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Preemptive Cram Down

by

Lynn M. LoPucki

and

William C. Whitford*

In a recently published article we proposed that bankruptcy courts enter "preemptive cram down" orders extinguishing the interests of the shareholders of clearly insolvent debtors.¹ The purpose of these orders would be to prevent shareholders who have no plausible claim to share in the distribution under the absolute priority rule from disrupting the reorganization process in the hopes of obtaining such a share through negotiations. Our proposal would have most impact in the cases of large, publicly held companies, where it would tend to reduce the costs of reorganization while bringing case outcomes closer into accord with the absolute priority rule.

Our proposal stems from a recently completed empirical study of the bankruptcy reorganizations of forty-three large, publicly held companies.² For

*Lynn M. LoPucki is Professor of Law at the University of Wisconsin Law School. William C. Whitford is Young-Bascom Professor of Business Law at the University of Wisconsin Law School. The names are listed in alphabetical order. The order is not intended to indicate anything about relative contribution to this Article. This has truly been a joint effort.

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We owe an incalculable debt to the many people who helped in our empirical endeavor. A nearly complete list of the lawyers that we interviewed appears in the initial footnote to LoPucki and Whitford, *Venue Choice and Forum Shopping in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 1991 Wis. L. Rev. 401.

We thank Elizabeth Warren for her comments on an earlier draft of this article. Thanks are also due Bankruptcy Judges Samuel L. Bufford, Keith M. Lundin, Robert D. Martin and James Queenan, Jr. for asking many of the questions about preemptive cram down that we attempt to answer here. Throughout this project we have been ably assisted by the following student assistants: Kevin Demet, John Gerber, Margot Lefler, John Stoneman and John Thomure.

¹LoPucki & Whitford, *Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. Pa. L. Rev. 125, 186-90 (1990) (hereinafter *Bargaining Over Equity's Share*).

²We have published findings from this study in the article cited in note 1 and in LoPucki & Whitford, *Venue Choice and Forum Shopping in the Reorganization of Large, Publicly Held Companies*, 1991 Wis. L. Rev. 401 (hereinafter *Venue Choice*). Additional findings will be included in two other articles, LoPucki & Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, (hereinafter LoPucki & Whitford, *Corporate Governance*) and LoPucki & Whitford, *Patterns in the Reorganization of Large, Publicly Held Companies*. Our study included all chapter 11 reorganization cases filed on or after October 1, 1979, which resulted in confirmation of a plan on or before March 31, 1988, if the debtor had assets of at least \$100 million at the time of filing and at least one class of its securities was publicly held.

each case in that study, we determined the market value, as of the date of confirmation, of the property distributed to unsecured creditors and equity holders. For the thirty insolvent companies in that study, the results are shown in Table 1.

Table 1
INSOLVENT^a DEBTORS: ADHERENCE TO THE ABSOLUTE
PRIORITY RULE

(1)	(2)	(3)	(4)	(5)	(6)
Name of Case	Percentage Paid on Unsecured Claims ^b	Distribution to Equity (in millions)	Total Distribution, Unsecureds and Equity (in millions)	(3) as % of (4)	Equity Committee Appointed?
Seatrains Lines	0.5%	\$0 ^c	\$1.4	0	No
MGF	1.1%	0	2.0	0	No
Towner	2.5%	0	3.2	0	No
Air Florida	3.1%	0 ^c	6.0	0	No
Braniff	4.9%	1.7	35.4	4.9%	Yes
Amarex	7.8%	0	18.5	0	No
Oxoco	9.5%	0.4	11.2	4.0%	No
Technical Equities ^d	11.0%	0	6.6	0	No
Sambo's ^e	11.0%	0	unknown	0	No
Dreco ^f	11.7%	6.5	11.2	57.7%	Yes
NuCorp	13.4%	0	39.2	0	No
McLouth	18.2%	1.4	27.2	5.1%	No
Pizza Time Theatre	20.0%	0.5	23.0	2.2%	No
Crystal Oil	23.9%	3.9	52.7	7.5%	No
Evans Products ^g	26.5%	0	2.4	0	Yes
Combustion Equip.	27.7%	0.4	37.4	1.0%	Yes
Energetics	29.9%	3.0	14.5	20.8%	No
Tacoma Boat	29.6%	2.5	40.7	6.1%	No
Towle	35.6%	1.0	20.4	5.0%	Yes
FSC	37.6%	1.9	40.2	4.8%	Yes
Cook United	38.7%	2.3	28.1	8.1%	Yes
Marion	40.4%	0.9	60.9	1.5%	Yes
Saxon	41.2%	8.2	140.2	5.8%	Yes
Baldwin-United ^h	54.3%	20.0	259.1	7.7%	Yes
White Motor	60.9%	4.7	178.4	2.6%	Yes
KDT	62.6%	3.2	42.6	7.4%	No
Anglo Energy	64.6%	4.6	99.5	4.6%	Yes
Itel	64.9%	18.2	652.8	2.8%	No
HRT	68.5%	5.7	84.9	6.7%	Yes
Wickes	81.6%	63.0	1,100.4	5.7%	Yes

^aA debtor was considered "insolvent" if the total value distributed to unsecured creditors and shareholders was less than the allowed unsecured claims.

^bIn determining the percentage of unsecured claims paid, classes were omitted if the amounts of claims in the class were in substantial dispute. Distributions to the classes omitted were not substantial for any of the cases on this table. In determining the total amounts distributed to unsecured claims, these same classes were included.

^cEquity received property under the plan, but the property was of inconsequential value.

^dThe figure used for distribution to creditors is a rough estimate of a distribution not yet made.

^eIn the Sambo's Restaurants case the final distribution is not complete, but we have from the attorney for the trustee what we consider to be a reliable estimate of the percent of unsecured claims to be paid.

^fIn the Dreco Energy case insiders, who constituted management at filing, controlled 75% of the shares. They were able to secure a very favorable distribution to equity in part because their continued participation in the company was considered critical to its future success.

^gThe distributions shown here were made to creditors of Evans Products, Inc., the parent company whose shares were publicly held. A total of \$175.3 million was distributed to all creditors of the subsidiaries. On the average, unsecured creditors of corporations in the group recovered 80.9% of their claims.

^hIn the Baldwin-United case a major payout (\$170 million) was made to rehabilitation funds established by two state insurance commissioners for the benefit of purchasers of single premium deferred annuities from Baldwin. We did not include this payout as a distribution to unsecured creditors because, at the time of the bankruptcy filing, the rehabilitation funds held security interests in the stock of most of Baldwin's subsidiaries. These security interests were released with the filing. However, the payout was in full settlement of the annuitant's claims, including the unsecured portion. If we included this payout as part of the distribution to unsecured creditors, then the percentage distribution to equity would be reduced to 4.6%.

In each of these cases, creditors recovered substantially less than the full amounts of their claims. In a cram down under the absolute priority rule, the shareholders of these companies would have been entitled to nothing. Yet in 23 of the 30 cases equity was permitted to share in the distribution under the plan.³ Although these distributions to equity were generally small in relation to the amounts recovered by creditors, they typically consisted of millions of dollars of stock in the emerging company or the company purchasing the assets.

On the basis of interviews with approximately 80 of the lawyers who played key roles in these cases, we concluded that these distributions were, in substantial part, the result of equity's potential, under current procedures, to obstruct the plan process. In essence, equity holders were being paid the nuisance value of their positions.

Our proposal addresses the problem by inviting any party in interest to seek a determination, early in the case, that one or more classes of equity interests are clearly under water and there is no reasonable probability that they will cease to be under water by confirmation. The determination would be in the form of an order extinguishing those interests. We found in our data reason to believe that motions for preemptive cram down would rarely be contested and that, when they were granted, they would greatly reduce the obstructionist potential of equity.

The purpose of this article is to elaborate on our proposal and to address concerns over jurisdiction and procedure. In Part I of this article, we describe the current practice with regard to distributions to the equity holders of insolvent, large, publicly held companies and explain why we consider the practice to be undesirable. Part II describes the intended legal effect of a preemptive cram down order. In Part III we discuss several issues of jurisdiction and procedure

³LoPucki & Whitford, *Bargaining Over Equity's Share*, *supra* note 1, at 141-43. In two of the cases the distributions to equity were in the form of warrants to purchase stock of the emerging company. In both cases, when the stock was issued, it traded well below the warrant price. As a result, the warrants had no value under our valuation protocols.

that are likely to arise in implementing our proposal. These include the power of the court to enter preemptive cram down orders, the appropriate form of action for requesting preemptive cram down, the manner in which notice must be given to shareholders, and corporate governance after preemptive cram down. In Part IV we consider the appropriate uses of preemptive cram down and speculate on the way in which it will in fact be used.

