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An Agricultural Law Research Article

## **Rethinking Absolute Priority After *Ahlers***

by

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# RETHINKING ABSOLUTE PRIORITY AFTER *AHLERS*

*John D. Ayer\**

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## I. INTRODUCTION

There was no evident reason why the Supreme Court granted *certiorari* in *Norwest Bank Worthington v. Ahlers*.<sup>1</sup> It can be conceded that the issue was important: in the midst of an agricultural depression, a farmer was trying to hang onto his farm without paying the full amount of his bank debt. The farmer argued that he ought to be able to do so because he was offering to contribute "new value"<sup>2</sup> beyond what he was obliged to contribute — specifically, his efforts as a farmer.

The Eighth Circuit held, in effect, that he could do so and the Supreme Court (as became apparent) thought the Eighth Circuit was wrong.<sup>3</sup> But these facts alone hardly justify Supreme Court intervention. By common understanding, the Eighth Circuit decision was a maverick.<sup>4</sup> The issue was, on its face, statutory only. If the Supreme Court had any role, the obvious choice was simply to order summary reversal. The Court chose instead to address the issue head-on.

Now, the decision having been rendered, it is still not obvious just what the Court had in mind. The Court did reverse the Eighth Circuit — just as it might have in summary reversal. It held that the bank had a right to be paid in full before the farmer got anything — the so-called rule of "absolute priority." On the question of new value, the Court refused to hold that new value would never suffice to get around the rule. But it held that the contribution of labor, which the farmer offered in this case, would not be sufficient to take him out of the rule. Thus, by all appearances, the Court rendered judgment with an opinion which purports to add nothing to the law as it has been understood for fifty years. One is necessarily led to speculate as to just what the fuss was all about. It could be that the justices made a mistake: that they thought they saw an issue where in fact there

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1. 108 S. Ct. 963 (1988).

2. The use of the phrase "new value" is not standard, but it seems convenient for present purposes, and I will adopt it as a shorthand for the problem discussed here. On the related "no value" theory, see *infra* text accompanying notes 256-61.

3. *In re Ahlers*, 794 F.2d 388, 402 (8th Cir. 1986), *revd. sub nom.* *Norwest Bank Worthington v. Ahlers*, 108 S. Ct. 963 (1988). The district court held that the plan was not confirmable under the circumstances. See *Ahlers*, 794 F.2d at 393. Reversing and remanding, the Eighth Circuit had outlined what it conceived of as a confirmable plan. *Ahlers*, 794 F.2d at 399.

4. One bankruptcy court had taken a position apparently consistent with the Eighth Circuit. See *In re Star City Rebuilders, Inc.*, 62 Bankr. 983, 988 (Bankr. W.D. Va. 1986). Within months after the Eighth Circuit decision, a lower court in the same circuit found it possible to distinguish *Ahlers*. See *In re Baugh*, 73 Bankr. 414, 418-20 (Bankr. E.D. Ark. 1987). The eccentricity of the Eighth Circuit in *Ahlers* marks a contrast between this issue and the issue of "opportunity cost" in *United Sav. Assn. v. Timbers of Inwood Forest, Ltd.*, 108 S. Ct. 626 (1988), where the Supreme Court, just a few weeks earlier, resolved a genuine, active, current conflict among circuits.

turned out to be none.<sup>5</sup> It could be that they wanted to head off a spasm of judicial sympathy for debtors in the farm belt.

Or it could be anything. Speculation of this sort, in the absence of hard evidence, is necessarily futile. What is not futile, however, is an effort to understand the *Ahlers* opinion itself, which remains a force to contend with in Supreme Court bankruptcy jurisprudence. And the opinion is important in at least two ways. First, the opinion offers a striking insight into the way the Court approaches bankruptcy law — which conceptual tools it chooses to use, and which it chooses to ignore. Specifically, it is remarkable just how narrowly the justices defined the issue before them — how completely they chose to make it an issue of statutory construction only, resisting or ignoring any possible constitutional tincture.

Of greater practical interest is the Court's handling of the problem of new value. The Solicitor General asked the Court to hold that there is no new value rule under the new Bankruptcy Code. The Court refused to go that far, saying that it was taking no position on whether there is such a rule. But on closer scrutiny, it appears that the Court, advertently or otherwise, at least sharply restricted the use of the new value rule in future cases. Even more intriguing, a review of *Ahlers* in context raises a question as to whether there ever was a conceptual basis for the new value rule, at least as conventionally understood.

Both of these points require a fairly extensive sojourn into history. For *Ahlers* is a case with a past, as well as a future. Thus, in Part II, I sketch the history of the absolute priority doctrine. I undertake to show also how the Supreme Court had available two very different paths to its result — one constitutional, one statutory. And I offer a few thoughts on the relationship between the two. In Part III, I address myself directly to the new value rule. I try to show that it is a rule whose parentage is at best questionable. I also try to give an account of what a new value rule might look like. In that context, I suggest that Justice White may have invalidated any new value rule that did exist, and indeed, that there may never have been any adequate basis for such a principle.<sup>6</sup>

## II. ABSOLUTE PRIORITY

### A. *Ahlers on Absolute Priority*

On its face, *Ahlers* is simply a case of a farmer struggling to keep

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5. For an unsupported hypothesis, see the discussion *infra* at Part III.A.

6. The court granted partial *certiorari* in *Norwest Bank Worthington v. Ahlers*, 107 S. Ct. 3227 (1987).

his farm.<sup>7</sup> James and Mary Ahlers farmed 840 acres in southwestern Minnesota, on the edge of the grain belt of the Great Plains. They owed \$525,854 to the Federal Land Bank (FLB), on four separate loans secured by four separate parcels of farmland, and owed \$450,468 to Norwest. Norwest held a junior security interest (behind the FLB) on the land, and a senior security interest on some machinery and equipment. The Ahlerses also owed smaller sums on purchase-money security interests to equipment suppliers and (apparently) a small amount of unsecured trade debt.

When Ahlers fell behind in his payments on these debts, Norwest attempted to replevy the equipment, prompting Ahlers to file for protection under Chapter 11 of the Bankruptcy Code, which would have automatically stayed the collection actions. FLB and Norwest both asked the court for relief from the automatic stay and for adequate protection of their security interests. Norwest also continued its pre-bankruptcy replevin action in the bankruptcy court. The bankruptcy court, finding that the Ahlerses could not give adequate protection, granted relief from the stay, and also granted Norwest the right to replevin. The district court affirmed, and also reviewed a plan of reorganization proposed by the Ahlerses. The district court found that the plan had no reasonable prospect of success.

The court of appeals reversed, holding that the district court erred both in defining adequate protection, and in holding the reorganization unfeasible. The court also took the extraordinary step, on its own initiative, of outlining a possible plan of reorganization that it felt might win confirmation by creditors.<sup>8</sup> Under the court plan, secured claims would have been fully paid with interest over a thirty-year period. Unsecured claims would have been fully paid without interest.

FLB and Norwest objected to confirmation, relying on the so-called absolute priority rule. This rule provides, as stated by the court, "that a dissenting class of unsecured creditors must be provided for in full before any junior class can receive or retain any property under the plan."<sup>9</sup> The Bankruptcy Code (the "Code") codifies this rule,<sup>10</sup> and all parties agreed that the Code partially codifies Supreme Court case law dating back over seventy-five years as well.<sup>11</sup>

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7. This statement of facts derives primarily from the opinion of the Court of Appeals. *In re Ahlers*, 794 F.2d 388, 392-93 (8th Cir. 1986), *rehg. denied*, 794 F.2d 414 (1986), *revd. sub nom. Norwest Bank Worthington v. Ahlers*, 108 S. Ct. 963 (1988).

8. This "suggested" plan is presented as an appendix to the circuit court opinion. *Ahlers*, 794 F.2d at 408-14.

9. 794 F.2d at 401.

10. 11 U.S.C. § 1129(b)(2)(B) (1982 & Supp. 1986).

