's $38.5 million *unsecured* claim, and is contrary to both *Ahlers* and the absolute priority rule. The legislative history cited by NACM (at 10) concerns a Senate proposal, *rejected* by the House, for mandatory use of a public trustee for Chapter 11 proceedings involving public companies. See Markell Br. 19 & n.11.

investors — a universe consisting *entirely* of the debtor's pre-petition equity holders. See Pet. Br. 23 & n.13.[4] "[T]he *exclusive* right to retain the debtor's property upon making a capital contribution is itself property" received on account of prior equity interests. *In re Coltex Loop Central Three Partners, L.P.*, 138 F.3d 39, 43 (2d Cir. 1998).

Giving prior equity holders the *exclusive* opportunity to become post-petition owners — while freezing out other potential investors, such as senior creditors with unpaid claims — not only violates Section 1129(b)(2)(B)(ii), but also has pernicious consequences.[5] As Professor Markell argues (at 25-26), because an "increased number of bidders * * * tends to increase" the "final price," the "last thing this Court should do is fashion a rule that eliminates or reduces competition for bankruptcy debtors." (Why he thinks this supports the debtor's position is a complete mystery to us.)[6] The authors of the other amicus briefs filed in support of the debtor have also previously condemned plans that provide old equity with the exclusive right to receive new equity interests. See Elizabeth Warren, *A Theory of Absolute Priority*, 1991 ANN. SURV. AM. L. 9, 39 (old equity "may offer to buy any of the assets of the estate on the same terms as any other buyer," but "[n]othing in the Code" gives equity "a beneficial position. If courts are in fact giving them enhanced status, they should not do so."); Kenneth N. Klee, *Cram Down II*, 64 AM. BANKR. L.J. 229, 244 (1990) ("[t]he vice of the new value exception is that it enables the debtor's owners to purchase an ownership interest based on a

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[4] The decision by some prior equity holders not to contribute (see Resp. Br. 4 & n.7) does not change that reality; an exclusive option does not cease to be a property interest simply because not all the option holders exercise the option.

[5] The debtor (at 11, 26-27) and NACM (at 19-20) misrepresent our position as being based on the debtor's exclusive right to propose a plan under Section 1121(b). As we have explained (Pet. Br. 6-7 n.4), plan proposal exclusivity is not the basis for our argument that prior equity holders receive property "on account of" their prior equity holder status under *any* plan (proposed by anyone) when the plan grants them the exclusive right to become post-petition owners.

[6] See also James W. Bowers, *Rehabilitation, Redistribution or Dissipation: The Evidence for Choosing Among Bankruptcy Hypotheses*, 72 WASH. U.L.Q. 955, 959, 963 n.34, 975 (1994) (concluding, based on empirical research, that equity in reorganized firms is valued much more highly if third parties bid for the equity than if it simply rests with the pre-petition equity holders).

court-approved valuation without validation of the price in the market place"; "[a]t the very least, * * * chapter 11 creditors * * * should have the opportunity to match or exceed the pending offer").

2. The central issue here is whether the debtor's pre-petition owners received or retained any "property" under the plan "on account of" their prior equity interests. 11 U.S.C. § 1129(b)(2)(B)(ii). If so, then the plan *cannot* be "fair and equitable," because "the condition that a plan be fair and equitable with respect to a class *includes the following requirements*," 11 U.S.C. § 1129(b)(2) (emphasis added), and the mandate that the holder of a junior interest *not* "receive or retain under the plan on account of such junior claim or interest any property" is one of those "include[d]" "requirements." *Id.* § 1129(b)(2)(B)(ii).[7]

The debtor argues that Congress, in using the phrase "on account of" in Section 1129, had in mind a proximate cause standard, not but-for causation. According to the debtor, the partners' contribution of new value was *the* proximate cause of their retention of equity interests, so they did not retain those interests "on account of" their pre-petition interests. Resp. Br. 14-15, 19-22. The debtor relies on *O'Gilvie* v. *United States*, 117 S. Ct. 452, 454-455 (1996), where this

[7] Professor Markell denies that a plan *must* meet all the requirements of Section 1129(b)(2) to be considered "fair and equitable." According to him, the section merely provides "non-exclusive examples of compliance with the 'fair and equitable' rule." Markell Br. 2. What the Code calls "requirements" are, he claims, mere non-exclusive examples because Section 1129(b)(2) "introduces the various examples with the word 'includes,' which under the Code is expressly non-inclusive [*sic*]." *Id.* at 21. The flaw in that argument is painfully obvious. The direct object of the word "includes" is "requirements." The plain meaning of non-exclusively "includ[ing]" specified "requirements" is that a court may impose *additional* "requirements." See Pet. Br. 18 n.10. It is not that a court may treat the specified "requirements" as optional or as mere "examples." To say that the qualifications for President of the United States "include the requirement that she be at least 35 years old" cannot possibly mean that a 30-year-old is eligible just because the word "includes" is non-exclusive. Notably, this tortured interpretation of "includes" is the foundation on which Professor Markell has built not only his amicus brief, but also his entire textual analysis in both *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 STAN. L. REV. 69 (1991), and 7 COLLIER ON BANKRUPTCY ¶ 1129.04[4][c][iii] (L. King 15th ed. rev. 1997) (written by Professor Markell). Before Professor Markell assumed authorship of the relevant chapter of *Collier*, the treatise took the opposite position. See 5 COLLIER ON BANKRUPTCY ¶ 1129.03[e][i] (L. King 15th ed. 1996).