I. THE VULNERABILITY OF A REORGANIZATION PROCESS THAT RELIES ON CONSENSUAL PLANS

For each of the cases in our study, we conducted two to four interviews with lawyers who played key roles. Ordinarily, they included one of the lawyers who represented the debtor, one who represented the unsecured creditors' committee and, if an equity committee had been appointed, one who represented it. We devoted a portion of each interview to determining why there was or was not a deviation from the absolute priority rule in favor of equity.

A. *Why does equity share? The interview data.* There was virtually universal agreement among the interviewees that consensual plans⁴ were highly desirable and that, to obtain the necessary consents, everyone at the bargaining table had to get something. Contested cram down hearings were to be avoided.

Most of the interviewees were less definite as to their reasons for preferring a consensual plan to a cram down. Among the reasons they gave for allowing equity to share:

1. To save the direct expense of litigating to cram down. If equity was not offered a share under the plan, they could organize, retain counsel and litigate in opposition to cram down. The expenses of that litigation would reduce the amounts available for continuation of the business and distribution to creditors.

2. To avoid delay and uncertainty. Litigation in opposition to cram down might delay the case. The delay might adversely affect the operation of the business or interfere with attempts to liquidate all or part of it or have other effects that are difficult to anticipate. Because the expenses of reorganization are partly a function of the length of time spent under chapter 11, delay would cost more than just the direct expenses of litigating the issue of cram down.

3. To fulfill management's duty to represent equity. Because of their control

⁴The term "consensual plan" as it was used by our interviewees is not capable of precise definition. The term was generally used to refer to a plan agreed to by all parties actually capable of contesting confirmation. This definition leaves considerable uncertainty as to whose agreement is needed to render a plan "consensual." The Evans Products plan was confirmed over the active opposition of the debtor and the equity holders; all regarded it as nonconsensual. Though the representatives of equity never agreed to the plans in the HRT and Manville cases, both were confirmed without opposition at the hearing; probably most considered them nonconsensual. In other cases, such as Wickes and Saxon, the plans were considered consensual even though particular classes of interests were excluded from the distribution. Those classes were not considered capable of contesting the cram down against them and did not in fact contest it.

over information, their exclusive right to propose a plan, and other factors, management ordinarily had a great deal of leverage in negotiations over the contents of the plan. Management sometimes used some of that leverage to insist that equity receive a portion of the distribution.⁵

4. Sharing of the cost. The size of the distribution necessary to obtain equity's consent to the plan was usually small in relation to size of the proposed distribution to unsecured creditors. The cost of equity's portion would be shared among a large number of creditors. No individual creditor had much to gain by excluding equity from the distribution, and hence no creditor had much incentive to resist such a distribution.

5. To enhance the market for the securities of the emerging company. If prepetition shareholders each received even small amounts of stock in the emerging company, they would be more likely to continue trading in the company's shares. Their participation would increase the size of the market for the emerging company's shares, and perhaps induce exchanges to list them. Particularly the latter tends to raise share values and benefit the creditors who receive stock in the emerging company.

6. To enhance the image of the emerging company. If the parties visibly "make peace," it may help to convince customers, suppliers and potential lenders that the company's problems have been resolved to everyone's satisfaction.

The first four reasons on this list were frequently cited. The last two were mentioned as factors in only a few cases. None of the interviewees cited tax considerations among the reasons for allowing equity a share in the distribution.

B. *Why does equity share? A reconceptualization.* Two other findings led us to conclude that there were additional reasons, generally not mentioned by our interviewees, for permitting equity to share.

First, in the 30 cases for which our financial analysis showed the debtor to have been insolvent, the fact of that insolvency was apparent to the negotiators. The attorneys for most of the equity committees acknowledged that they could not have presented even a plausible case for solvency. Others thought they could have presented evidence of solvency, but that evidence was not strong enough to persuade even themselves. With only a single exception, the lawyers who negotiated equity's share believed that, in their particular case, equity could have been zeroed out through cram down. We found it difficult to believe that the threat to litigate from such weak positions could generate such sizeable settlements.

Second, in all three cases in our study in which plan proponents sought a cram down against equity, they were successful. Two of the three, Evans

⁵The extent to which management used its leverage to benefit equity is a central concern of LoPucki & Whitford, *Corporate Governance*, *supra* note 2.

Products⁶ and Manville,⁷ were the cases of companies bordering on solvency. In both cases, the plan proponents faced determined resistance from the representatives of equity. These were the most difficult kinds of cases in which to seek cram down. Yet in both cases the confirmation hearing, including the taking of evidence on valuation, was concluded in a single day.⁸ In the third case, HRT, the equity committee that had refused to agree to the plan declined to present evidence at confirmation. In all three cases cram down appeared to be considerably less difficult than the conventional wisdom suggested.

These findings led us to suspect that the reasons given by our interviewees were not sufficient in themselves to explain distributions to equity of the size we observed. We hypothesized that the difficulty of cram down was in

⁶During the negotiations, the creditors of Evans Products offered equity a share in the distribution that would have been worth over \$18 million. The equity committee accepted the offer, but Victor Posner, the major shareholder, vetoed the proposal. See *Committee of Non-Insider Equity Security Holders v. Evans Products Co.* (*In re Evans Products Co.*), 62 B.R. 173 (Bankr. S.D. Fla. 1986). The creditors then proposed a plan that extinguished the interests of equity holders without compensation. Based on the court's valuation of the company in a contested hearing, the plan was crammed down against equity. See *In re Evans Products, Co.*, 65 B.R. 31 (Bankr. S.D. Fla. 1986), *aff'd*, 65 B.R. 870 (S.D. Fla. 1986); LoPucki & Whitford, *Bargaining Over Equity's Share*, *supra* note 1 at 144-45.

⁷The debtor and creditors in Manville reached agreement on a plan that ultimately left common shareholders with only a 2% interest in the emerging company. The plan was accepted by the preferred shareholders, but rejected by the common shareholders. The equity committee then moved that the court disband it and order the appointment of two replacement committees to represent the conflicting positions of its constituents regarding confirmation. The court disbanded the equity committee, but declined to order the appointment of replacement committees. The plan was crammed down against the common shareholders at a confirmation hearing in which they did not have legal representation.

For the purpose of our study, we considered a company to be solvent if the total distribution to creditors and shareholders exceeded the total of creditors' claims. In accord with valuation protocols that we applied to all cases in the study, we classified Manville as "solvent." We ignored the asbestos claims and distributions in our calculations because we could quantify neither the amounts of those claims nor the values of the distributions made on them. Early in the Manville case the court also considered the company to be solvent. As the amounts of the asbestos claims mushroomed, the company's financial condition worsened. By the date of confirmation, the court considered the company insolvent. The implication is that the distribution on the asbestos claims finally allowed would be substantially less than 100 cents on the dollar. However, commercial creditors were paid 125.3 cents per dollar of their claims, and shareholders also received a substantial distribution.

⁸The extent to which the debtors suffered from delays during their battles with equity is less clear. In Manville there were more than four years of delay while the parties attempted to negotiate a consensual plan. Not all this delay was due to difficulty in reaching agreement with equity classes, but some of it probably was. Three groups of equity holders appealed from the confirmation order. Approximately 18 months later, the court of appeals affirmed the decision of the bankruptcy court. The plan was not implemented during the appeal because it expressly provided that it would not become effective until all appeals from the confirmation order were resolved. The asbestos health claimants certainly suffered from the delay; the automatic stay remained in effect during the appeal and the debtor did not pay any claims. The delays may actually have benefitted the debtor: the uncertainty caused by the appeal may have been more than offset by the respite from payment of claims.

The Evans Products case moved quickly to confirmation despite active opposition from equity holders. The confirmation order was affirmed on appeal exactly three months after it was entered. *In re Evans Products Co.*, 65 B.R. 870 S.D. Fla. 1986).

large part a convenient myth that served the interests of the relatively small group of lawyers who repeatedly play important roles in major reorganization cases.⁹ Because these lawyers appeared against each other so often, they had an interest in preserving their reputations as reasonable and responsible negotiators. If a lawyer insisted on a plan that provided nothing to equity, the lawyer risked earning a reputation as an unreasonable negotiator that could haunt the lawyer in future representations. The myth that cram down is impractical, therefore, allowed lawyers to do the conventional thing by agreeing to distributions to equity, even though cram down might have produced better results for their current clients.¹⁰

At the same time, it was apparent that equity's potential to organize and make trouble for other parties to the reorganization case constituted a very real deterrent to the use of cram down in some cases in which cram down would have been appropriate. A plan of reorganization for a large company is essentially a settlement agreement among thousands of parties. Decisions as to who will share and in what proportion must be made a minimum of about three to five months before the plan comes before the court for confirmation. In the interim, the plan and disclosure statement must be reduced to writing and the disclosure statement must be approved by the court on no less than twenty-five days notice. Thousands of creditors must be given time to vote. After the voting, some parties will need additional time to prepare for the confirmation hearing.