11. *See Northern Pac. Ry. v. Boyd*, 228 U.S. 482, 504-05 (1913); *Case v. Los Angeles Lum-*

The creditors argued, and the court agreed, that the creditors' unsecured deficiency claim would not be paid in full.<sup>12</sup> Hence, the creditors argued that it was unlawful for the Ahlerses to keep anything under the plan. The Eighth Circuit accepted the analysis but rejected the conclusion. Relying on Supreme Court precedent, it reasoned that there is a "modification"<sup>13</sup> to the absolute priority rule that would allow the Ahlerses to participate in the plan. Specifically, the Ahlerses might participate if they contributed something to the reorganized enterprise "that is reasonably compensatory and is measurable"<sup>14</sup> — the so-called new value principle.<sup>15</sup> In a 2-1 decision, the court held that the Ahlerses' "farm operation and management skills" constituted new value. A sharply divided court denied rehearing en banc.<sup>16</sup>

The Supreme Court granted *certiorari*, on the absolute priority question only.<sup>17</sup> A unanimous Supreme Court, Justice White writing, reversed. Justice White's opinion can be tightly summarized. He held that the Ahlerses' promise of future labor did not justify an exception to the absolute priority rule. But for a fuller appreciation of his rationale, it is useful to identify four separate points in the opinion, as follows:

First: Justice White accepted as binding the principle of absolute priority as codified in the Bankruptcy Code.<sup>18</sup> This is hardly surpris-

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ber Prods. Co., 308 U.S. 106, 119-22 (1939). A good case can be made for the proposition that the rule goes back much further. See, e.g., Louisville Trust Co. v. Louisville, New Albany and Chicago Ry., 174 U.S. 674-84 (1899); Chicago, Rock Island & Pac. RR. Co. v. Howard, 74 U.S. (7 Wall.) 392, 411 (1868). See also *infra* text accompanying notes 26-66.

12. The opinion doesn't spell out the point, but the crux is that the court plan provided for payment of the nominal amount of the unsecured claims, but in installments over 10.5 years without interest. 794 F.2d at 413. If the "effective" rate is anything above zero, then the creditors are not being paid in full.

13. See *Ahlers*, 794 F.2d at 401 ("[T]he Supreme Court specifically recognized that there may be circumstances in which the absolute priority rule could be modified . . ."). Justice White refers to "an 'exception' or 'modification' to the absolute priority rule . . ." *Ahlers*, 108 S. Ct. at 966. To what extent this new value principle is a "modification," an "exception," or simply implicit in the rule is an issue discussed *infra* at Part III.B.

14. *Ahlers*, 794 F.2d at 402.

15. The court relied, *inter alia*, on *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106 (1939); *Kansas City Terminal Ry. v. Central Union Trust Co.*, 271 U.S. 445 (1926); and also on *In re U.S. Truck Co.*, 47 Bankr. 932 (Bankr. E.D. Mich. 1985); *In re Marston Enters.*, 13 Bankr. 514 (Bankr. E.D.N.Y. 1981); and *In re Landau Boat Co.*, 13 Bankr. 788 (Bankr. W.D. Mo. 1981). *Ahlers*, 794 F.2d at 401-03.

16. 794 F.2d 414 (1986). There were two dissenting opinions in the 5-4 vote. 794 F.2d at 415.

17. *Ahlers*, 107 S. Ct. 3227 (1987).

18. 11 U.S.C. § 1129(b)(2)(B) (1982 & Supp. 1986). The debtors had advanced various arguments to the effect that the absolute priority rule should not apply in a case like this, but Justice White gave them short shrift. Of particular interest is Justice White's summary dismissal of the argument that there is some sort of "roving commission" to do equity in bankruptcy cases: "[W]hatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code." See *Ahlers*, 108 S. Ct. at 968-69.

ing: indeed, no one really challenged it. But it is nonetheless an essential building block for understanding his analysis.

Second: Justice White accepted, for purposes of analysis, that there is a new value exception to the absolute priority rule. Some of the briefs, particularly that of the Solicitor General, had urged him to hold that there was no such exception under the Bankruptcy Code,<sup>19</sup> but Justice White refused to go so far.

Third: Justice White found that the Ahlerses' "labor, experience and expertise"<sup>20</sup> were not a sufficient contribution to permit them to keep their farm, in a case where they were paying the bank less than the full amount owed. Justice White thus treated the case as "analogous" to *Case v. Los Angeles Lumber Products Co.*,<sup>21</sup> which everyone conceded is the leading case in the field.

Finally, Justice White rejected one more of the Ahlerses' arguments, which is related to, but separate from, the arguments discussed so far. Specifically, the Ahlerses argued that the Bank wasn't being deprived of anything because the Bank was getting all it could have gotten for the farm in liquidation. Thus, the interest they wished to retain had no value to the Bank. Justice White identified and rejected this "no value" theory, as he called it.<sup>22</sup> Even so, the implications of that rejection are probably far more important than the opinion suggests — perhaps more than even he understood, as will be discussed below in Part III.

### B. *Our Two Laws of Absolute Priority*

The first remarkable fact about *Ahlers* is its doctrinal posture. The court — and indeed, all of the parties and *amici* — treated it as a problem under the absolute priority rule, developed in a well-known series of cases and crystallized in Bankruptcy Code section 1129(b)(2)(B). I shall label this the "statutory" line of cases. While this is a perfectly legitimate way to approach the issue, there is a wholly separate body of doctrine more closely suited to the facts of *Ahlers*, which arose to deal with the regulation of farm foreclosures in the Great Depression of the 1930s. This separate body of doctrine treats the problem as involving the taking of property, governed by the

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19. See Brief for the United States as Amicus Curiae Supporting Petitioner at 17-20, *Norwest Bank Worthington v. Ahlers*, 108 S. Ct. 963 (1988) (No. 86-958).

20. 108 S. Ct. at 966 (quoting *In re Ahlers*, 794 F.2d at 403).

21. 308 U.S. 106 (1939). See *Ahlers*, 108 S. Ct. at 967 ("*Los Angeles Lumber* itself rejected an analogous proposition . . .").

22. 108 S. Ct. at 969.

due process clause of the fifth amendment to the Constitution;<sup>23</sup> I shall label this the “constitutional” line of cases.

The Court in *Ahlers* never even considered this constitutional line, although there may be good reasons for its adherence to the statutory line. It is an accepted tradition that the courts “do not review issues, especially constitutional issues, until they have to.”<sup>24</sup> In *Ahlers*, the Court had available a statutory formula which could be made to fit the facts. By holding only that labor does not constitute new value, the Court avoided any decision concerning whether absolute priority was constitutionally mandated. In so doing, it avoided a constitutional determination concerning the new value rule. Additionally, the courts (and the commentators with them) have always kept these two lines of authority in separate, water-tight compartments with only trifling seepage between the two. Trifling as it is, this seepage links these divergent principles.

### 1. *The Statutory Line*

The first point to be understood about the “statutory line” is that it is not “statutory” — or at best, is statutory only incidentally and belatedly. To Justice White, the issue in *Ahlers* turned on the language of the Bankruptcy Code.<sup>25</sup> But the Code’s language must be read under layers of case law that run back more than 100 years.<sup>26</sup>

The early history of the absolute priority rule has been told before and can be quickly recapitulated here. The rule arose in the context of the equity receivership.<sup>27</sup> The equity receivership, in turn, is bound up

23. U.S. CONST. amend. V.

24. *Joint Anti-Fascist Refugee Comm. v. McGrath*, 341 U.S. 123, 154-55 (1951) (Frankfurter, J., concurring). See *Ashwander v. Tennessee Valley Authority*, 297 U.S. 288, 341 (1936) (Brandeis, J., concurring).

25. See 11 U.S.C. § 1129(b)(2)(B)(ii) (Supp. IV 1987).

26. Justice White stated that the absolute priority rule “had its genesis in judicial construction of the undefined requirement of the early bankruptcy statute that reorganization plans be ‘fair and equitable.’” 108 S. Ct. at 966. For this proposition, he cited *N. Pac. Ry. Co. v. Boyd*, 228 U.S. 482, 498 (1913), and *Louisville Trust Co. v. Louisville, N.A. & C. Ry. Co.*, 174 U.S. 674, 677 (1899). He was on the right track, but he didn’t get it quite right. In fact, both *Boyd* and *Louisville Trust* are equity receivership cases, where the court exercised its pre-*Erie* power to fashion commercial law. Statutory interpretation comes in with *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106, 114 (1939).