Court held that "on account of" in Internal Revenue Code § 104(a)(2) means "by reason of, or because of," and that "proximate" rather than "but-for" causation best reflects the meaning of those words. *O'Gilvie* is consistent with normal usage of the phrase. See U.S. Br. 11-12; see also *Textron Lycoming Recip. Eng. Div.* v. *UAW*, 118 S. Ct. 1626, 1629 (1998) (equating "because of," "on account of," and "in consequence of").

Statutory language, however, must be construed in the context in which it is used. *O'Gilvie* notwithstanding, "on account of" in Section 1129(b)(2)(B)(ii) is most naturally read to denote but-for causation. See, *e.g.*, *Price Waterhouse* v. *Hopkins*, 490 U.S. 228, 262-263 (1989) (O'Connor, J., concurring) ("I disagree with the plurality's dictum that the words 'because of' do not mean 'but-for' causation; manifestly they do"). But the Court need not resolve, in this case, the type of causal connection required by Section 1129(b)(2). Even under a proximate cause test, it is clear that the prior equity holders' previous interest in the debtor was a proximate cause of their receipt or retention of property under the plan.

The fatal flaw in the debtor's argument is the assumption that events have only one cause. It is common for events to have multiple proximate causes. *Jerome B. Grubart, Inc.* v. *Great Lakes Dredge & Dock Co.*, 513 U.S. 527, 541 (1995) (referring to "the arguably proximate causes of the incident"); *Exxon Co.* v. *Sofec, Inc.*, 517 U.S. 830, 837 (1996) (several tortfeasors' acts may be "proximate causes of an injury"); *Serbin* v. *Bora Corp.*, 96 F.3d 66, 75 (3d Cir. 1996) ("'it is fundamental that there may be more than one proximate cause of an injury'"). The proximate cause standard eliminates causes that are "bizarre," *Grubart*, 513 U.S. at 536, but is satisfied when there is "some direct relation" between one event and another, *Holmes* v. *SIPC*, 503 U.S. 258, 268 (1992).

There is undoubtedly "some direct relation" between the prior owners' pre-petition status and their ability under the plan to retain a post-petition equity interest. Pre-petition equity holders were the *only* ones given the opportunity to receive post-petition ownership interests (and their sole motivation, avoiding $20 million in taxes, was tied to their pre-petition status). Pet. Br. 23 & n.13. As a matter of law, being a pre-petition equity holder was clearly "a proximate cause," *Grubart*, 513 U.S. at 541, of having a post-petition ownership interest here — it was a critical requirement, integrally rather than remotely tied to the results sought and achieved by the plan. See Pet. Br. 20

& n.11. The plan barred other possible investors who were not pre-petition owners.

Such a plan violates Section 1129(b)(2)(B)(ii), which prohibits plans in which senior claims are not provided for in full and old equity holders retain an ownership interest because of their prior position. It does not matter that those ownership interests were *also* retained "'on account of' their contribution of new capital" (Resp. Br. 22), a proposition we have never contested. See Pet. Br. 22. To say that an event *does* have a cause that is not prohibited tells us nothing about whether it *also* has a prohibited cause.

NACM likewise commits a fatal flaw of logic in its one attempt to deal with the statutory language. According to NACM (at 16 (boldface emphasis added)), "The Code unambiguously permits old equity to participate if it receives something other than 'property' *or* if it receives property in some way other than 'under the plan' **or if it receives value 'on account of' something other than its pre-bankruptcy claim.**" The emphasized part of that sentence is false. The Code does not *permit* retention of property "on account of" something other than owning a junior interest. It *prohibits* retention of property "on account of" the junior interest.

As we observed in our opening brief (at 21-22), this Court has experience with construing statutes that prohibit taking specified actions "on account of" or "because of" specified motives or causes. See 42 U.S.C. § 2000e-2(a)(1) (forbidding discrimination "because of" sex). The Court likewise has experience dealing with actions motivated or caused by both the forbidden factor and other, non-forbidden factors. Never has the Court construed such statutes — as NACM would construe Section 1129(b)(2)(B)(ii) — as affirmative *permission* to act whenever *a* cause or motive is *not* forbidden. Rather, the Court has followed the statutory language and inquired into the role the *forbidden* motive played.[8] So too here, the relevant question is what role the pre-petition equity holders' status played in

[8] *Price Waterhouse*, 490 U.S. at 239-247 (plurality opinion); see also *id*. at 284 (Kennedy, J., dissenting) ("No one contends * * * that sex must be the sole cause of a decision before there is a Title VII violation. This is a separate question from whether consideration of sex must be *a* cause of the decision. Under the accepted approach to causation that I have discussed, sex is a cause for the employment decision whenever, either by itself or in combination with other factors, it made a difference to the decision.").

allowing them to receive or retain property. A focus on the role other causes played is irrelevant and a mere distraction.