If the plan is modified while it is under consideration, the holders adversely affected by the modification may have to be afforded twenty days notice and an opportunity to change their votes.¹¹ Thus, if a proponent proposes a plan that excludes equity from the distribution and, in response, equity organizes and forces a compromise, these adjustments themselves may be disruptive. To avoid that, plan proponents have reason to, and sometimes do, provide for equity holders who have neither organized nor made demands.¹² One campaign like

⁹Fifteen law firms obtained nearly half of the appointments as principal attorney for the debtor, creditors' committee or equity committee in the 43 cases we studied. LoPucki & Whitford, *Bargaining Over Equity's Share*, *supra* note 1, at 156 n.65.

¹⁰It may also be that it is easier for lawyers to dominate the process of negotiation than the process of litigation where the judge ordinarily plays the central role. By channeling reorganization into the former process, the myth may make it more difficult for outsiders to play major roles and reinforce the hold that insiders have on the reorganization process. If cases are routinely settled, outcomes may be more predictable. That in turn would make it easier for lawyers to advise future clients.

¹¹BANKRUPTCY RULE 2002(a)(6).

¹²For example, in the McLouth Steel case, the company's only assets were its net operating loss carryovers, or NOLs. It was mathematically impossible to value the NOLs high enough to render the company solvent. In fact, creditors were compromising the amounts of their claims and then, by our calculations, receiving only 18 cents on each dollar of the compromised amounts. Despite the fact that equity holders had no committee, did not organize and made no demands, the negotiators gave them a share in the distribution which we valued at \$1.4 million. They did so largely out of a concern that if confronted with a proposed plan that provided them with nothing, equity might organize and, in the words of one participant, "kick sand in our faces."

that described in the court's opinion in *In re Heck's, Inc.*¹³ can result in numerous offers to apparently docile equity holders in other cases.

Even though equity holders conduct few obstructionist campaigns,¹⁴ the proponents of a plan must be concerned about them in every case. They must decide how to deal with this uncertainty before they propose their plan. If an equity committee has been appointed and organized, the decision is apparently an easy one. In every such case in our study the proponents offered equity a share. In all but two of the cases they obtained the equity committee's consent to the plan. Among the cases in which there was no equity committee, proponents sometimes provided equity with a share of the distribution. The decision seemed to depend upon how far the equity interests were under water.¹⁵

C. *The vulnerability of the consensual plan process.* In most kinds of litigation bargaining and adjudication are alternatives available to the parties to resolve their differences.¹⁶ But in the reorganization of large publicly held companies, a combination of unwieldy issues, crowded dockets, sheer size and complexity of the cases, and perhaps most importantly, the shared belief among the professionals that to seek adjudication, except in the most extreme circumstances, is irresponsible, the process of adjudication has largely ceased to be a practical alternative for disposing of cases. As one prominent attorney put it, "the underlying philosophy of chapter 11 is to force settlement."¹⁷

Pressure to settle arises from several sources. In our study we observed instances in which the court declined to approve interim attorneys fees, granted or denied extensions of exclusivity, or declined to appoint a committee, at least in part in order to promote settlement. Pressure from peers was previously mentioned.¹⁸

Equity that is under water is less vulnerable to some of these pressures than other parties to the negotiations. Their share in the distribution will be

¹³112 B.R. 775, 803, 808 (Bankr. S.D. W.Va. 1990) ("[T]he litigation commenced by the Equity Committee . . . [was] solely for the purpose of extorting a settlement or extorting a compromise for equity interest holders above and beyond that to which they were entitled [L]ead counsel of the Equity Committee launched a barrage of meritless demands and threats . . . that were intended to coerce other creditors in the case and put in jeopardy the ability of the DIP to provide recovery for anyone. These actions were improper in the representation of equity interests and damaged the DIP by creating substantial administrative expense, delay and confusion.")

¹⁴Equity committees fought hard campaigns in *Manville*, *HRT*, *Wickes*, and *EPIC*. None was obviously obstructionist. But in other cases, equity shared in the distribution even though no committee was organized and the interests of equity holders went virtually unrepresented.

¹⁵As can be seen on the table *supra* at page 626, among the nine cases in which creditors were paid less than approximately 15 cents on the dollar and no equity committee was appointed, equity won a measurable share in the distribution in only one, *Oxoco*. By contrast, equity won a measurable share of the distribution in all seven cases in which creditors were paid more than approximately 15 cents on the dollar and no equity committee was appointed.

¹⁶See, e.g., R. POSNER, *ECONOMIC ANALYSIS OF LAW*, § 21.5, 522-28 (3d ed. 1986).

¹⁷Broude, *Cramdown and Chapter 11 of the Bankruptcy Code: The Settlement Imperative*, 39 *BUS. LAW.* 441, 441 (1984).

¹⁸See text accompanying notes 9 and 10, *supra*.

relatively small, so they may be less fearful of losing it. In most of the cases in which an equity committee was appointed, its members were not major shareholders. The lawyers who represented equity committees were less likely to be "members of the club" than the lawyers who represented debtors and unsecured creditors' committees, and therefore they were not as subject to the discipline of peers. They were in a better position to hold out.

Though under water equity did not conduct any obviously obstructionist campaigns in the cases we studied, they did conduct campaigns of opposition in several¹⁹—enough to make them a threat to the consensual reorganization process. The danger is not merely that equity will demand more than their share. The danger is that in trying to get it, they will interfere with the timing of the reorganization process in a way that will defeat its purpose.²⁰

The reorganization process is slow and cumbersome in part because the interests of so many parties must be accommodated. Our proposal for preemptive cram down is based in large part on the assumption that the early extinguishment of under water equity will simplify the process and make it easier for the remaining parties to reach agreement on a consensual plan.

II. THE EFFECT OF A PREEMPTIVE CRAM DOWN ORDER

We contemplate that a preemptive cram down order against a particular class of equity will be based on findings that the allowed claims and interests of classes senior to that class clearly exceed the reorganization value of the estate, and that there is no reasonable probability that they will cease to be so at the date of confirmation of a plan. The order will determine that the interests of the class are without value within the meaning of § 1129(b)(2)(C)²¹ and will extinguish those interests.²² While we do not think it is necessary for the court to order the appointment of an equity committee or otherwise provide for the representation of the equity holders at hearings on preemptive cram

¹⁹See *supra*, note 14.

²⁰See *supra*, note 13.

²¹The word "value" as it is used in this section might be interpreted in two ways. In what we will call the "theoretical sense," it refers to an excess of reorganization value over the amount of senior claims and interests. In the "practical sense," the value of the interest would be the amount for which it could be sold. If the term "value" is given this latter meaning, the requirement of 11 U.S.C.A. § 1129(b)(2)(C) (West 1979 & Supp. 1991) becomes self referential and ultimately nonsensical. One could not know the "value" of an equity security until one knew what it was worth in the marketplace. If there is trading in the equity security, its price will reflect partly the market's speculation about the outcome of the chapter 11 case. The problem is best resolved by interpreting "value" in the theoretical sense.

²²Bankruptcy Rule 3017(d) requires that, on approval of the disclosure statement, the plan proponent or other person mail a copy of the plan and disclosure statement to equity security holders. If the preemptive cram down order provides for the extinguishment of the equity interests, the mailing to these parties would be unnecessary.

down,²³ we do think it advisable that the court require the movant to present evidence regarding value.²⁴

In the cases in which it is employed, preemptive cram down will prevent equity holders from sharing in the distribution on account of their interests. The rule of absolute priority will be enforced. Some probably will view this change in procedure as depriving equity holders of substantive rights.²⁵ But, as we have discussed elsewhere,²⁶ we find nothing in the legislative history of the Bankruptcy Code to suggest that Congress intended to foster deviations from the absolute priority rule in favor of under water equity. Congress contemplated that such deviations would exist. But the legislative history is consistent with the idea that Congress did not seek them as a distributive norm, but simply was willing to tolerate them to avoid the necessity for valuation hearings in all cases. That is, Congress was unwilling to insist upon compliance with the absolute priority rule in the face of high transaction costs. But preemptive cram down will make compliance possible at much lower transaction costs. We think that absolute priority continues to be the public policy regarding distributions in reorganization cases.²⁷

As previously mentioned, a preemptive cram down order would extinguish the equity interests. Among the effects would be the following:

1. Except with regard to motions for relief from preemptive cram down orders or appeals from such orders, the former equity holders would no longer be considered parties in interest in the reorganization case. They would no longer be entitled, for example, to object to plans, disclosure statements, sales of assets or compensation of professionals.