27. The literature on equity receiverships is vast, although it is hard to find a tight summary in any single source. The “official” version, though not readily accessible, is in SECURITIES AND EXCHANGE COMMISSION, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES (1937-1939) [hereinafter PROTECTIVE COMMITTEE STUDY]. See also Sabel, *Equity Jurisdiction in the United States Courts with Reference to Consent Receiverships (pts. 1 & 2)*, 19 IOWA L. REV. 406, 540 (1934); Note, *The Propriety of Friendly Receiverships in the Federal Courts*, 43 HARV. L. REV. 1298 (1930); Note, *Consent Receiverships*, 81 U. PA. L. REV. 979 (1933); Comment, *Equity Receiverships in Federal Courts*, 27 ILL. L. REV. 542 (1933). For “textbook” accounts, see 1 R.



with the building of the railroads. From the Civil War until World War II, investors repeatedly built railroads that could not generate operating revenues sufficient to service their debt.<sup>28</sup> Picture a railroad that borrows \$100 to lay down rail lines and build stations, selling \$100 worth of bonds and giving the creditor-bondholder a senior mortgage on all the plant and equipment. Suppose the interest rate is 5%: Thus, the road needs \$5 of revenue per year just for debt service. Suppose the railroad also owes an additional \$20 to junior, unsecured trade creditors. Suppose the railroad generates only \$4 a year of income above operating costs. One way of interpreting these numbers is to say that the plant and equipment are “worth” no more than \$80 — \$4 per year capitalized at 5%. One solution to the problem would be simply to “give” the railroad to the bondholders. They lose \$20 on their \$100 investment, but they capture the whole value of the enterprise, and junior interests, including trade creditors and stockholders, are extinguished.

But the equity receivership didn't work that way. Instead, a “creditor,” often in collusion with management, would file a proceeding in federal court, alleging that the debtor was unable to pay its debts as they matured. He would ask the court to use its equity power to administer the property for the satisfaction of claims, and to appoint a receiver to keep the business going in the meantime: hence, “equity receivership.”<sup>29</sup> The debtor would consent. Eventually, the receiver would “sell” the assets to a “new” entity — typically a reshuffling of the old investors. The price would be lower than the amount of the senior debt — in the current example, the buyers might agree to pay \$30 for a railroad “worth” \$80. The money would go to senior bondholders, but they would receive less than the total of their claim (\$100) and less even than the nominal worth of the road (\$80). Unsecured creditors would be eliminated, but the “new” entity, controlled by stockholders of the “old,” would emerge with a company worth \$80, for which they had paid only \$30.

One may well ask why creditors would ever assent to such a deal,

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CLARK, A TREATISE ON THE LAW AND PRACTICE OF RECEIVERS § 188 (2d ed. 1929); 1 J. GERDES, CORPORATE REORGANIZATIONS §§ 11-12 (1936); G. GLENN, THE LAW GOVERNING LIQUIDATION § 172 (1935). Racier, nontechnical accounts may be found in E. HOWARD, WALL STREET FIFTY YEARS AFTER ERIE (1923); M. LOWENTHAL, THE INVESTOR PAYS (1933).

28. A leading reorganization lawyer noted in 1927 that as of March, 1916, 16% of the nation's total rail mileage (80 railroads, 42,000 miles) was in receivership; at the end of 1925 these figures were 48 railroads with 18,000 miles of track. Swaine, *Reorganization of Corporations: Certain Developments of the Last Decade*, 27 COLUM. L. REV. 901, 901 (1927).

29. The validity of the practice seems to have been established by *In re Metropolitan Ry. Receivership*, 208 U.S. 90 (1908). See also the comments of Judge Learned Hand in *Luhrig Collieries Co. v. Interstate Coal & Dock Co.*, 281 F. 265, 268-70 (S.D.N.Y. 1922).

let alone collude in it. There are two reasons. One is the price of justice: old shareholders found out that they could always raise objections which, however invalid, might cost time and money to litigate. So seniors often found it cheaper to buy them off than to insist on their rights.<sup>30</sup> A far more important reason is that the typical reorganization was controlled by "managers" — insiders who had an interest both in bonds and in stock. For the insider-managers, it didn't matter if they lost on bonds if they gained on stock. This approach is innocent enough for those who hold both bonds and stock, but it is devastating to those who do not. In particular, this approach damages two groups. One is the unsecured trade creditors. The other group is the noninsider bondholders, not part of the management ring, who don't hold stock and who don't have the inducement of the managers to trade away their bond interest.<sup>31</sup>

This *modus vivendi* collapsed during the Great Depression under the weight of the investor protective legislation implemented by the New Deal.<sup>32</sup> Those regulatory changes have become so pervasive that they are almost part of the air we breathe. To understand the absolute priority rule, it is necessary to recognize that it emerged first as a primitive pre-statutory effort to regulate receiverships in the judicial process.

In the chronicle of case law, the critical juncture is *Northern Pacific Railway Co. v. Boyd*, decided 5-4 by the Supreme Court in 1913.<sup>33</sup>

30. The classic case seeking to restrict the debtor's power to litigate creditors into submission is *Fleischmann & Devine, Inc. v. Saul Wolfson Dry Goods Co.*, 299 F. 15 (5th Cir. 1924). *Fleischmann* is not an equity receivership case; it can be thought of as a precursor of the "best interests" liquidation test of Bankruptcy Code § 1129(a)(7). 11 U.S.C. § 1129(a)(7) (1982). See also SEC v. Canandaigua Enters. Corp., 339 F.2d 14 (2d Cir. 1964); PROTECTIVE COMMITTEE STUDY, *supra* note 27, at pt. 8, § 72.

31. For a dramatic instance of court-sanctioned minority victimization, see *Aladdin Hotel Co. v. Bloom*, 200 F.2d 627 (8th Cir. 1953).

32. See, e.g., Glass-Steagall Act of 1933, ch. 89, 48 Stat. 162 (1933) (codified as amended at 12 U.S.C. § 378 (1982)); Public Utility Holding Company Act of 1935, ch. 687, tit. I, 49 Stat. 803 (1935) (codified as amended at 15 U.S.C. § 79k (1982 & Supp. IV 1986)); Investment Company Act of 1940, ch. 686, tit. I, 54 Stat. 789 (1940) (codified as amended at 15 U.S.C. § 80a-1 to -64 (1982 & Supp. IV 1986)); Chapter X of the old Bankruptcy Act, codified in former 11 U.S.C. §§ 501-676 (repealed 1978); Trust Indenture Act of 1939, ch. 411, 53 Stat. 1149 (1939) (codified as amended at 15 U.S.C. § 77aaa-yyy (1982)). See MEMORANDUM OF HOMER KRIPKE, REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 137, 93d Cong., 1st Sess. 359-61 (1973). On the courts' declining enthusiasm for equity receiverships, see *First Natl. Bank of Cincinnati v. Flershem*, 290 U.S. 504 (1934); *New England Coal & Coke Co. v. Rutland R.R. Co.*, 143 F.2d 179 (2d Cir. 1944).

33. 228 U.S. 482 (1913). The Northern Pacific is intimately involved in the history of railroad and corporate finance. Chartered in 1884, the railroad went through receivership twice, first in 1873 and then again (the case cited here) in 1893. For a detailed summary of the Road's finances in the second receivership, see *Northern Pac. Ry. Co. v. Boyd*, 177 F. 804, 817 (9th Cir. 1910). The 1893 reorganization took place under the aegis of J.P. Morgan, the banker, and J.J. Hill, of the competing Great Northern Railway Company. In 1901, the Northern Pacific, the Great Northern Railway, and the Chicago, Burlington & Quincy were brought together in the

Boyd was a general creditor of the Northern Pacific Railroad. The "Road" asserted that it was not liable, in that all of its property had been transferred (via receivership) to the Northern Pacific Railway.<sup>34</sup> Boyd then sued the Railway, which, of course, claimed that it was insulated in that it had purchased the assets via a bona fide receivership. But by the Court's account, the receivership sale was in fact a transfer engineered by the old bondholders and stockholders from themselves and to themselves, "squeezing out" the intermediate unsecured debt. The Court held that such a sale cannot defeat the claim of a nonassenting creditor. As against him the sale is void in equity, regardless of the motive with which it is made.<sup>35</sup> As the Court put it: "[I]f purposely or unintentionally a single creditor was not paid, or provided for in the reorganization, he could assert his superior rights against the subordinate interests of the old stockholders in the property transferred to the new company."<sup>36</sup>

The decision sent chills of terror down the spines of the corporate reorganization bar.<sup>37</sup> It may be hard to see why. The Supreme Court prefigured the *Boyd* decision in the so-called "*Monon*" case just fourteen years before.<sup>38</sup> And the *Boyd* Court found the same principle in another case a half century earlier.<sup>39</sup> Moreover, Boyd's claim seemed peculiarly appealing because it dated back twenty-seven years; he and his predecessor had been pursuing it like the fat man pursuing the Maltese falcon. And while the Supreme Court expressly refused to find any "fraud" in the proceeding,<sup>40</sup> the Court's own summary sug-

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Northern Securities Company, also controlled by Morgan and Hill with others. In the *Northern Securities Case*, the United States Supreme Court ordered the dissolution of the company. The Northern Pacific thereupon reverted to its former status, in which form it remained until it became part of Burlington Northern, Inc., in 1970. See generally User's Guide to the Northern Pacific Papers in the holdings of the Minnesota Historical Society, Northern Pacific Railway Company Papers, Part I, 1864-1922 (W. White ed. 1985).