3. The debtor and its amici also argue that "on account of" could mean "in exchange for" or "in consideration for." Resp. Br. 12-13, 15 n.16; Org. Br. 12-13. But they cite no cases that have adopted either definition. Nor are those definitions compatible with the normal meaning of the phrase or the way "on account of" is used in Section 1129 and other parts of the Code. See *Cohen* v. *De La Cruz*, 118 S. Ct. 1212, 1217 (1998) (courts "presum[e] that equivalent words have equivalent meaning when repeated in the same statute"); see also Pet. App. 36a-37a (Kanne, J., dissenting). The debtor's argument relies on the proposition that "on account of" has "mercantile origins" and refers to an "exchange of old pre-petition claims and interests for new rights." Resp. Br. 12-13. But Section 1129 uses "on account of" several times in sentences referring to the property that a "holder" of a "claim" or "interest" will "*retain*" "on account of" its "claim" or "interest."[9] If property is being *retained* — for example, if shareholders retain the same interest in a corporation without contributing new capital — there is no "exchange" and thus there can be no "consideration" for an exchange. When the Code uses "receive *or retain*" it necessarily uses "on account of" expansively to mean more than receipt "in exchange for" a claim or interest. Sense can be made of the word "retained" in Section 1129, and in other Code sections in which "on account of" appears,[10] only if "on account of" is given its natural meaning — "because of."

4. It is not true that we have proposed, or that our argument would require, an auction whenever pre-petition equity holders seek to contribute new money to retain their interests in the post-petition debtor. See Resp. Br. 21, 28 n.32; NACM Br. 16-19. Compare Pet. Br. 11 n.6. Rather, we contend that the Code prohibits plans in which

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[9] See 11 U.S.C. § 1129(a)(7)(A)(ii), (a)(7)(B), (b)(2)(B)(i), (b)(2)(B)(ii), (b)(2)(C)(i), (b)(2)(C)(ii).

[10] See, *e.g.*, *In re Evenson*, 165 B.R. 27, 28 (Bankr. E.D. Mich. 1994) (cited at Org. Br. 13) (Section 522(d)(10)(E), which permits debtors to exempt payments under employer plans and contracts "on account of illness, disability, death, age or length of service," means "because of"); 11 U.S.C. § 1111(b)(1)(A) (treating certain claims as if the holder of the claim "had recourse against the debtor on account of such claims").

the debtor's pre-petition insiders are granted, in effect, the exclusive opportunity to sell the property to themselves.[11]

Thus, our position does not foreclose old equity from ever participating in the reorganized firm (see Org. Br. 5, 10-11, 25; NACM Br. 19), and the debtor's assertion (at 10) that our reading of the statute renders "on account of" superfluous is plainly wrong. Prior equity holders may participate if they prevail in an open auction, if they hold unsecured claims against the debtor, or if senior creditors consent. See Pet. Br. 22 n.12. In the first two instances, their post-petition interests would be solely "on account of" their superior bids or unsecured claims and not at all on account of their prior equity interests. In the third instance, the absolute priority rule is inoperative by its own terms. Pet. Br. 1-2. The contentions that we object to the "source of funds" (NACM Br. 10) and that our position "den[ies] access to capital" (*id.* at 14) are similarly erroneous. Prior equity holders are perfectly welcome to inject new capital as part of a Chapter 11 reorganization, but they must do it in a way that complies with the statute.

5. The debtor pretends that the only alternative to its plan is liquidation and that, as long as dissenting creditors are receiving more under a Chapter 11 plan than what a bankruptcy judge determines

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[11] The debtor suggests that the procedure approved by the Seventh Circuit in this case permits creditors to "'shop' that plan with the possibility that another more generous plan might be proposed and confirmed." Resp. Br. 29. Of course, the plan here had no feature that would permit such "shopping" or the making of any "higher or better" offer. Under the plan, the only possible purchase was to be done by the debtor's pre-petition equity holders. And the assertion that, if an auction had been held, "no one other than old equity holders * * * would have been a prospective bidder" (*id.* at 21 n.25) is preposterous. The bank, which believes the property is worth considerably more than its appraised value but still less than the loan amount, certainly would have been a prospective bidder, particularly because, as the debtor points out, every dollar bid by the bank beyond that required for the Property (up to the amount of its unsecured claim) would have had to have been returned to the bank on account of its $38.5 million unsecured claim. *Id.* at 28 n.32. This would not have been the action of a "shill" (*id.* at 29 n.32), but instead the economically rational action of an unsecured creditor with $38.5 million at stake trying to protect its claim. Unlike the exclusive opportunity the plan accords to those on the very bottom of the priority ladder, this scenario would have been consistent with the absolute priority rule. Finally, we did not state that "Section 363 prohibits a debtor from selling property to its shareholders." *Id.* at 48 n.58. What we said was that Section 363 prohibits "closed, insider-only sales," exactly the type of sales that the recognition of the new value exception would permit on the facts of this case. Pet. Br. 43.

they would receive in a Chapter 7 liquidation, they have no right to complain. That view makes the absolute priority rule swallow the "best interests" test of 11 U.S.C. § 1129(a)(7), which is a *separate* prerequisite to confirmation and already requires that impaired creditors do at least as well under the proposed plan as they would in a Chapter 7 liquidation. Making the creditors at least as well off as they would be under liquidation is only a starting point for an acceptable plan, not the last question.