²³We expect that preemptive cram down will be used primarily in cases in which it is indisputable that the equity interests are under water. In the types of cases we contemplate, representation would be useless. Nonetheless, notice and an opportunity to be heard would still need to be provided to equity holders. See notes 59-69 *infra* and accompanying text.

²⁴The taking of evidence on an uncontested motion for preemptive cram down is apparently not required by the rules. Rule 9014 requires that the equity holders be provided only *the opportunity for hearing*. The court is required to make findings to support its order only when a matter has been "tried." FED. R. BANKR. P. 7052; FED. R. CIV. P. 52. The court should take evidence before entering a preemptive cram down order nevertheless to assure that the procedure is not abused. Even when equity interests have substantial value, no one may come forward to defend them.

Storage Technology, one of the cases in our study, provides a dramatic example. Even though the equity holders ultimately received property with a market value of \$117 million by our calculations, the U.S. Trustee was unable to find qualified persons willing to serve on an equity committee, and consequently none was organized. In plan negotiations management maintained a neutral stance between the interests of creditors and equity holders, which left the equity holders virtually unrepresented.

²⁵See, e.g., Radick & Blauner, *Shareholders Unite!*, BARRONS, Apr. 14, 1986, at 22.

²⁶LoPucki & Whitford, *Bargaining Over Equity's Share*, *supra* note 1, at 131-34.

²⁷Our view is not based upon a philosophical commitment to the fairness or efficiency of the absolute priority rule. We have argued elsewhere that neither the rule's fairness nor its efficiency has been proven. LoPucki & Whitford, *Bargaining Over Equity's Share*, *supra* note 1, at 179-84. Our view is based on a reading of the legislative history.

Other academics share this view. See, e.g., Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527, 537 (1983) (referring to the "statutory right" of "higher-ranking claimants . . . to receive full compensation before those below them receive anything.")

2. The former equity holders would no longer be entitled to notice in the reorganization case or to receive a copy of the plan and disclosure statement.²⁸

3. Except with regard to attacks on the preemptive cram down order, official committees would not be permitted to organize at the debtor's expense or employ professional persons to represent the former equity holders. The debtor in possession would no longer be paying equity's legal fees.

4. Directors and officers of the debtor in possession would be relieved of any remaining fiduciary duty to represent the former equity holders. The directors and officers would neither be obligated nor entitled to represent their interests in the conduct of the business or in plan negotiations. The former equity holders would no longer be entitled to compel meetings of shareholders or to elect directors.²⁹

5. A plan of reorganization would not be confirmable over the negative vote of any impaired class, if it provided for the extinguished class to receive or retain any property on account of their extinguished interests. Valuation would not be an issue at confirmation.³⁰

Extinguishing equity's interests early in the case would not necessarily prevent them from sharing in the distribution. The other parties to the case may want under water equity to share for reasons of their own. As was previously mentioned,³¹ in the cases we studied, other parties occasionally allowed under water equity to share in the distribution for public relations reasons or to improve the market for the emerging company's securities. In most smaller reorganization cases, creditors want to allow equity holders who are also managers to share in the distribution in order to secure their cooperation in the future management of the business.³² These distributions do not result from the bargaining leverage of equity holders in their capacity as equity holders and therefore they would not be objectionable, even after a preemptive cram down order had been entered.³³

²⁸Copies need only be sent to equity security holders. FED. R. BANKR. P. 3017(d). The former shareholders would no longer qualify.

²⁹See text accompanying notes 70-73, *infra*.

³⁰See 11 U.S.C.A. §§ 1129(b)(2)(B)(ii) and (C)(ii) (West 1979 & Supp. 1991).

³¹See section A of Part I.

³²See Warren, *A Theory of Absolute Priority*, 1991 N.Y.U. ANN. SURV. AM. L. 9 ("An a priori rule barring participation of old equity results in lost value for the estate, with no obvious off-setting value."). Often, continuation of the business is dependent on the owner/manager's cooperation. The owner/manager may be the only one with the necessary knowledge and expertise, the only one who can guarantee continuation of essential business relationships or the only one willing to work for the amount of money the business can produce. See generally, Peeples, *Staying In: Chapter 11, Close Corporations and the Absolute Priority Rule*, 63 AM. BANKR. L.J. 65 (1989); LoPucki, *The Debtor in Full Control—Systems Failure Under Chapter 11 of the Bankruptcy Code?*, 57 AM. BANKR. L.J. 99, and 247, at 255-57 (1983).

³³Such distributions do not violate the cram down provisions of the Code because they are not "on account of [the under water] interests." See 11 U.S.C.A. §§ 1129(b)(2)(B)(ii) and (C)(ii) (West 1979 & Supp. 1991). Parties opposing such distributions might wish to obtain a preemptive cram down order to clarify the basis for proposed distributions to the holders of under water equity interests.

III. ISSUES IN IMPLEMENTING PREEMPTIVE CRAM DOWN

A. *Entry of a preemptive cram down order is within bankruptcy jurisdiction.* The authority for preemptive cram down is found in § 105 of the Bankruptcy Code.³⁴ That section "arms bankruptcy courts with broad powers, analogous to those of a court of equity, to protect the estate."³⁵ Protection of the estate from unwarranted litigation expense, from harassment, and from misallocation is precisely the purpose of a preemptive cram down order. Preemptive cram down is in one sense a new remedy, but under § 105 the bankruptcy courts may "look through form to the substance of a transaction and devise new remedies where those at law are inadequate."³⁶

By the entry of a preemptive cram down order, the bankruptcy court will determine matters relating to confirmation before the entry of a confirmation order. That is not unusual. Bankruptcy courts commonly enter such determinations when they give their reasons for denying confirmation of a plan,³⁷ when they enter an order partially confirming a plan,³⁸ when they abort consideration of a plan at the disclosure hearing stage because it is not confirmable,³⁹ and in other orders in which they anticipate problems that may arise on confirmation.⁴⁰

B. *Entry of a preemptive cram down order is a core proceeding.* The Bankruptcy Code defines core proceedings by example.⁴¹ Generally speaking, matters that arise only in bankruptcy cases are core proceedings.⁴² Preemptive cram down is such a matter. Preemptive cram down is also part of the process of confirming a plan, which is one of the statutory examples of core proceedings.⁴³ Although it occurs before the confirmation hearing, so does

³⁴In relevant portion, that section provides: "The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." 11 U.S.C.A. § 105 (West Supp. 1991). See also, *In re Kehn Ranch, Inc.*, 41 B.R. 832 (Bankr. S.D. 1984) (Under § 105 bankruptcy court has the power to determine, at the time of the hearing on the disclosure statement, that confirmation of a creditor's chapter 11 liquidation plan would violate § 1129(a)(1).)

³⁵*In re Davis*, 730 F.2d 176, 183 (5th Cir. 1984).

³⁶*Chinichian v. Campolongo (In re Chinichian)*, 784 F.2d 1440, 1443 (9th Cir. 1986).

³⁷See, e.g., *In re Hayes*, 101 B.R. 569 (Bankr. E.D. Ark. 1989); *In re Hooper*, 14 B.R. 729 (Bankr. N.D. Ga. 1981).

³⁸*Chinichian v. Campolongo (In re Chinichian)*, 784 F.2d 1440 (9th Cir. 1986).

³⁹*In re Kehn Ranch, Inc.*, 41 B.R. 832 (Bankr. D.S.D. 1984).

⁴⁰For example, in determining whether to permit payment of priority claims during pre-plan stages of the reorganization case, the courts frequently value the assets of the estate to assure that the prepayments will not have the effect of altering priorities under any plan that is ultimately confirmed. See, e.g., *Michigan Bureau of Workers' Disability Compensation v. Chateaugay Corp. (In re Chateaugay Corp.)*, 80 B.R. 279, 285 (S.D.N.Y. 1987) ("The question raised is whether a bankruptcy judge has the authority, in the preplan stages of a reorganization proceeding under Chapter Eleven of the Bankruptcy Act, to authorize the debtor in possession to pay prepetition debts" The court concluded that the judge did.); *Tabb, Emergency Preferential Orders in Bankruptcy Reorganizations*, 65 AM. BANKR. L.J. 75, 92-102 (1991).