34. The flummery over name changes in equity receiverships may account for one of the more cherished arcana in the Bluebook — the distinction between the abbreviation used in citing the name of a Railroad (R.R.) and that used in citing the name of a Railway (Ry.). A UNIFORM SYSTEM OF CITATION R.10.2.2(a) (14th ed. 1986).

35. *Boyd*, 228 U.S. at 502.

36. 228 U.S. at 504.

37. "The *Boyd* case was received by the reorganization bar and bankers with something akin to horror. It has been a nightmare to the lawyer who presents a decree for the sale of property to a reorganization committee." Rosenberg, *Reorganization — The Next Step*, 22 COLUM. L. REV. 14 (1922). See generally Cravath, *The Reorganization of Corporations; Bondholders' and Stockholders' Protective Committees; Reorganization Committees, and the Voluntary Recapitalization of Corporations*, in SOME LEGAL PHASES OF CORPORATE FINANCING, REORGANIZATION AND REGULATION 191-98 (The Association of the Bar of the City of New York ed. 1917).

38. *Louisville Trust Co. v. Louisville, New Albany and Chicago Ry. Co.*, 174 U.S. 674 (1899).

39. 228 U.S. at 505 (citing *Railroad Co. v. Howard*, 74 U.S. (7 Wall.) 392 (1868)).

40. 228 U.S. at 503-04.

gests that Boyd had bought himself, at the very least, a persistent, determined, and resilient foe.

On the other hand, *Boyd* itself was a bare five-four majority: four judges, while not rejecting the principle, indicated that they felt the fairness of the plan had been well ventilated by other creditors in the original proceeding.<sup>41</sup> They treated *Boyd* as something of a spoilsport, like the guest who arrives late at the wedding and tells stories about the bride just as the festivities are about to begin. Under the circumstances, lawyers may have been justified in seeing the Supreme Court as more insistent on the principle than it had been before.

In any event, absolute priority thereafter passed into the language and lore of the corporate lawyer.<sup>42</sup> But ingrained practice seems to have proved stronger than writ, as reorganization lawyers developed elaborate schemes to circumvent or emasculate the rule. Thus, counsel developed the practice of getting the reorganization court to bless the deal, with the intent of barring later objections.<sup>43</sup> Some courts seem to have assumed (in the teeth of *Boyd*) that acceptance by a substantial majority of senior creditors gave evidence of the fairness of the plan.<sup>44</sup> And reorganization managers learned how to engineer the process so as to discourage dissent.<sup>45</sup> Fifteen years after *Boyd*, two scholars were able to argue that corporate practice recognized two priority rules — a rule of absolute priority, à la *Boyd*, and a rule of “relative” priority, functioning in practice much like the informal “share” scheme that obtained before *Boyd*.<sup>46</sup> And then there was the wild-card uncertainty of new value, discussed in Part III below. Moreover, Congress complicated matters during the Great Depression by adopting legislation to supplant the equity receivership, without really clarifying how it wanted to deal with the new value problem.<sup>47</sup>

41. 228 U.S. at 511-15 (Lurton, J., dissenting).

42. The first important use of the term seems to have occurred in Bonbright & Bergerman, *Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization*, 28 COLUM. L. REV. 127, 130 (1928).

43. See Swaine, *supra* note 28, at 907-11.

44. *Jameson v. Guaranty Trust Co.*, 20 F.2d 808, 815 (7th Cir. 1927); *Samuels v. Northeastern Pub. Serv. Co.*, 20 Del. Ch. 204, 211, 174 A. 127, 130 (Del. Ch. 1934).

45. Weiner, *The Conflicting Functions of the Upset Price in a Corporate Reorganization*, 27 COLUM. L. REV. 132 (1927), outlines the process by which the upset price, designed as a method for protecting debtors, evolved into a device for scotching dissent.

46. Bonbright & Bergerman, *supra* note 42. Bonbright, who first embraced the relative-priority alternative, later repented and called for “the strictest feasible enforcement of the absolute-priority idea.” 2 J. BONBRIGHT, *THE VALUATION OF PROPERTY* 868 n.64 (1937).

47. Particularly, Act of March 3, 1933, ch. 204 § 77, 47 Stat. 1467, 1474 (repealed 1978); Act of June 7, 1934, ch. 424, § 77B, 48 Stat. 911 (repealed 1938) (corporate reorganizations).

*Downtown Inv. Co. v. Boston Metro. Bldgs., Inc.*, 81 F.2d 314 (1st Cir. 1936), held that the absolute priority rule did not apply under § 77B. See Dodd, *The Securities and Exchange Commission's Reform Program for Bankruptcy Reorganizations*, 38 COLUM. L. REV. 223, 236 (1938).

That was the situation as it stood when the Supreme Court decided *Case v. Los Angeles Lumber Products Co.* in 1939.<sup>48</sup> The facts of *Case* are simple: the debtor holding company had liabilities of \$3.8 million and held a subsidiary that owned the Los Angeles Shipyard and Drydock — an asset valued at \$830,000. The plan was to cancel old securities and issue new ones in their place. Some twenty-three percent of the new securities would go to the former stockholders.<sup>49</sup> Both lower courts confirmed the plan, but a unanimous Supreme Court<sup>50</sup> reversed.

The case is both historically and doctrinally important. In terms of political history, the case marks a milestone in the career of Justice William O. Douglas, who wrote the opinion for the unanimous Court. Douglas had served on the Court less than a year at the time of the decision, having come from the chairmanship of the Securities and Exchange Commission.<sup>51</sup> At the SEC, he was one of the principal architects of the New Deal corporate law reforms, and one of the authors of Chapter X of the Bankruptcy Act.<sup>52</sup> His opinion adopts much of the substance of an *amicus* brief filed by the SEC.<sup>53</sup>

As an instance of decisionmaking strategy, the case is noteworthy because it is the first major absolute priority case in which the Court interprets a statute. And indeed, Justice Douglas' interpretation has become so rooted in the culture of the law that it is a surprise to note just how attenuated it is. For the statute — Bankruptcy Act, section 77B, the precursor of Chapter X — nowhere states that claims must be paid by a principle of absolute priority.<sup>54</sup> Instead, Justice Douglas

48. 308 U.S. 106, *rehg. denied*, 308 U.S. 637 (1939).

49. 308 U.S. at 112. The 23% figure seems imprecise, but it is close enough for present purposes.

50. Justice Butler did not participate.

51. Indeed, Justice Douglas' participation in *Case* carries just a hint of that kind of partisanship which, in a later generation, might have given rise to an imputation of impropriety. Justice Douglas was sworn in on April 17, 1939, succeeding Justice Brandeis, who resigned on February 13, 1939. See J. SIMON, *INDEPENDENT JOURNEY* 192, 199 (1980). The Supreme Court granted *certiorari* in *Case* on May 22, 1939. Billyou points out that the SEC was on record supporting absolute priority as early as January, 1939. Billyou, *Priority Rights of Security Holders in Bankruptcy Reorganization: New Directions*, 67 HARV. L. REV. 553, 563 n.31 (1954).