Moreover, there is a third alternative to confirmation of the debtor's plan and liquidation: negotiation. Indeed, "[t]he premise of the bill's financial standard for confirmation" was that "negotiation among the parties after full disclosure will govern how the value of the reorganizing company will be distributed among creditors and stockholders." H.R. Rep. No. 95-595, at 224. It is "[o]nly when the parties are unable to agree on a proper distribution" that the court may become involved and "confirm the plan anyway" — as long as it complies with the absolute priority rule. *Ibid.*; see also Pet. Br. 29-30, 44-47. The Code is structured so that the parties have the incentive to negotiate a plan that is acceptable to creditors and stockholders alike. The likelihood that that will occur is lessened substantially if one negotiator (the debtor) knows that a judge will bail it out.

6. Professor Markell argues that it can be shown "math[e]matically" that the new value exception is really part of the absolute priority rule when owners and third parties are free to participate "on the same terms." Markell Br. 3. Even if that is so, it has nothing to do with this case, because the critical assumption on which his mathematics depend is that third parties had the same opportunity as the debtor to bid "new value" for the equity. And the pre-petition equity holders here had a far superior — in fact, the *only* — opportunity to bid for the equity. As another "mathematically" oriented commentary correctly concluded, "Exclusivity is inconsistent with new value principles. * * * [T]he debtor's monopoly power also creates economic inefficiency." Michael H. Strub, Jr., *Competition, Bargaining, and Exclusivity Under the New Value Rule: Applying the Single-Asset Paradigm of* Bonner Mall, 111 BANKING L.J. 228, 257 (1994); see also *id*. at 246-256 (generally correct mathematical analysis of new value exception).

According to Professor Markell, "new value cases and the absolute priority rule yield the same result," because both require that all of the debtor's "reorganization value" go to senior creditors. Markell Br. 23-24; see also Resp. Br. 30 & n.34. If they are "the same" in reality, one wonders why litigants have been fighting about this issue for more than a decade.

In any event, the legal flaws in the argument are apparent. First, the absolute priority rule does not mandate simply that senior creditors receive "reorganization value"; it requires that a senior dissenting class of creditors "'*must be provided for in full* before any junior class can receive or retain any property.'" *Ahlers*, 485 U.S. at 202 (emphasis added).[12] Second, Professor Markell seems to assume that the entity to which the old owners are contributing new capital has no value. See Markell Br. 24. But this Court held in *Ahlers* that even entities that are "worthless" in a balance-sheet sense may have some value. 485 U.S. at 208 ("there may be some value in the control of the enterprise"). Prior equity holders will *choose* to contribute new value only if they will be obtaining an interest that they believe — for whatever reason (see note 19, *infra*) — to be worth more than the amount of the contribution. See John D. Ayer, *Rethinking Absolute Priority After* Ahlers, 87 MICH. L. REV. 963, 1012-1016 (1989); DOUGLAS G. BAIRD, THE ELEMENTS OF BANKRUPTCY 262-263 (1993).

7. The debtor and its amici offer no direct response to the obvious point (Pet. Br. 25) that, had Congress intended to include a new value exception in Chapter 11 of the Bankruptcy Code, it easily could have done so.[13] Nor do they respond to the observation of amici that,

[12] Professor Markell (at 23-24 n.16) criticizes this part of the unanimous decision in *Ahlers* as an "overstate[ment]" that is "contrary" to prior cases and "has far-reaching and pernicious implications." In fact, the quoted statement in *Ahlers* is strikingly similar to a statement in H.R. Rep. No. 95-595, at 413: "if the class is impaired, then they must be paid in full or, if paid less than in full, then no class junior may receive anything under the plan." The debtor also dismisses as an "oversimplifi[ed]" "slogan[ ]" that is "patently inconsistent with the plain language of the Code" (Resp. Br. 3 & n.5) the statement in *Ahlers* that whether creditors would be "better off if [the] reorganization plan was confirmed" is a "determination * * * for the creditors to make" and for the judiciary to "effectuate." 485 U.S. at 207. We submit that the unanimous *Ahlers* decision was correct.

[13] They likewise offer no rejoinder to the point (Pet. Br. 25 n.14) that Congress provided no guidance regarding the content of any new value exception, and that its failure to do so reinforces the conclusion that it intended the codified absolute priority rule to be enforced as written, not to be subject to an exception — uncodified and unmentioned in the legislative

since the enactment of the Code in 1978, Congress has included exceptions along those lines in two other chapters of the Bankruptcy Code. See ABA/CBA Br. 12-13 (citing 11 U.S.C. §§ 1225(b)(1)(B), 1325(b)(1)(B)). At the time of these subsequent statutory enactments, Congress made no similar changes to Section 1129(b)(2)(B)(ii). Moreover, even at the time of the Code's enactment, Congress knew how to use the phrase "new value" when it wanted to. 11 U.S.C. § 547(a)(2), (c)(1), (c)(3), (c)(4).