⁴¹28 U.S.C.A. § 157(b)(2) (West Supp. 1991).

⁴²See GINSBERG, *BANKRUPTCY* § 1.03[c][1] (1989).

⁴³28 U.S.C.A. § 157(b)(2)(L) (West Supp. 1991).

approval of a chapter 11 disclosure statement. Even though such approval is not on the list of examples of core proceedings, it has been held to be a core proceeding.⁴⁴ From the conclusion that preemptive cram down is a core proceeding, it follows that a bankruptcy judge can issue the order: it is not necessary that it be issued by a district judge.⁴⁵

Because it attempts to prevent mischief before it occurs, the request for a preemptive cram down order arguably might be considered a request for a declaratory judgment.⁴⁶ That would not deprive the bankruptcy court of the power to issue the order. The bankruptcy court may not be a "court of the United States" authorized to issue declaratory judgments pursuant to 28 U.S.C. § 2201(a).⁴⁷ But even if it is not, a particular bankruptcy court probably has been delegated that authority by the district court's standing referral order.⁴⁸ The entry of declaratory judgments in the exercise of bankruptcy jurisdiction is specifically contemplated by the Federal Rules of Bankruptcy Procedure.⁴⁹

C. Preemptive cram down can be accomplished by motion. While the matter is certainly debatable, it does not appear that a request for a preemptive cram down order must be in the form of an adversary proceeding.⁵⁰ Whether preemptive cram down is considered to be in the nature of a declaratory judgment is not dispositive of the matter. Despite an occasional statement to the contrary,⁵¹ the requirement of Bankruptcy Rule 7001(9) that declaratory actions be brought in the form of adversary proceedings is limited by its own terms to the types of relief covered by clauses (1) through (8) of Rule 7001.⁵² A declaratory judgment relating to cram down must be sought by adversary proceeding only if cram down itself must be sought by adversary proceeding.

The argument that clause (2) of Rule 7001 requires that a request for preemptive cram down be in the form of an adversary proceeding is plausible

⁴⁴See *in re* AOV Industries, Inc., 792 F.2d 1140, 1145 (DC. Cir. 1986).

⁴⁵See 28 U.S.C.A. § 157(c)(1) (West Supp. 1991).

⁴⁶"The essential distinction between an action for a declaratory judgment and the usual action is that no actual wrong need have been committed or loss have occurred in order to sustain the declaratory judgment action." *Emerald Isle v. State*, 320 N.C. 640, 360 S.E.2d 756 (1987); *Demorest v. Di Pentima*, 118 Mich. App. 299, 324 N.W.2d 634 (1982).

⁴⁷See 9 COLLIER ON BANKRUPTCY, ¶ 7001.12, note 2 and accompanying text (L. King 15th ed. 1990); *contra*, *Bear Valley Mutual Water Co. v. Prestige Point (In re Prestige Point)*, 113 B.R. 643, 646-47 (Bankr. C.D. Cal. 1990) *aff'd without opinion*, 130 B.R. 362 (9th Cir. BAP 1991) (bankruptcy court has the power to issue declaratory judgment pursuant to 28 U.S.C.A. § 2201).

⁴⁸See, e.g., *Korhumel, Inc. v. Korhumel Industries, Inc. (In re Korhumel, Inc.)*, 103 B.R. 917, 920-21 (N.D. Ill. 1989).

⁴⁹Bankruptcy Rule 7001(9) provides that a proceeding "to obtain a declaratory judgment relating to any of the foregoing" is an adversary proceeding.

⁵⁰See FED. R. BANKR. P. 7001.

⁵¹See, e.g., *Bear Valley Mutual Water Co. v. Prestige Point (In re Prestige Point)*, 113 B.R. 643, 646 (Bankr. C.D. Cal. 1990) *aff'd without opinion*, 130 B.R. 362 (9th Cir. BAP 1991) ("Declaratory relief actions in Bankruptcy Court are adversary proceedings. Bankruptcy Rule 7001(9).")

⁵²9 COLLIER ON BANKRUPTCY, ¶ 7001.12 (L. King 15th ed. 1991).

on the face of the clause. The clause requires that any "proceeding . . . to determine the validity . . . or extent . . . of a lien or other interest in property" be in the form of an adversary proceeding.

This argument should not prevail.⁵³ It is beyond dispute that cram down can be accomplished by simple motion to confirm the plan. There is no reason to believe that additional procedural safeguards are necessary when the cram down is accomplished before confirmation.

D. *Preemptive cram down can be accomplished on the court's own motion.* A bankruptcy court need not wait for a motion by an interested party before entering a preemptive cram down order. Instead, it can enter the order *sua sponte*.⁵⁴

Preemptive cram down *sua sponte* might be appropriate in a variety of situations. For example, our data indicate that the appointment of an equity committee is virtually the equivalent of a declaration that equity share of the distribution. Equity committees were appointed and organized to represent under water equity in 14 of 30 cases in our study.⁵⁵ In all 14 cases, equity was offered a share of the distribution.⁵⁶ That included the Braniff case, in which unsecured

⁵³First, the argument would lead to the absurd conclusion that cram down itself can be accomplished only through an adversary proceeding. The path to that conclusion is as follows: If an action is within the coverage of clause (2), it can be brought only in the form of an adversary proceeding. A plan proponent is not permitted to circumvent the procedural requirement by raising the same matter on a motion to confirm the plan. Thus, in the context of an action to avoid a lien under the strong arm provision of Bankruptcy Code § 544(a), it has been held that a motion to confirm a plan of reorganization cannot be used as a substitute. *Brady v. Andrew (In re Commercial Western Fin. Corp.)*, 761 F.2d 1329, 1337-38 (9th Cir. 1985). So also, if cram down against equity must be accomplished by adversary proceeding, the plan proponent should not be permitted to circumvent procedural requirements by raising the matter by motion to confirm the plan.

Second, even though the wording of clause (2) is broad enough to encompass an attempt to avoid a lien on the grounds that the collateral is of insufficient value, the clause has not been so interpreted. Instead, a distinction has been made between actions to determine what property is covered by a lien and actions to determine the value of property covered by a lien. *See, e.g., 9 COLLIER ON BANKRUPTCY*, ¶ 7001.05 (L. King 15th ed. 1990) (the advisory committee note to rule 3012 refutes the notion that a proceeding to value collateral is a proceeding to determine the extent of a lien). The courts are divided on this issue. *See In re Jablonski*, 88 B.R. 652 (E.D. Pa. 1988) (split of authority in the district over whether adversary proceeding or motion is proper procedural context for considering valuation and bifurcation issues in Chapter 13 cases); *Hollinrake v. Federal Land Bank (In re Hollinrake)*, 93 B.R. 183 (Bankr. S.D. Iowa 1988) (not necessary that action to avoid lien based on value of collateral be brought by adversary proceeding; motion is sufficient in context of Chapter 12 case).

In contrast to actions to avoid liens, which must be by adversary proceeding, actions to determine the value of property covered by a lien can be accomplished by motion. *FED. R. BANKR. P. 3012*.

⁵⁴11 U.S.C.A. § 105(a) (West Supp. 1991) provides in part:

No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, *sua sponte*, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.

⁵⁵*See* LoPucki & Whitford, *Bargaining Over Equity's Share*, *supra* note 1, at 142.

⁵⁶Plans providing a share for equity were confirmed in 13 of the 14 cases. In *Evans Products* the equity committee attempted to accept a plan that provided equity with a share worth in excess of \$18 million, but the committee's efforts were blocked by the controlling shareholder. *See* note 6.

creditors recovered only 4.9 cents on the dollar. To avoid unintentionally causing such deviations from the absolute priority rule, an inquiry should be made into equity's right to share in the distribution before the appointment of an equity committee. If equity's right to share is not at least plausible, not only should the court refuse to appoint an equity committee, but it should immediately enter a preemptive cram down order.