52. See generally Hopkirk, *William O. Douglas — His Work in Policing Bankruptcy Proceedings*, 18 VAND. L. REV. 663 (1965); Jennings, *Mr. Justice Douglas: His Influence on Corporate and Securities Regulation*, 73 YALE L.J. 920, 934-951 (1964). Justice Douglas, in his autobiography, says that he wrote Chapter X along with Abe Fortas and U.S. Rep. Walter Chandler. See W. DOUGLAS, *GO EAST, YOUNG MAN* 260 (1974). His biographer recounts that Douglas' mother, as an impoverished widow, had lost money that she entrusted to a lawyer for investment. See J. SIMON, *supra* note 51, at 27.

53. See Brief for the United States as Amicus Curiae, *Case v. Los Angeles Lumber Prods.*, 308 U.S. 106 (1939) (Nos. 23 & 24).

54. Pub. L. No. 73-296, 48 Stat. 912 (1933) (repealed 1978).

deploys a provision in subsection (f), which provides that a plan must be "fair and equitable." These words, Justice Douglas writes, "are words of art which prior to the advent of Section 77B had acquired a fixed meaning through judicial interpretations in the field of equity receivership reorganizations."<sup>55</sup> Strictly speaking, this is poppycock, and Justice Douglas knew it. None of the Supreme Court's absolute priority cases used that particular phrase in that particular way. Indeed, Justice Douglas himself cites only one prior use of the term in case law, and that is in an appellate opinion which the Supreme Court later overturned.<sup>56</sup> On the other hand, the question was at least open, and it was reasonable to infer that the drafters intended to import at least some kind of absolute priority rule into Section 77B.<sup>57</sup>

But what kind of rule? Substantively, the remarkable fact about *Case* is that over ninety percent of all bondholders had accepted the plan.<sup>58</sup> Justice Douglas held that this fact was "immaterial on the basic issue of its fairness."<sup>59</sup> The only possible inference was that this time, the Supreme Court meant business.

*Case* interpreted old Section 77B, already superseded before the Supreme Court issued its opinion.<sup>60</sup> But the Court soon made clear that the "fair and equitable" language also applied under the superseding Chapter X.<sup>61</sup> The Court also articulated one further principle necessary to make the absolute priority rule work in practice. Thus, in *Consolidated Rock Products Co. v. Du Bois*,<sup>62</sup> the Court held that in order to apply the absolute priority rule, a finding as to the value of the reorganized enterprise must be made.<sup>63</sup> On reflection, this seems

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55. 308 U.S. at 115.

56. *Flershem v. National Radiator Corp.*, 64 F.2d 847, 852 (3d Cir. 1933), *modified sub nom.* *First Natl. Bank of Cincinnati v. Flershem*, 290 U.S. 504 (1934) (cited in 308 U.S. at 118 n.9). Justice Douglas also cited a number of variants of the phrase. *See* 308 U.S. at 118.

57. Also, it must be conceded that the analysis did not originate with Justice Douglas. Much of Justice Douglas' rhetoric on "fair and equitable" is drawn from the government's brief, which in turn relies on Spaeth & Winks, *The Boyd Case and Section 77*, 32 ILL. L. REV. 769, 778-88 (1938). *See* Brief for the United States as Amicus Curiae at 24-29, 25 n.27, *Case v. Los Angeles Lumber Prods.*, 308 U.S. 106 (1939) (Nos. 23 and 24). The government also conceded that the rule had not been consistently applied. *See id.* at 18. Not all scholarly authority supported Justice Douglas at the time. *See* Dodd, *supra* note 47, at 235-56.

58. By the Court's account, holders of 92.81% of the bonds, 99.75% of the Class A stock, and 90% of the Class B stock accepted the plan. 308 U.S. at 115. *Case* himself had bonds in the face amount of \$18,500. The plan had won the approval of the district court and a unanimous circuit panel.

59. 308 U.S. at 115.

60. *Case* was argued October 18, 1939, and decided on November 6, 1939. The Chandler Act, repealing § 77B and replacing it with Chapter X, was adopted June 22, 1938. *See* Chandler Act, ch. 575, 52 Stat. 883 (1938).

61. *See* *Marine Harbor Properties, Inc. v. Manufacturers Trust Co.*, 317 U.S. 78, 85 (1942).

62. 312 U.S. 510 (1941).

63. 312 U.S. at 525-27.

obvious. If the creditors hold claims worth \$10 and the debtor is worth \$8, then it violates the absolute priority rule to leave any interest with the debtor; if the debtor is worth \$12, then it does not. Nevertheless, this obvious truth seems to have eluded a number of the earlier courts. *Consolidated Rock Products* also established that the criterion of "value" for purposes of the rule was not merely the value of the enterprise in liquidation. Rather, it was the (presumably higher) value of the business as a going concern.<sup>64</sup> Though conceptually irrelevant to the new value approach, and discredited as a matter of congressional intent, the going concern concept would buttress the Eighth Circuit's finding of new value in *Ahlers*. Ultimately, the Supreme Court rejected this thinking.<sup>65</sup>

The Court thus established absolute priority as the ruling principle in Chapter X.<sup>66</sup> That would have finished the story (until the coming of the Bankruptcy Act of 1978) except that Chapter X was not the only pre-1978 source of reorganization law. Rather, there were — indeed there long had been — two separate strains of reorganization law, existing side-by-side in uneasy harness. One evolved from the law of equity receivership and crystallized in Chapter X, as just described. The other grew out of the common law remedy of composition, whereby creditors and debtor together agree to "compose" — or scale down — the debtor's debts. A common law composition might be binding on all creditors who agreed to it, but it was not binding on dissenters. As early as 1874, American bankruptcy law provided a scheme whereby a compromise accepted by a majority of creditors might be binding on all, including dissenters.<sup>67</sup> In 1938, Congress acknowledged this tradition by embodying it in Chapter XI of the Chan-

64. 312 U.S. at 525-27. On the content of the valuation, see *infra* Part III.B. See generally Pachulski, *The Cram Down and Valuation Under Chapter 11 of the Bankruptcy Code*, 58 N.C. L. REV. 925, 938-44 (1980).

65. See *infra* Part III.C.3.

66. A summary of the "fair and equitable" rule under Chapter X is in 6A COLLIER ON BANKRUPTCY ¶ 11.06 (J. Moore 14th ed. 1977). The rule was also applied to railroad reorganizations under § 77 of the Bankruptcy Act, 11 U.S.C. § 205 (repealed 1978); *Group of Institutional Investors v. Chicago, Milwaukee, St. Paul & Pac. R.R.*, 318 U.S. 523 (1943); to recapitalizations under the Public Utility Holding Company Act of 1935, 15 U.S.C. § 79k(e) (1982); and to registered investment companies under the Investment Company Act of 1970, 15 U.S.C. § 80a-25(c) (1982). But the Court's firm stand did not resolve all problems over the application of the absolute priority rule. In particular, the rule did nothing to resolve important questions such as the valuation of claims. See generally Billyou, *supra* note 51; Billyou, "New Directions": A Further Comment, 67 HARV. L. REV. 1379 (1954); Blum, *The "New Directions" for Priority Rights in Bankruptcy Reorganizations*, 67 HARV. L. REV. 1367 (1954).

67. See Act of June 22, 1874, ch. 390, 18 Stat. 178, 182-86 (amending the Bankruptcy Act of 1867, ch. 176, 14 Stat. 517, repealed by Act of June 7, 1878, ch. 160, 20 Stat. 99). For sources on the history of composition law, see J. MACLACHLAN, BANKRUPTCY § 309 (1956). See also Riesenfeld, *The Evolution of Modern Bankruptcy Law: A Comparison of the Recent Bankruptcy Acts of Italy and the United States*, 31 MINN. L. REV. 401, 438-52 (1947).

Chandler Act.<sup>68</sup>

The line between "compositions" and equity receiverships had never been clear, but a vulgar oversimplification, adequate for present purposes, is that the composition cases involved small businesses and face-to-face dealings between owner-managers, on the one hand, and vendor-creditors, on the other. The receivership cases, by contrast, involved publicly-traded, mortgage-backed debt and limited-liability corporations. Perhaps more important, the cases emerged from different cultures, each habituated to its own way of going about its task.<sup>69</sup> No one can be certain of the influence that the competing principles of equity receivership and common law composition had upon the development of absolute priority doctrine. It is safe to conclude, however, that each laid an independent foundation for the ultimate bankruptcy structure.