II. THE LEGISLATIVE HISTORY DOES NOT SUPPORT ADOPTION OF A NEW VALUE EXCEPTION

The briefs of the debtor and its amici are conspicuously silent with respect to key passages in the 1978 legislative history: unequivocal statements that the absolute priority rule adopted by Congress means that junior interests cannot receive *anything* until senior creditors are *paid in full*. See Pet. Br. 28-31; U.S. Br. 17-18. Nor do those briefs attempt to square their interpretation of the statute — that Congress incorporated *in toto* case law at least 40 years old concerning the meaning of "fair and equitable" — with the House Report's discussion of Section 1129(b)(2). The report described the statute as a "*partial* codification of the absolute priority rule," H.R. Rep. No. 95-595, at 414 (emphasis added), explaining that, "if the class is impaired, then they must be paid in full or, if paid less than in full, then no class junior may receive *anything* under the plan." *Id.* at 413 (emphasis added); see also *id.* at 224 ("The bill defines 'fairly' in terms of the relative rights among the classes. * * * The rule is a *partial* application of the absolute priority rule now applied under Chapter X.") (emphasis added).

Instead, the debtor and its amici emphasize a rejected 1973 proposal that would have permitted new value plans like that overturned in *Ahlers*. Resp. Br. 37-38; Org. Br. 20; Markell Br. 15-16. As we have already explained (Pet. Br. 27-28), this tells us little about the far different statute — with no provision for a new value exception — that Congress enacted five years later. The legislative history of *that* statute indicates plainly that Congress intended to adopt, with respect to a dissenting class of unsecured claims against an insolvent debtor, an unqualified absolute priority rule that is irreconcilable with a new value exception.

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history — developed by the courts.

III. CONGRESS DID NOT TACITLY ADOPT A NEW VALUE EXCEPTION IN 1978

Although the statute does not include a new value exception and the legislative history describes the absolute priority rule in terms that preclude any such exception, the debtor and its amici argue that Congress must have adopted a new value rule. The argument rests on two pillars: (1) before 1978 "fair and equitable" were words of art in the bankruptcy world that this Court had construed since 1869 to include new value concepts; and (2) Congress, although silent on the matter, meant to incorporate that prior construction into the Code. We begin with the latter point.

1. It is always hazardous to try to divine Congress's intent when Congress has not spoken. But that is not what we have here. Congress *has* spoken. It completely overhauled the law of bankruptcy (Pet. Br. 37-40; U.S. Br. 26-30) — a sea change barely acknowledged in the briefs of the debtor and its amici. In Section 1129(b)(2), Congress adopted a detailed definition of "fair and equitable" that did not exist in pre-1978 bankruptcy law. Moreover, in doing so, the House Report explained that "[t]he elements of the test *are new*[,] *departing from both the absolute priority rule* and the best interests of creditors tests found under the Bankruptcy Act." H.R. Rep. No. 95-595, at 414 (emphasis added). And as noted, the House Report also described Section 1129(b)(2) as a *partial* codification of the absolute priority rule and summarized the absolute priority rule in unequivocal terms that did not leave any room for a new value exception. The language and structure of the Code alone are compelling evidence that Congress did not adopt pre-Code law on this point. When the statutory text is considered in conjunction with the House Report, the conclusion that Congress intended to depart from pre-Code law here is inescapable.

The treatment of "give up" plans under the Code is further confirmation that Congress decided *not* to adopt pre-1978 case law construing "fair and equitable." As the Solicitor General has explained (at 22), Congress squarely rejected a Senate proposal that would have permitted plans in which senior creditors gave up part of their own claims to junior creditors, without the consent of an impaired intermediate class of creditors. See also Prof. Br. 14-15; H.R. Rep. No. 95-595, at 416 (Section 1129(b)(2) "is designed to prevent a senior class from giving up consideration to a junior class unless every

intermediate class consents, is paid in full, or is unimpaired. This gives intermediate creditors a great deal of leverage in negotiating with senior or secured creditors who wish to have a plan that gives value to equity.").[14] "Give up" plans were, however, permitted under this Court's iteration of the "fair and equitable" test in *Kansas City Terminal Ry.* v. *Central Union Trust Co.*, 271 U.S. 445 (1926), the principal authority on which the dicta in *Case* v. *Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939), were based. See Pet. Br. 34; BAIRD, *supra*, at 261-262. Thus, the contention that "[t]he Code made no change to the substance of the 'fair and equitable' rule * * * as interpreted in *Kansas City Terminal*" (Resp. Br. 11) is dead wrong — the Code effectively **overruled** *Kansas City Terminal*'s interpretation.

The new statutory definition of "fair and equitable" and Congress's rejection of the use of "give up" plans both refute the contention (Resp. Br. 39) that "the Code merely changed the identity of the party who possessed standing to invoke the absolute priority rule" with "no effect on the substance" of the rule. And changing the absolute priority rule so that it could be invoked by a dissenting class, but not by a "gadfly creditor" (U.S. Br. 27), *is* a fundamental change in the substance of the rule — particularly when combined with the Code's reallocation of bargaining power between creditors and debtors and the Code's dramatic reduction in the role of the independent trustee. See *id*. at 26-29; Pet. Br. 38-40.