E. *Preemptive cram down can be based on affidavits or an evidentiary hearing.* Bankruptcy Rule 9014 contemplates that contested matters may be resolved under the procedures governing motions for summary judgment⁵⁷ or through the taking of testimony.⁵⁸

F. *Notice to equity holders.* What is ultimately at stake on the issue of motion versus adversary proceeding discussed above⁵⁹ is the practicality of preemptive cram down. In a large chapter 11 case there may be thousands of equity holders of record, many of whom are financial intermediaries such as brokers who hold the shares for beneficial owners who are their customers. If the bankruptcy courts were to determine that a request for preemptive cram down must be by adversary proceeding, it would not be clear whether the plaintiff could name the record owners as defendants or whether the plaintiff would have to name the beneficial owners.⁶⁰ If it were necessary to name the beneficial owners, preemptive cram down probably would not be feasible in cases in which stock was widely held. The clerical problems would be enormous.⁶¹ Even if it were sufficient to name the record owners, the plaintiff's burden would still be considerable. That burden would include naming perhaps thousands of defendants in the complaint, obtaining the issuance of separate process against each, serving that process by mail, making an affidavit of service and filing that affidavit

⁵⁷Bankruptcy Rule 9014 provides that, unless the court otherwise directs, Bankruptcy Rule 7056 applies in contested matters. Bankruptcy Rule 7056 provides that Rule 56 of the Federal Rules of Civil Procedure applies. Rule 56 provides for the entry of summary judgment when the documents filed in the cause show that there is no genuine issue as to any material fact and that the moving party is entitled to summary judgment as a matter of law. The taking of testimony is not required.

⁵⁸Bankruptcy Rule 9014 provides that, unless the court otherwise directs, Bankruptcy Rule 7052 applies in contested matters. Bankruptcy Rule 7052 provides that Rule 52 of the Federal Rules of Civil Procedure applies. Rule 52 provides for the finding of facts in actions tried without a jury.

⁵⁹The issue is discussed in the text accompanying notes 50-53, *supra*.

⁶⁰*See, e.g.,* Meckel v. Continental Resources Co., 758 F.2d 811 (2d Cir. 1985) (securities firm as registered holder of debentures, holding them in its own name on behalf of customers, had standing to sue as the signatory agent of the holders); *but see* cases cited in note 62, *infra*.

⁶¹The names and addresses of the equitable owners of securities are known only to the intermediaries. Even the intermediaries do not have ready access to this information. They must incur expense in searching their records to find the names and addresses of the beneficial owners. *See* Harris v. Peddle (*In re* Victor Technologies Sec. Litig.), 792 F.2d 862 (9th Cir. 1986). The plaintiff who sought to discover the names and addresses of the beneficial owners in order to name them as defendants would have to conduct a campaign for that purpose. The campaign probably would include extensive discovery.

with the court.⁶²

If preemptive cram down may be requested by motion, service of process is unnecessary. But the movant still must give notice to the equity holders. Three different notice provisions of the Bankruptcy Rules may be applicable:

1. Rule 2002(d)(6) requires notice to equity holders of the hearing to consider confirmation of a plan. This requirement should be held to apply to a hearing to consider preemptive cram down because preemptive cram down would have the same effect on equity holders as would confirmation.⁶³

2. Rule 3017(d) requires that a copy or summary of the plan and a copy of the disclosure statement be mailed to all equity security holders. By its terms, the rule applies only "upon approval of a disclosure statement." If a preemptive cram down order is entered prior to approval of the disclosure statement, the equity holders would already have lost their status as such. The proponent would not be required to send them copies of the plan and disclosure documents.

3. If a motion for cram down is regarded as a contested matter,⁶⁴ reasonable notice and an opportunity for a hearing must be afforded the party against whom relief is sought.⁶⁵

Regardless of which of these notice requirements applies, the court would have authority to designate "the time within which, the entities to whom, and the form and manner in which the notice shall be given."⁶⁶ Due process would,

⁶²FED. R. BANKR. P. 7004(a); FED. R. CIV. P. 4(a) and (g).

If the court requires an adversary proceeding, the plaintiff may be able to lighten its clerical burden through the mechanism of a class action. See FED. R. BANKR. P. 7023; FED. R. CIV. P. 23; *In re Mortgage & Realty Trust*, 125 B.R. 575 (Bankr. C.D. Cal. 1991) (certifying a class for the purpose of filing proof of claim in a chapter 11 case). However, substantial difficulties would remain. The plaintiff would have to give class members "the best notice possible under the circumstances." FED. R. CIV. P. 23(c)(1), as made applicable in the adversary proceeding by FED. R. BANKR. P. 7023. Once the matter is cast as a class action, it would appear that the notice must be given to the beneficial owners, and notice to the record owners would not be sufficient. *Harris v. Peddle (In re Victor Technologies Sec. Litig.)*, 792 F.2d 862, 863 (9th Cir. 1986) ("The beneficial owners have an interest in the lawsuit; the object of notification procedures is to notify them."); see also, *In re Mortgage & Realty Trust*, 125 B.R. 575 (Bankr. C.D. Cal. 1991). The plaintiff could send the notices to the record owners with requests that they forward them to the beneficial owners, but the plaintiff probably would have to pay the record owners' expenses of discovering the names and addresses of the beneficial owners in their own records and forwarding the notices to the beneficial owners. *Victor Technologies*, *supra*.

⁶³The requirement of notice under this rule applies "unless otherwise ordered by the court." FED. R. BANKR. P. 2002(d). The advisory committee note to the rule states: "The court may decide whether notice is to be given and how it is to be given." Under a literal reading of the note, it would appear that the court could dispense with Rule 2002(d) notices altogether, but to do so in the instance of preemptive cram down would violate due process. See notes 67 and 68 and accompanying text.

⁶⁴Arguably, an attempt at preemptive cram down would become a contested matter only when an equity holder objected. This argument is based on the analogy to objections to confirmation. See FED. R. BANKR. P. 3020(b)(1), which provides that an objection to confirmation is governed by Rule 9014.

⁶⁵FED. R. BANKR. P. 9014.

⁶⁶FED. R. BANKR. P. 9007.

however, require that notice be given and that it be reasonable.⁶⁷ Although notice by publication is provided for under the rules, it is doubtful that it would meet requirements of due process for equity holders whose names and addresses are available to the movant.⁶⁸

There remains the question whether it is sufficient to send notice of the hearing on the motion for preemptive cram down to equity holders of record or whether provisions must be made for notice to the beneficial owners. The issue is troubling.⁶⁹ But it is not peculiar to preemptive cram down. The issue arises whenever notices are sent to equity holders in chapter 11 cases. The simple solution is to raise it with the court upon making a motion for preemptive cram down.

G. *Corporate governance after a preemptive cram down.* After a preemptive cram down, directors and officers would no longer have a fiduciary duty to equity, and shareholders could not elect new directors. This is the meaning of a preemptive cram down order, as discussed above.⁷⁰ Officers and directors would have a fiduciary duty to creditors.⁷¹ If officers or directors performed in a manner that violated their duty of care or loyalty, creditors could sue.

Existing directors would continue to have the same authority to replace officers that they had prior to preemptive cram down, but nobody would have a right to elect new directors. This is no different than the situation that exists when shareholders are enjoined from electing new directors because it would constitute a "clear abuse" of the Bankruptcy Code, something bankruptcy courts

⁶⁷Reliable Electric Co. v. Olson Construction Co., 726 F.2d 620 (10th Cir. 1984) (the discharge of a claim without reasonable notice of a confirmation hearing violates due process.); Lubeck v. Littlefield's Restaurant Corp. (*In re Fauchier*), 71 B.R. 212, 215 (9th Cir. BAP 1987) ("Due process of law mandates notice be given to a creditor whose property rights are being affected so that he may have his day in court."); *In re Mortgage & Realty Trust*, 125 B.R. 575 (Bankr. C.D. Cal. 1991).

⁶⁸Mullane v. Central Hanover Bank & Trust Co., 339 U.S. 306 (1950) ("Where the names and post office addresses of those affected by a proceeding are at hand, the reasons disappear for resort to means less likely than the mails to apprise them of [the action's] pendency.")

⁶⁹One court has recently held that it is the beneficial owner of shares, not the holder of record, who is entitled to accept or reject the plan. *In re Southland Corp.*, 124 B.R. 211 (Bankr. N.D. Tex. 1991). While the logic of the opinion seems sound, the logical extension would seem to be that notices to equity holders must be sent to the beneficial owners. We doubt that this is currently the practice in the bankruptcy courts. If the practice of sending notices to the beneficial owners of equity rather than to the record owners were generally adopted in bankruptcy cases, the notice practices on preemptive cram downs would resemble that followed in shareholder class actions. See *Harris v. Peddle (In re Victor Technologies Sec. Litig.)*, 792 F.2d 862 (9th Cir. 1986). Subsection (e) was added to Bankruptcy Rule 3017 in 1991 in an attempt to give the bankruptcy court broad discretion in dealing with this problem.

⁷⁰See text accompanying note 29, *supra*.