Under the Bankruptcy Act, the Court encountered recurrent difficulties over the years in determining just which chapter was appropriate for any particular case.<sup>70</sup> For our purposes, the important point is this: The absolute priority rule had never been a principle of composition law.<sup>71</sup> Quite the contrary, the point was that a creditor might be bound to anything he agreed to in a composition.<sup>72</sup>

This was part and parcel of the theory of composition: if you had to pay the full going concern value of the enterprise to your creditors, even though they might agree to accept less, composition was never possible. This might have been acceptable public policy to an enterprise like a publicly-held corporation, where the equity ownership might come and go. It was less palatable in the case of the typical Chapter 11 debtor — a sole proprietorship or a closely-held "family" corporation.<sup>73</sup>

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68. Ch. 575, 52 Stat. 840, 912 (1938).

69. The same kind of "different cultures" problem may account for the existence of two lines of absolute priority authority.

70. See *SEC v. United States Realty & Improvement Co.*, 310 U.S. 434 (1940); *General Stores Corp. v. Shlensky*, 350 U.S. 462 (1956); *SEC v. American Trailer Rentals*, 379 U.S. 594 (1965).

71. For a summary of the history, together with an attack on the absolute priority rule, see J. MACLACHLAN, *supra* note 67, at §§ 323, 384-85.

72. On the relation between common law compositions and relief in bankruptcy, see Mulder & Solomon, *Effect of the Chandler Act upon General Assignments and Compositions*, 87 U. PA. L. REV. 763 (1939). See also Trost, *Corporate Bankruptcy Reorganizations: For the Benefit of Creditors or Stockholders?*, 21 UCLA L. REV. 540, 549 (1973); Chandler Act, ch. 575, § 366(2), 52 Stat. 840, 911 (1938) (amending the Bankruptcy Act of 1898, ch. 541, 30 Stat. 544). MacLachlan argued that not even liquidation value was required. J. MACLACHLAN, *supra* note 67, at §§ 322, 384.

73. The objections are summarized in the committee report that led to the amendments discussed *infra* at note 75. See H.R. REP. NO. 310, 82d Cong., 1st Sess. 21 (1952).



The difficulty was that Chapter 11 as drafted included the "fair and equitable" standard which Justice Douglas, construing Chapter X in *Case*, read to mean absolute priority.<sup>74</sup> It took an amendment to the Bankruptcy Act, striking the phrase "fair and equitable" from Chapter 11, to solve that problem.<sup>75</sup> If it were not amended, the Committee Report declared, "no individual debtor and, under chapter 11, no corporate debtor where the stock ownership is substantially identical with management could effectuate an arrangement except by payment of the claims of all creditors in full."<sup>76</sup>

Against this background, Congress adopted the Bankruptcy Code of 1978. The Code clearly adopted a modified absolute priority rule, but it is crucial here to grasp not only what Congress did, but what it chose not to do. The fountainhead of learning that underlay the 1978 Code was the *Report of the Bankruptcy Commission*, filed in 1973.<sup>77</sup> The *Report* proposed to emasculate substantially the absolute priority rule.<sup>78</sup> Specifically, it would have given broad powers to the reorganization court to leave a stake with the old equity owners even though claims were not paid in full<sup>79</sup> and it would have invited the court to fudge the question of value.<sup>80</sup> It would have given equity owners, even though their interests were eliminated in the plan, a chance to participate if the debtor's fortunes improved at any time up to five years after confirmation — in effect, a sort of option or warrant.<sup>81</sup> Additionally, it would have permitted individual debtors or shareholders to partici-

74. See Chandler Act, ch. 575, § 366(3), 52 Stat. 840, 912 (amended 1952; repealed 1978); *United States Realty*, 310 U.S. 434. Justice White mistook this point in *Ahlers*, apparently misled by the Solicitor General. He distinguished *U.S. Realty* because it purportedly arose under "a chapter of the old bankruptcy statutes under which the absolute priority rule did not apply." 108 S. Ct. at 968 n.4. Cf. Brief for the United States as Amicus Curiae at 27-28, *Norwest Bank Worthington v. Ahlers*, 108 S. Ct. 963 (1988) (No. 86-958). At least one court had held that absolute priority applied in Chapter 11 just as it did in Chapter X. See *Mecca Temple v. Darrock*, 142 F.2d 869 (2d Cir. 1944).

75. Act of July 7, 1952, ch. 579, § 35, 66 Stat. 420, 433 (1952) (repealed 1978). Parallel amendments solved a parallel problem under Chapters 11 and 13. See Act of July 7, 1952, ch. 579, §§ 43, 50, 66 Stat. 420, 435, 437 (repealed 1978). The history of "fair and equitable" in Chapter 11 can be found in 1A COLLIER ON BANKRUPTCY ¶ 9.18 (J. Moore 14th ed. 1978).

76. H.R. REP. NO. 2320, 82d Cong., 2d Sess. 1960, 1982 (1952).

77. REPORT OF THE COMM. ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 137, 93d Cong., 1st Sess. (1973). The report contains three parts. Part I is a text summary of recommendations and support [hereinafter COMMISSION REPORT]. Part II is a proposed bill [hereinafter the COMMISSION BILL]. Part III is a selection of studies prepared for the Commission.

78. See COMMISSION REPORT, *supra* note 77, at 277. One of the Commission's consultants defended its position. See Trost, *supra* note 72.

79. A critic stated that "the Commission both proclaims its attachment to the absolute priority rule and proposes effectively to abolish the rule." Brudney, *The Bankruptcy Commission's Proposed "Modifications" of the Absolute Priority Rule*, 48 AM. BANKR. L.J. 305, 308 (1974).

80. COMMISSION BILL, *supra* note 77, at 254-55 (notes to § 7-310(d)(2)(B)).

81. COMMISSION BILL, *supra* note 77, at 241 (§ 7-303(3)).

pate in any event, if the court found that they would make an "important" contribution to the reorganized enterprise.<sup>82</sup>

The Commission proposal met with adverse criticism in the law reviews,<sup>83</sup> and in due course Congress abandoned it in favor of the present scheme. That present scheme, in effect, adopts the absolute priority rule as a "default" or "off-the-rack" standard, but permits waiver by consent. It provides that any individual may block confirmation unless he gets at least what he would get in liquidation.<sup>84</sup> Subject to this limitation, it provides that a plan may be binding on any class of creditors if it is accepted by more than half in number, and at least two thirds in amount, of that class.<sup>85</sup>

That is the state of the "statutory" branch of absolute priority doctrine at the adoption of the Bankruptcy Reform Act of 1978. But before continuing the story from there, it is necessary to discuss our second source of absolute priority law — the Constitution. In Part III, I discuss both the statutory and constitutional principles relating to absolute priority and its new value corollary.

## 2. *The Constitutional Line*

a. *Radford and the Wrights*. The following discussion traces the constitutional history of the absolute priority rule from the time of its birth to its apparent demise during the New Deal, and its reputed reappearance six years ago. Central to the discussion is the relation of absolute priority to the takings clause of the fifth amendment. Bankruptcy clause, states' rights, and contracts clause issues, while of ancillary significance to the constitutional rule of absolute priority, are also discussed.

In a seminal analysis, Bonbright and Bergerman stressed that resistance to absolute priority law comes from an effort by debtors to retain their property without paying their debts. The irony was not lost on them, as they remarked:

To anyone familiar merely with the ordinary law of priorities as applied to individual debtors and creditors, and to house and lot mortgages, it would come as a surprise to learn that there can be any uncertainty as to the fundamental legal principles underlying the priority rights of the different classes of security holders enumerated above.<sup>86</sup>

Their comment sets the stage for a discussion of the "constitutional"

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82. COMMISSION BILL, *supra* note 77, at 242 (§ 7-303(4)).

83. *See, e.g.*, Blum & Kaplan, *The Absolute Priority Doctrine in Corporate Reorganizations*, 41 U. CHI. L. REV. 651 (1974); Brudney, *supra* note 79.

84. 11 U.S.C. § 1129(a)(7)(A) (1982).

85. 11 U.S.C. §§ 1126, 1129(a)(8) (1982).