2. It is not true that this Court has "always" indicated that new value principles are "part of the 'fair and equitable' concept." Markell Br. 3; see also Resp. Br. 29-34 (arguing that the new value "corollary" has been "established" since 1869); Org. Br. 6 ("the new value principle was not '*dicta*' prior to the Code[ ]"). In *Ahlers*, this Court referred to the new value discussion in *Case* as "dicta." 485 U.S. at 203. Professors Markell and Klee reached the same conclusion in academic articles. See Markell, *supra*, 44 STAN. L. REV. at 90, 92 (explaining that the new value exception is found in "[a] distinct line of cases tracing back to *Case*" and that before 1978 "no reported case seems to have adopted Justice Douglas' dicta as its holding"); Klee, *supra*, 64 AM. BANKR. L.J. at 241 ("no reported decision appears to exist under the Bankruptcy Act in which the exception applied"). As those articles indicate, this Court has never upheld a plan of reorganization based on a new value exception. See also

[14] The "give up" plan in *In re Resorts Int'l, Inc.*, 145 B.R. 412 (Bankr. D.N.J. 1990) (see Org. Br. 28 & n.14), should not have been confirmed. The statutory text and the legislative history discussed above make clear that that plan violated Section 1129(b).

Ayer, *supra*, 87 MICH. L. REV. at 969-979, 999-1007, 1015-1016; Walter W. Miller, Jr., *Bankruptcy's New Value Exception: No Longer a Necessity*, 77 B.U. L. REV. 975, 987-1002 (1997) (both discussing the history of the absolute priority rule and the origins of the new value exception); U.S. Br. 24-25; Pet. Br. 33.[15]

3. Lower court cases are irrelevant to the question whether the Code implicitly incorporates the new value exception. See *Ahlers*, 485 U.S. at 205 ("the statutory language and the legislative history of § 1129(b) clearly bar any expansion of any exception to the absolute priority rule beyond that recognized *in our cases* at the time Congress enacted the 1978 Bankruptcy Code") (emphasis added). In any event, as *all* the articles just cited conclude, *no* reported lower court decision between 1939 and 1978 transforms the *Case* dicta into a holding; none of the cases cited by our opponents involved new value plans in which equity holders participated over senior creditors' objections. See Resp. Br. 34 n.40; Org. Br. 16-17; Markell Br. 14. In short, unlike *Midlantic Nat'l Bank* v. *New Jersey Dep't of Envt'l*

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[15] The government's brief in *Case*, arguing in favor of the *creditors* there, hardly supports the debtor's position. Most obviously, of course, the pertinent statutory language has changed completely since then. In addition, that brief's discussion of new value (at 40-50) is based on *Kansas City Terminal*, which was overruled by the Code, and *Northern Pac. Ry.* v. *Boyd*, 228 U.S. 482 (1913), which held that the absolute priority rule *precluded* stockholders from retaining their prior ownership interests without providing first for unsecured creditors. In fact, the *Case* brief argues (at 14-15) that the new value "corollary * * * has been perverted into a device for depriving senior interests of the property values which this Court has held them entitled to retain." See also, *e.g.*, *id.* at 23-24 ("A plan of reorganization which fails to give precedence to the entire claim of senior creditors before permitting participation by junior creditors or stockholders is not fair and equitable as a matter of law.").

The pre-*Boyd* cases that the debtor cites do not support its position either. The Court held in *Chicago R.I. & P.R.R.* v. *Howard*, 74 U.S. 392, 411 (1868), a case involving the distribution of the proceeds from the sale of an insolvent railroad, that unsecured creditors should take ahead of shareholders. *Louisville Trust Co.* v. *Louisville, N.A. & C. Ry.*, 174 U.S. 674, 684 (1899), reversed a foreclosure decree that did not provide for unsecured creditors and reaffirmed the "familiar rule" that "the stockholder's interest in the property is subordinate to the rights of creditors." Neither case involved an infusion of new capital by existing shareholders. See generally Miller, *supra*, 77 B.U. L. REV. at 987-990.

Protec., 474 U.S. 494 (1986), this case involves *no* pre-Code holdings on the issue at hand.

IV. THE POLICY ARGUMENTS ADVANCED BY THE DEBTOR AND ITS AMICI DO NOT SUPPORT CREATION OF A NEW VALUE EXCEPTION

The debtor and its amici proffer a potpourri of policy reasons why the Court should adopt a new value exception. Those arguments are unpersuasive.