⁷¹Once a corporation is insolvent, the better view is that there is a fiduciary duty to creditors. See, e.g., *Clarkson Co. Ltd. v. Shaheen*, 660 F.2d 506 (2d Cir. 1981), *cert. den.*, 455 U.S. 990 (1982); See also, *Case, Fiduciary Duty of Corporate Directors and Officers*, in ALLABA'S WILLIAMSBURG CONFERENCE ON BANKRUPTCY, CRITIQUE OF THE FIRST DECADE UNDER THE BANKRUPTCY CODE AND AGENDA FOR REFORM, at 373, 391 (1988).

This issue and others discussed in this section are more fully discussed in LoPucki & Whitford, *Corporate Governance*, *supra* note 2.

have done, albeit occasionally, for many years.⁷² Creditors dissatisfied with the manner in which the corporation is run could ask the bankruptcy court to appoint a trustee, however. Although it is often thought that a trustee can only be appointed for "cause," in fact the Bankruptcy Code permits appointment of a trustee "if such appointment is in the interests of creditors, any equity security holders, and other interests of the estate."⁷³ If equity security holders have already been eliminated in a preemptive cram down order, it would be appropriate for the court to appoint a trustee only if it would be "in the interests of creditors . . . and other interests of the estate."

H. *Relief from preemptive cram down orders.* There will undoubtedly be cases in which there has been an unexpected improvement in the debtor's business after a preemptive cram down order has been entered, but prior to confirmation. If the improvement is sufficient to entitle equity to a distribution, the equity holders could seek relief from the preemptive cram down order pursuant to Rule 60 of the Federal Rules of Civil Procedure.⁷⁴ Under that rule, the court would be authorized to grant relief from the preemptive cram down order for "any other reason justifying relief from the operation of the judgment."⁷⁵ If either the reorganization or liquidation value of the company increases to the extent that the extinguished equity interests are no longer under water, we believe that relief from the preemptive cram down order should be granted.

IV. THE APPROPRIATE USE OF PREEMPTIVE CRAM DOWN

A. *Generally.* Motions for preemptive cram down should not be used as a vehicle for litigating genuine disputes over solvency. Such use might increase the amount of litigation in reorganization cases; the intent of our proposal is to reduce it. If there is to be a full blown valuation hearing, it should take place at confirmation, after the parties have failed to reach a negotiated solution. Preemptive cram down should be used only in cases in which solvency is clear and will continue at least through the date of the confirmation hearing.⁷⁶

⁷²See *Johns-Manville Corp. v. Equity Security Holders Committee* (*In re Johns-Manville Corp.*), 66 B.R. 517 (Bankr. S.D.N.Y. 1986), *on remand from* 801 F.2d 60 (2d Cir. 1986); *Hartsell Mills Co. v. NLRB* (*In re Linihan*), 111 F.2d 590 (2d Cir. 1940). See also Gerber, *The Election of Directors and Chapter 11—The Second Circuit Tells Stockholders to Walk Softly and Carry a Big Lever*, 53 BROOKLYN L. REV. 295 (1987); Chou, *Corporate Governance In Chapter 11: Electing A New Board*, 65 AM. BANKR. L.J. 559 (1991).

⁷³11 U.S.C.A. § 1104(a)(2) (West 1979 & Supp 1991). This section is usually interpreted as requiring that the appointment of a trustee be in the interest of all the groups listed. See Nimmer & Feinberg, *Chapter 11 Business Governance: Fiduciary Duties, Business Judgment, Trustees and Exclusivity*, 6 BANKR. DEV. J. 1, 54-60 (1989).

⁷⁴See FED. R. BANKR. P. 9024.

⁷⁵FED. R. CIV. P. 60(b)(6).

⁷⁶It is not uncommon for a debtor to enter a period of insolvency and then emerge from it with equity intact. But if, under ordinary reorganization practice or preemptive cram down practice, a confirmation hearing is held during the period of insolvency, the equity interests can be extinguished. See 11 U.S.C.A. § 1129(b)(2)(B) and (C) (West 1979 & Supp. 1991). We do not intend that preemptive cram down increase equity's risk of extinguishment. We intend only that an extinguishment that could have occurred through later adjudication occur earlier.

We expect that this pattern of use will develop naturally, as parties to reorganization cases seek their own advantage. We base this prediction in part on our findings with regard to the use of cram down in current practice. Among the cases we studied, cram down was employed primarily against classes that were unlikely to appear in opposition.⁷⁷ Other cases were resolved through settlement. Only in the Evans Products case did equity holders appear and offer evidence in opposition to cram down.

We interpret the data to mean that plan proponents are reluctant to seek a cram down against any class of equity that might be able to mobilize in opposition. As plan proponents use it, cram down is not the clash of opposing armies: it is armies marching over undefended territory.

We anticipate the same reluctance in the use of preemptive cram down. Only when equity has no plausible argument for entitlement will other parties try to take the territory. When equity is plausibly entitled to share or when values are sufficiently volatile that equity may become entitled to share, the motion will be futile. If it is made anyway, the court should defer ruling. In such cases it will be, as it is under current practice, in the interests of all to bargain for a consensual plan.

B. *Against subordinate debt holders.* The reasons for allowing preemptive cram down against under water equity apply equally to subordinate debt that is under water. Preemptive cram down should be available against such classes of claims. Though nominally subordinate debt often appears to be under water in large reorganization cases, there probably will be few cases in which preemptive cram down can be successfully employed against it.⁷⁸ Unlike equity, whose only likely defense against cram down in the context of the large, publicly held company is likely to be valuation, subordinated debt typically has other plausible defenses.⁷⁹ Among the cases in our study, subordinated debt holders derived leverage from defenses based on equitable subordination, fraudulent conveyance and ambiguity in the subordination contract. Such defenses are

⁷⁷Plans were crammed down against 21 classes of claims or interests in the cases studied. Only three of those classes appeared at the confirmation hearing in opposition to cram down. Those classes were a secured creditor in Crystal Oil, securities fraud claimants in NuCorp and equity holders in Evans Products. LoPucki & Whitford, *Bargaining Over Equity's Share*, *supra* note 1, at 140.

⁷⁸There were several cases in our study in which subordinated debt was so far under water that its holders could not present a plausible case on valuation. In every one of those cases subordinated debt nevertheless obtained a share of the distribution.

⁷⁹The cases in our study commonly included allegations of transfers fraudulent as against the claims of subordinate debt. For example, the bondholders of a corporation in the debtor group would allege that assets of the corporation had been appropriated for the benefit of another corporation in the group. Such allegations usually resulted in compromise. These kinds of allegations were rarely made with regard to equity.

We do not assert that equity cannot raise defenses to cram down other than valuation; only that, among the cases in our study, they were much less likely to do so.

likely to cloud attempts at preemptive cram down against subordinate debt. When they are plausibly raised, bankruptcy courts can and should defer ruling on them until confirmation.

C. *Against shareholders of closely held companies.* Probably the large majority of the companies that file for reorganization under chapter 11 are owned by one or two persons who serve also as managers.⁸⁰ If such a company were clearly insolvent, theoretically creditors could obtain a preemptive cram down order. But, except in rare cases, they would have no reason to do so. Extinguishing the equity interest would have no significant effect on the owner/manager's leverage, which is derived from other sources.⁸¹ As was discussed above, preemptive cram down would prevent former equity holders from receiving or retaining property under the plan "on account of" their extinguished interests, but not on other accounts.⁸² The manager whose knowledge or continued service is essential to the survival of the business does not need rights as a shareholder to drive a hard bargain in plan negotiations.⁸³

D. *Preemptive cram down will not deprive equity of rights under the new value exception.* Even if the new value exception to the absolute priority rule remains viable,⁸⁴ equity holders have no "rights" under it.⁸⁵ The new value exception originated in the Los Angeles Lumber case.⁸⁶

It is, of course, clear that there are circumstances under which stockholders may participate in a plan of reorganization of an insolvent debtor Where [the necessity of seeking new money essential to the success of the undertaking] exists and the old stockholders make a fresh contribution and receive in return a participation reasonably equivalent to their contribution, no objection can be made.

Whether it survived the enactment of the Bankruptcy Code in 1978 remains in doubt.⁸⁷ Even if it does, there is no suggestion in the case law that it was

⁸⁰In an earlier study, one of us found that 26 of 35 corporate filers had either one or two shareholders. LoPucki, *The Debtor In Full Control*, *supra* note 32, at 118-19.

⁸¹See authorities cited *supra*, note 32.

⁸²See notes 31 to 33 and accompanying text.