86. Bonbright & Bergerman, *supra* note 42, at 129.

branch of absolute priority law. This branch is rooted in the recurrent war between the Supreme Court on the one hand and Congress or the states on the other, with the Court policing supposedly undesirable economic legislation.<sup>87</sup> "Debtor relief" legislation, however defined, intensifies this conflict; witness the repeated challenges to the constitutionality of debtor relief laws during the Great Depression.

The central episode is the case of *Louisville Joint Stock Land Bank v. Radford*.<sup>88</sup> The Court had to consider the Frazier-Lemke Act,<sup>89</sup> a farm mortgage relief bill passed by Congress in 1934. Frazier-Lemke offered farm debtors a five-year moratorium on foreclosure, with the power to buy the farm property at its "appraised" value — *i.e.*, below the debt.<sup>90</sup> To readers acquainted with *Ahlers* and its ancestors, the facts of *Radford* bear a familiar ring. The Radfords borrowed \$9,000 at six percent from the bank, secured by a mortgage on farmland "then presumably of the appraised value of at least \$18,000."<sup>91</sup> After the Radfords fell behind in their payments, the bank began a foreclosure, prompting the Radfords to file for relief under Frazier-Lemke.<sup>92</sup>

Frazier-Lemke gave the debtor a right to stay in possession of his property for up to five years on payment of "a reasonable rental," the proceeds to be distributed to creditors.<sup>93</sup> At or prior to the end of five years, he might acquire title and possession if he paid the appraised value of the property.<sup>94</sup> Speaking for a unanimous Court, Justice Brandeis held the Act unconstitutional as a denial of the creditor's property right, guaranteed under the fifth amendment.<sup>95</sup>

87. For a particularly vivid, if partisan, account of this controversy, see R. JACKSON, *THE STRUGGLE FOR JUDICIAL SUPREMACY* (1941).

88. 295 U.S. 555 (1935).

89. The Act amended the Bankruptcy Act by adding subsection (s) to § 75. Pub. L. No. 73-486, 48 Stat. 1289 (1934) (amended 1935). Frazier-Lemke expired on March 1, 1949. See Act of Apr. 21, 1948, Pub. L. No. 80-495, 62 Stat. 198.

90. Pub. L. No. 73-486, § 75(s)(7), 48 Stat. 1289, 1291 (1934).

91. *Radford*, 295 U.S. at 573. The bank was authorized to make individual loans in amounts not to exceed 50% of the value of the land and 20% of the value of the improvements.

92. *Radford*, 295 U.S. at 573-75.

93. Pub. L. No. 73-486, § 75(s)(7), 48 Stat. 1289, 1291 (1934).

94. Pub. L. No. 73-486, § 75(s)(7), 48 Stat. 1289, 1291 (1934).

95. *Radford*, 295 U.S. at 602. Professor Rogers correctly stresses that *Radford* focused on the fact that Frazier-Lemke allowed a retroactive modification of rights. Rogers, *The Impairment of Secured Creditors' Rights in Reorganization: A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Clause*, 96 HARV. L. REV. 973, 985 (1983). In light of this fact, he concludes that "none of the Frazier-Lemke Act cases provides any support whatsoever for the proposition that fifth amendment property-protection concepts limit the substantive scope of the bankruptcy power." *Id.* It is not clear what he means here. If he means that *Radford* says nothing at all about prospective application, he is probably right. But *Radford* seems to say that the fifth amendment trumps the bankruptcy power when the issue applies retroactively. His mistake seems to be in assuming that a statute, invalid in retroactive application only, cannot also be a property-rights limitation on the bankruptcy power. There is no apparent justification for

Striking down the Act, Justice Brandeis identified five items that he characterized as "property rights recognized by the Laws of Kentucky."<sup>96</sup> They were the right (1) to retain a lien until paid; (2) to have a public judicial sale; (3) to determine when sale shall be held (subject only to the discretion of the court); (4) to bid at the sale; and (5) to control the property during the default, subject to the discretion of the court, and to have the rents and profits collected by a receiver for the creditor's benefit. The Court held that Frazier-Lemke denied all of these.<sup>97</sup>

Prior to the decision, Frazier-Lemke had been something of a political sideshow in the theater of the New Deal. President Roosevelt had signed the bill, but it was not an administration measure.<sup>98</sup> Nevertheless, an onslaught of pressure from desperate farmers overwhelmed Congress, as Frazier-Lemke took the center stage of the debtor relief agenda. Some of the heat is reflected in the remarks of Representative Truax in the debate over the original Act:

When this law becomes effective I can but wonder what will become of the ruthless money lender when the breath of gold leaves his feculent body and a financial death stops the rattling of his grasping brain, for he is unfit for the higher realm of life, and too foul for the one below. He cannot be buried in the earth, lest he provoke a pestilence; nor in the sea, lest he poison the fish; nor swing in space like Mahomet's coffin, lest the circling worlds in trying to avoid contamination, crash together, wreck the universe, and bring again the noisome reign of chaos and Satan.<sup>99</sup>

Complicating the political dynamic was the fact that *Radford* was announced on "Black Monday" — May 27, 1935, the day that also saw the invalidation of two other initiatives, both central to the New Deal.<sup>100</sup> In this charged climate, Congress almost immediately undertook to revise Frazier-Lemke; a new version won approval just three months later, on August 28 (hereinafter referred to as "Frazier-Lemke

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such an assumption. For still another approach to *Radford*, see Carlson, *Post Petition Interest Entitlements Under the Bankruptcy Code*, 43 U. MIAMI L. REV. (1988) (forthcoming).

96. *Radford*, 295 U.S. at 594.

97. 295 U.S. at 594.

98. See K. DAVIS, *FDR: THE NEW DEAL YEARS, 1933-1937*, at 514-15 (1986); N. DAWSON, LOUIS D. BRANDEIS, FELIX FRANKFURTER, AND THE NEW DEAL 127 (1980); A. SCHLESINGER, *THE AGE OF ROOSEVELT: THE POLITICS OF UPHEAVAL* 280 (1960). It was largely the handiwork of William Lemke, North Dakota Congressman and in 1936 himself a third-party candidate for President. On Lemke, see generally E. BLACKORBY, *PRAIRIE REBEL* (1963), which, however, adds little or nothing to the specific history of Frazier-Lemke.

99. 78 CONG. REC. 11,923 (June 15, 1934).

100. See generally R. JACKSON, *supra* note 87, at 106-14. The other two cases were *Humphrey's Executor v. United States*, 295 U.S. 602 (1935) (invalidating the President's power to remove an FTC commissioner) and *Schechter Poultry Corp. v. United States*, 295 U.S. 495 (1935) (invalidating the National Industrial Recovery Act).

II”;<sup>101</sup> the original will be referred to as Frazier-Lemke I).

This time in *Wright v. Vinton Branch of Mountain Trust Bank* (“*Wright I*”)<sup>102</sup> the Court, again speaking through Justice Brandeis, unanimously upheld the Act. *Wright I*’s facts were distressingly familiar. Wright mortgaged his farm to the bank. The bank undertook to foreclose, and he filed for relief under Frazier-Lemke II. In the ensuing contest over constitutionality, all parties agreed that the mortgagee in Virginia enjoyed the same five “property rights” that the Kentucky mortgagee enjoyed in *Radford*. But early on, Justice Brandeis carved out some room to maneuver in evaluating the revised Act. “It was not held,” he declared, “that the deprivation of any one of these rights would have rendered the Act invalid, but that the effect of the statute in its entirety was to deprive the mortgagee of his property without due process of law.”<sup>103</sup> Translated, this means: Frazier-Lemke II does violate at least one of the five rights enumerated in *Radford*, but we are going to uphold it anyway. Justice Brandeis went on to state that “[i]t is not denied that the new Act adequately preserves three of the five above enumerated rights of a mortgagee.”<sup>104</sup> These were the right to retain the lien until paid (number (1) above); the right to a judicial public sale (number (2) above); and the right to bid in at sale (number (4) above). That left items (3) (to determine when the sale was held) and (5) (control during default; rents for mortgagee’s benefit).