1. NACM argues (at 12-14) that a new value exception is needed because small businesses may have trouble finding other financing. That concern is misdirected because, again, our position does *not* in any way suggest that prior equity holders are *prohibited* from participating in reorganizations or from contributing new value. We contend only that they must either obtain creditor *consent* to a plan that involves such a contribution or comply with the absolute priority rule. In any event, NACM's concern is overstated. Many businesses are able to obtain new funding, convince creditors to agree to plans that would otherwise violate the absolute priority rule, or reach some other accommodation with their lenders. See Pet. Br. 48-49; Prof. Br. 24-25. To the extent that some debtors are unable to achieve any of those alternatives, that is undoubtedly a reflection of the fact that most Chapter 11 reorganizations fail and many Chapter 11 plans, as here, are proposed for reasons unrelated to the firm's ongoing business prospects. It makes little sense to create a new value exception that will serve, in most cases, simply to delay the inevitable. As a study cited by NACM concludes, most Chapter 11 businesses (particularly small businesses) ultimately fail, and thus "the interests of creditors in the assets of an insolvent business must be paramount." Lynn M. LoPucki, *The Debtor in Full Control — Systems Failure Under Chapter 11 of the Bankruptcy Code?*, 57 AM. BANKR. L.J. 99, 100, 247, 258-259, 273 (1983); see also *Associates Commer. Corp.* v. *Rash*, 117 S. Ct. 1879, 1885 (1997) (the "'vast majority of reorganizations fail'"); Pet. Br. 49.

2. The notion that creditors would rather be undersecured than fully secured (see NACM Br. 22) is bizarre. Fully secured creditors stand to be paid in full while undersecured creditors rarely are, and fully secured creditors will be entitled to the accrual and ultimate payment of post-petition interest, while undersecured creditors will not be. 11 U.S.C. § 506(b); *United Sav. Ass' n* v. *Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365 (1988); *In re Delta Resources,*

Inc., 54 F.3d 722, 727 (11th Cir. 1995). Creditors seldom will forgo these valuable economic rights for the purpose of possibly increasing their negotiating leverage as undersecured creditors.

3. We do not contend that bankruptcy judges "should be prohibited from ever making valuation decisions." Resp. Br. 48. The Code sometimes requires that judges make valuation decisions. But the Code also minimizes the instances in which they are necessary, a reflection of Congress's expressed conviction that "a valuation is usually 'a guess compounded by an estimate'" and that, "[t]hough valuation is theoretically * * * precise," it is "more often" used to "fudg[e] a result that will support the plan that has been proposed." H.R. Rep. No. 95-595, at 222. Valuation is an essential component of any new value exception and, in practice, a new value exception will frequently result in a decision by old equity holders to contribute new capital *only* if they believe that the judge has undervalued the firm and that they will thus benefit, at the expense of unpaid creditors. See Pet. Br. 45; BAIRD, *supra*, at 262-263. "This is not an objection based on the notion that bankruptcy judges are bad at valuing firms"; rather, it is based on the reality that, "[i]n operation, the new value exception is going to systematically favor the shareholders at the creditors' expense." *Id.* at 263.

4. NACM claims (at 23) that without the new value exception "unsecured creditors will get nothing unless the debtor has unencumbered assets or is solvent." That is not necessarily so given the dynamics of negotiation, as NACM inadvertently concedes (at 23 n.16). Even if it were so, however, it would be no reason to inject a new value exception into the Code. Giving more junior classes "nothing" unless more senior classes are paid in full is the *purpose* of the absolute priority rule. *Ahlers*, 485 U.S. at 202; *Kham & Nate's Shoes No. 2, Inc.* v. *First Bank*, 908 F.2d 1351, 1359 (7th Cir. 1990) ("Priority is 'absolute' in the sense that every cent of each class comes ahead of the first dollar of any junior class."). Hostility to the absolute priority rule enacted by Congress is not a legitimate reason to create an exception to it.

Sympathy for unsecured creditors with small claims (see NACM Br. 24) is an equally invalid method for construing a statute.[16] It is the

[16] Glossing over the fact that the bank's $38.5 million unsecured claim exceeded the other non-insider unsecured claims (paid in full in cash under the plan on the effective date) by more than $38.4 million, the debtor criticizes the bank for attempting to use an "artificially created" unsecured claim (Resp.

absolute priority rule, not notions of redistributive justice, that "animates the law of corporate reorganizations" and is "central to Chapter 11." BAIRD, *supra*, at 262.

5. NACM also asserts that "Chapter 11 favors debtor rehabilitation over liquidation, so long as the creditors are adequately protected," and speculates that jobs and tax revenue may be lost without reorganization. NACM Br. 3, 5, 9. However,

> no one has presented evidence showing that fewer jobs are lost when a firm reorganizes than when a firm is liquidated. In fact, reorganizations often involve the firing of employees, and liquidations often involve the selling off of entire components of a business without resulting in a substantial loss of employment.

Eric A. Posner, *The Political Economy of the Bankruptcy Reform Act of 1978*, 96 MICH. L. REV. 47, 53 (1997).

NACM's speculations about the effects of liquidation are especially unwarranted in a single-asset real estate case like this one.[17] If this Court reverses the judgment below and the bank

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Br. 2) to hold up a plan approved by another class of unsecured creditors. The debtor's real quarrel is with the legislative choices made by Congress. The Code divides the bank's undersecured claim into secured and unsecured claims. 11 U.S.C. § 1111(b). The bank objected to the plan, as it was entitled to, so that its senior claim would have to be provided for in full before the equity holders could receive any property under the plan on account of their pre-petition interests. Moreover, the Seventh Circuit, unlike other circuits, *requires* that unsecured claims like the bank's be placed in a class *separate* from the other unsecured claims. See J. Ronald Trost, et al., *Survey of the New Value Exception to the Absolute Priority Rule and the Preliminary Problem of Classification*, SB37 ALI-ABA 595, 605-617 (1997) (available on Westlaw). If the majority rule had been followed here and all unsecured claims had been placed in the same class, the bank's votes would have resulted in disapproval of the plan by the entire class, and the plan could not have been confirmed because *no* class of impaired, non-insider creditors would have consented to it. See 11 U.S.C. § 1129(a)(10).