⁸³See, e.g., *Gekas v. Pipin (In re Met-L-Wood Corp.)*, 861 F.2d 1012 (7th Cir. 1988) (shareholder-managers secretly purchased business at auction sale, court ratified sale after the identity of the purchasers was discovered).

⁸⁴*Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 203-04 n.3 (1988) ("Thus, our decision today should not be taken as any comment on the continuing vitality of the *Los Angeles Lumber* exception—a question which has divided the lower courts since passage of the Code in 1978."); *Kham & Nate's Shoes No. 2, Inc. v. First Bank*, 908 F.2d 1351, 1362 (7th Cir. 1990) ("Bank asks us to hold that the new value exception vanished in 1978. We stop short of the precipice, as the Supreme Court did in *Ahlers*")

⁸⁵Warren, *A Theory of Absolute Priority*, 1991 NYU ANN. SURV. AM. L. 9.

⁸⁶*Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106, 121 (1939).

⁸⁷See cases cited *supra*, note 84.

intended to create valuable rights in shareholders.⁸⁸

The better view, expressed by Professor Warren in a recently published article, is that the new value exception is not an exception in favor of the equity holders.⁸⁹

The "new value exception" to the absolute priority rule is inaptly named. It does not permit old equity to participate "on account of such junior claim or interest" which is flatly prohibited by statute. Nothing in the "new value exception" purports to permit old equity to gain any advantage based on its pre-bankruptcy equity ownership.

In Professor Warren's view, reorganization value is maximized by compelling these owner-managers to compete with other potential purchasers on as even a basis as possible.⁹⁰

Where the new value exception may be invoked,⁹¹ preemptive cram down can clarify the situation for outside bidders by extinguishing equity interests that are clearly under water. We make no claim that preemptive cram down will do anything to prevent insiders from abusing their roles as managers to

⁸⁸To the contrary, in considering the argument that the shareholders had surrendered valuable rights to litigate against the bondholders, the court in *Los Angeles Lumber* commented that, "As a result of the filing of the petition in this cases, the court, not the stockholders, acquired exclusive dominion and control over the estate. Hence any strategic position occupied by the stockholders prior to these proceedings vanished once the court invoked the jurisdiction."

⁸⁹Warren, *A Theory of Absolute Priority*, 1991 N.Y.U. ANN. SURV. AM. L. 9 ("The 'new value' exception modifies the Code rules by providing greater creditor protection than do the specific statutory rules."). Her view is in accord with the bankruptcy courts' descriptions of their dispositions of cases involving the new value exception. None appears to give equity any preference over other bidders for the company's assets. Instead, most stress the fact that efforts to attract outside bidders have failed. See, e.g., *In re Jartran, Inc.*, 44 B.R. 331, 379, 384-85 (Bankr. N.D. Ill. 1984) (permitting use of the new value exception in situation in which company had been shopped extensively and no alternative buyer could be found). Alternatively, they assert that the shareholders have defeated other bidders on a level playing field. See *Gekas v. Pipin (In re Met-L-Wood Corp.)*, 861 F.2d 1012 (7th Cir. 1988) (old shareholders secretly purchased company at auction sale); *In re Landau Boat Co.*, 13 B.R. 788 (Bankr. W.D. Mo. 1981) (equity holders who proposed to buy the company for \$100,000 of new value demonstrated fairness of their offer by giving creditors a right of first refusal at the same price).

⁹⁰See Warren, *supra* note 89. See also, Ryland, *Bracing for the "Failure Boom": Should a Revlon Auction Duty Arise in Chapter 11?*, 90 COLUM. L. REV. 2255 (1990) (advocating that management be under a duty to conduct an auction of the debtor company in appropriate cases); *In re Jartran, Inc.*, 44 B.R. 331, 379, 384-85 (Bankr. N.D. Ill. 1984) (permitting use of the new value exception in situation in which company had been shopped extensively and no alternative buyer could be found); *In re Landau Boat Co.*, 13 B.R. 788 (Bankr. W.D. Mo. 1981) (equity holders who proposed to buy the company for \$100,000 of new value demonstrated fairness of their offer by giving creditors a right of first refusal at the same price).

⁹¹The new value exception appears to play a negligible role in the reorganization of large, publicly held companies. In only one of the 43 cases in our study did old equity contribute new capital in return for an ownership interest in the emerging company. In *Towner Petroleum* the bulk of the company's assets were surrendered to secured creditors. The old shareholder then paid \$3 million for 75% of the shares of the company as it emerged from Chapter 11. In the remaining cases, a "new value exception" to the absolute priority was not applied in any form.

effectuate sales to themselves,⁹² but there is no reason to think that preemptive cram down will make the situation worse.

V. SUMMARY AND CONCLUSION

Based on data gathered in the context of the reorganization of large, publicly held companies, we have proposed a procedural innovation in the process of plan formulation. From our study, we found that the holders of under water equity interests frequently were permitted to share in the distribution under consensual plans. Surprisingly, the leverage that enabled them to share was not derived in any substantial part from doubts about valuation. In the large majority of cases it was clear at the outset of plan negotiations whether the equity interests would be entirely under water at confirmation. The leverage that enabled equity to share was derived in substantial part from the implicit or explicit threat that, if plan proponents did not offer them an adequate share in the distribution, equity would make trouble. Equity did make trouble in only a few cases, but, in many others, their capacity to do so nonetheless exacted its price.

We propose the entry of "preemptive cram down" orders extinguishing clearly under water equity interests early in reorganization cases. The proposal would make no change in substantive law. All the interests subject to elimination in a preemptive cram down would be from the larger set subject to elimination in a cram down at confirmation. Preemptive cram down is merely an early recognition of the fact that some equity interests are so far under water that the holders are no longer real parties in interest in the reorganization case.

Entry of a preemptive cram down order against a class of equity holders will sharply limit participation by the class in the reorganization case. Once the order has been entered, their role will be limited to attacks on the order by appeal or motion for relief from the order based on a change in circumstances. Directors and officers of the debtor company will neither be obligated nor permitted to represent the equity holders in the conduct of the business or in plan negotiations. The equity holders will no longer be parties in interest. Their leverage will be defused.

In responding to requests for preemptive cram down, bankruptcy lawyers and judges will encounter a number of issues of jurisdiction and procedure. We have anticipated and addressed some of them here. We have argued that the bankruptcy courts already have the power to issue preemptive cram down

⁹²Under current practice, the shareholders who utilize the new value exception are nearly always in day to day control of the debtor in possession. They are therefore in a position to facilitate unfairly what is in essence a sale of the company to themselves. See LoPucki, *STRATEGIES FOR CREDITORS IN BANKRUPTCY PROCEEDINGS*, § 11.11.2 (2d ed. 1991) (discussing the leverage that enables insiders to make a bargain transfer of the business); see also the discussion of *In re Landau Boat Co.*, 13 B.R. 788 (Bankr. W.D. Mo. 1981), which appears in LoPucki, *The Debtor in Full Control*, *supra* note 32, at 257.

orders, so that enabling legislation is not necessary; that a request for a preemptive cram down order can be by motion rather than by adversary proceeding; that it may be determined upon affidavits or pursuant to an evidentiary hearing; that notice of the preemptive cram down hearing must be given to each holder of an equity interest, but that notice can be given by mail and proof of service need not be made.

How effective preemptive cram down will be in addressing the problems identified in Part I of this article will depend in large part on how it is used. We advocate its use only in cases in which it is clear that the debtor is insolvent and will remain so for the duration of the case. If the solvency of the company is legitimately in dispute, the court should not attempt to resolve that dispute before confirmation. Preemptive cram down will make its contribution in the cases that go by default.

The logic of preemptive cram down applies to subordinated debt as well as equity. We do not, however, anticipate that there will be many cases in which it can be used successfully against subordinated debt. Preemptive cram down will work best in clear cases; subordinated debt exists in an environment that is usually cloudy.

Preemptive cram down will be available for use in the cases of closely held companies, but we do not expect much actual use will be made of it in those cases. Entry of a preemptive cram down order would not prevent the former shareholders from acquiring ownership of the emerging company pursuant to the new value exception to the absolute priority rule. But it would make clear that they do so entirely on the basis of their new contribution and not on account of their former status as shareholders.

Preemptive cram down is directed at a narrow range of cases. They are the ones in which equity is clearly under water but, under current practice, would be permitted a share in the distribution out of fear that they might otherwise disrupt the reorganization process. Preemptive cram down would enable parties to force the issue of entitlement expeditiously and early in the case. If employed skillfully by the courts, it has the potential to reduce deviations from the absolute priority rule, simplify plan negotiations, clarify the duties of management, and reduce the cost of reorganization.