[17] This is the typical context in which new value plans are proposed. 7 COLLIER ON BANKRUPTCY ¶ 1129.04[4][c][ii][B], at 1129-113 (L. King 15th ed. rev. 1997). Thus, contrary to NACM's suggestion (at 4), most new value plans are proposed in cases in which plan confirmation *is* "a two-party negotiation between a debtor and a creditor." See Strub, *supra*, 111 BANKING L.J. at 256-257. And it is fanciful to hypothesize a new value case in which there is a secured creditor with a $90,000 deficiency and unsecured claims totaling $93 million. NACM Br. 24. This would never happen in the real

forecloses, the bank will sell the property. The office building will continue to be leased to tenants. No jobs will be lost, and tax revenues will actually rise — the debtor's owners will have to pay the $20 million tax bill they have deferred because they have continued to own the property.

In general, moreover, the bank's position would *not* lead to more liquidations and fewer reorganizations. If the bank's position is accepted, debtors will no longer be able to threaten cramdown of new value plans as an alternative to agreeing with creditors. Faced with the downside risk of a liquidation, which would often deprive *both* debtors and creditors of *any* going-concern surplus, the parties would have a powerful incentive to negotiate to *agreement* on a reorganization plan. Thus, it is likely that accepting the bank's position will lead to an increase in *consensual* reorganizations, and a decrease in *both* liquidations and cramdowns.

Even when liquidation is a patently undesirable outcome, it is still true that the *threat* of liquidation plays a critical role in the scheme Congress enacted. Just as the threat of a nuclear strike may actually promote peaceful coexistence, so too the threat of a liquidation may promote the crafting of a better plan to which all creditors, voting as classes, and the debtor consent. That plan may be better for all concerned because, if a going-concern surplus exists but would be lost in a liquidation, any allocation of that surplus among creditors and the debtor will make all of them better off than liquidation.[18] And the legislative history unequivocally shows that negotiation among the parties, not cramdown by a judge, is how Congress intended any such surplus to be allocated. See Pet. Br. 29-30.

The threat of cramdown, like the threat of liquidation, plays an important role in shaping negotiations. But cramdown, as it appears in the Code, requires adherence to the absolute priority rule. It

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world, and, if it did, the estate could pay the $90,000 claim in full to prevent the secured creditor from objecting to the plan.

[18] No individual creditor can ever be worse off under a confirmed plan than under liquidation. 11 U.S.C. § 1129(a)(7). In the present case, no going-concern surplus would be lost on liquidation: the bankruptcy judge found that the bank could realize the going-concern value of the property on foreclosure of its mortgage. Pet. App. 117a-118a. In other cases, however, there will be a going-concern surplus that could be lost on liquidation, and the Court may legitimately consider the incentives that the ruling in this case will create in other settings.

removes the creditors' legitimate objections *not* by attempting to allocate the going-concern surplus, but by requiring that they be paid *in full* before more junior classes may receive property under the plan. Creating an exception to that rule makes cramdown easier and fundamentally alters the negotiating incentives that the Code provides.

If judges can approve plans that do not honor the absolute priority rule, then the incentives the Code creates for fruitful negotiation are perversely altered. The debtor's insiders will have a sharply diminished incentive to negotiate whenever they have a chance of retaining property with an economic value to them greater than the "new value" they put in,[19] or of accomplishing other business objectives that benefit the equity holders but not the bankruptcy estate or the creditors. That is manifestly what happened here. Retaining rather than losing ownership of the property resulted in an immediate tax benefit of $20 million to the debtor's equity holders; compelled the bank to continue for ten years a business relationship with a "reorganized" debtor that will remain insolvent for the duration of its plan; and provided the bank with an expectation to receive in year ten only 16% of its $38.5 million unsecured claim on a present-value basis. Adding insult to injury, the debtor's plan assumes that the bank will "voluntarily" re-lend $4.5-$5 million by year eight of the plan. See Pet. Br. 7 n.5; Pet. App.153a.

A plan may be confirmed by consent, or by honoring the absolute priority rule. There is no third possibility. In that way parties are given the proper negotiating incentives. The contrary results that the debtor and its amici urge are neither permitted by the Bankruptcy Code nor consistent with sound bankruptcy policy.

CONCLUSION

The judgment of the court of appeals should be reversed.

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[19] In any particular case, the property may have value to the equity holders greater than the value a bankruptcy judge places on it for any of several reasons: because of tax considerations that the judge regards as irrelevant to valuation; because the judge — being human and applying the notoriously inexact "science" of valuation — makes a mistake; because the property appreciates, after the judge values it, in a manner unforeseen by the judge at the time of valuation; or because the ability to control an entity may have value even if the ability is "worthless" in a balance-sheet sense (*Ahlers*, 485 U.S. at 208).

Respectfully submitted.

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SEPTEMBER 1998