The nub of the matter turned out to be item (3).<sup>105</sup> The Act provided, in essence, for a three-year moratorium on foreclosure. If it meant what it seemed to say, Justice Brandeis reasoned, then it was clear that the Act deprived the creditor of the right to determine when the sale should be held. But, the Court found, the stay was not absolute; indeed, the Act gave the courts “broad power to curtail the stay for the protection of the mortgagee.”<sup>106</sup> The finding of a moratorium subject to reduction thus transformed itself into the right to determine

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101. Act of Aug. 28, 1935, Pub. L. No. 74-384, 49 Stat. 942 (1936). See generally Hanna, *New Frazier-Lemke Act*, 1 MO. L. REV. 1 (1936); Diamond & Letzler, *The New Frazier-Lemke Act: A Study*, 37 COLUM. L. REV. 1092 (1937).

102. 300 U.S. 440 (1937). Lower court judges might have felt like the little boy with the butter on his hat, who keeps applying the right rule to the wrong situation. Most lower court decisions had upheld Frazier-Lemke I, only to see the Supreme Court in *Radford* go the other way. Guided by *Radford*, most lower court decisions struck down Frazier-Lemke II, only to see their expectations dashed a second time.

103. 300 U.S. at 457.

104. 300 U.S. at 458.

105. 300 U.S. at 460-64.

106. 300 U.S. at 464.

when the sale should be held, and the requirement of item (3) was held fulfilled.

Finally, the Court turned to item (5) (control during default): "The argument is that possession by the mortgagor during the stay is necessarily less favorable to the mortgagee than possession by a receiver or trustee would be."<sup>107</sup> The Court went straight to the point: "This is not true."<sup>108</sup> In fact, Justice Brandeis reasoned, the mortgagor remained at all times under the supervision and control of the court. There is undoubtedly room for argument over the clarity and consistency of the doctrine created by *Radford* and *Wright I*. But there can be no doubt that the opinion is a Brandeis *tour de force*. *Frazier-Lemke II* was different from *Frazier-Lemke I*, particularly insofar as it gave the creditor the power to demand a sale. But the fact is that, under both versions, the creditor was barred from foreclosure for long periods of time, during which the debtor remained in possession, obliged to pay over no more than what the property, after necessary expenses, would yield.<sup>109</sup>

The suspicion is that the Court had not so much seen the light as felt the heat. This was, by any measure, one of the most explicitly "political" periods in the history of the Court. Two relevant events intervened between *Radford* and *Wright I*. One was President Roosevelt's landslide reelection in 1936, where he carried all but two states. The other was the advent of President Roosevelt's campaign to finesse a hostile judiciary by enlarging membership on the Supreme Court, memorialized in history books as the "court-packing plan."<sup>110</sup>

Roosevelt began the campaign with his message to Congress on February 5, 1937, recommending the reorganization of the judicial branch.<sup>111</sup> The Supreme Court decided *Wright I* less than two months later, on "White Monday," March 29, 1937.<sup>112</sup> For the Court it was a period of repentance on many fronts.

Further decisions undercut *Radford* still more. In *Wright v. Union*

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107. 300 U.S. at 466.

108. 300 U.S. at 466.

109. Hanna and MacLachlan declare that "[s]ubsequent lower court cases indicate that total delays of six to eight years are not uncommon before the mortgagee is permitted to realize upon his security." J. HANNA & J. MACLACHLAN, CREDITORS' RIGHTS AND CORPORATE REORGANIZATION 302 (consol. 5th ed. 1957).

110. See generally A. COPE, FRANKLIN D. ROOSEVELT AND THE SUPREME COURT (1952).

111. H.R. DOC. NO. 142, 75th Cong., 1st Sess., reprinted in 81 CONG. REC. 893 (1937).

112. R. JACKSON, *supra* note 87, at 207-13. Other decisions that same day upheld a minimum wage law, see *West Coast Hotel Co. v. Parrish*, 300 U.S. 379 (1937), railway collective bargaining, *Virginian Ry. v. System Fedn.* No. 40, 300 U.S. 515 (1937), and the taxation of firearms, *Sonzinsky v. United States*, 300 U.S. 506 (1937).

*Central Life Insurance Co. ("Wright II")*<sup>113</sup> the Court had occasion to speak on the constitutionality of the "extension" aspect of Frazier-Lemke II; it found the extension provision was constitutional. Arriving on the heels of *Wright I*, the result can hardly have come as a surprise, although the strategy will get a moment's notice later.<sup>114</sup> In *John Hancock Mutual Life Insurance Co. v. Bartels*,<sup>115</sup> the Court considered a provision permitting early termination of the stay. In *Wright I*, Justice Brandeis had said that Frazier-Lemke II provided for early termination, but *Bartels* held that it did not.<sup>116</sup>

Finally, one year later, in *Wright v. Union Central Life Insurance Co. ("Wright III")*,<sup>117</sup> the debtor sought to purchase the property at its appraised value; the secured creditor sought to insist on his right of sale. This right of sale was item (3) in Justice Brandeis' catalog of rights in *Wright I*. In that case, Justice Brandeis had made it clear that the presence of the right of sale was a critical distinction between (constitutional) Frazier-Lemke II and its (unconstitutional) predecessor. The Court in *Wright III*, this time speaking through Justice Douglas, conceded that there was a right of sale in Frazier-Lemke II.<sup>118</sup> But Justice Douglas pointed out that the right of sale and the right of redemption appeared to trump each other. In that event, Justice Douglas said, the debtor wins. He said Frazier-Lemke II provided "safeguards" to protect the value of the secured creditor's interest in the property. He stated: "There is no constitutional claim of the creditor to more than that."<sup>119</sup> Indeed, he said that a decision for the creditor would bar the debtor from "equal protection" — though he did not specify whether he was talking about constitutional equal protection or some more evanescent right.<sup>120</sup>

*b. The constitutional doctrine of absolute priority today.* In *Wright III*, Justice Douglas drew the teeth from Justice Brandeis' analysis; when the dust settled, debtors and creditors found themselves pretty

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113. 304 U.S. 502 (1938). But the earlier *Union Central* case has no relevance to this account.

114. See *infra* notes 131-33 and accompanying text.

115. 308 U.S. 180 (1939).

116. See *Wright I*, 300 U.S. at 462; *Bartels*, 308 U.S. at 184 & n.3.

117. 311 U.S. 273 (1940). Both *Union Central* cases (*Wright II* and *Wright III*) involved the same parties; *Vinton Branch (Wright I)* involved a different *Wright* and a different bank.

118. 311 U.S. at 277-79. Justice Brandeis resigned February 13, 1939; Justice Douglas was confirmed as his successor April 4, 1939. L. TRIBE, *GOD SAVE THIS HONORABLE COURT* (1985).

119. 311 U.S. at 278.

120. 311 U.S. at 279.

much where they were before the Court decided *Radford*, given that one would have concluded in 1940 that the *Wrights* overruled it.

Today, can we conclude that because *Ahlers* was entirely “statutory,” lacking any trace of *Radford*-based constitutional doctrine, that the constitutional branch is dead? The answer seems to be “no”: The constitutional branch is not dead; it is only sleeping — and sleeping rather fitfully, at that. Supporting the idea that the constitutional doctrine is dead, I have already noted that the Supreme Court had a generally distasteful experience applying constitutional doctrine to bankruptcy cases in the Great Depression. These highly salient constitutional postures proved indefensible, and inglorious retreats followed. The superabundance of doctrine suggests a bewilderment on the Court’s part as to just how to proceed. Indeed, the experience of the 1930s seemed more than enough to justify the views of the leading bankruptcy historian, who wrote when the process was only half begun: “The trail of [the bankruptcy clause], is strewn with a host of unsuccessful objections based on constitutional grounds against the enactment of various provisions, all of which are now regarded as perfectly orthodox features of a bankruptcy law.”<sup>121</sup>

Constitutional doctrine? Who needs it! All it brings is trouble and strife. This analysis gains plausibility from the insight that the facts of *Ahlers* are, after all, far closer to *Radford* than they are to *Case*. A more cautious position would be that *Ahlers* proves nothing about the survival of constitutional absolute priority doctrine because the Court customarily avoids constitutional issues when it can, and there were entirely adequate reasons to resolve *Ahlers* on a statutory basis.<sup>122</sup> Or the Court may simply not have grasped that there was any constitutional substrate to work on here. Thus, silence alone does nothing to justify constitutional agnosticism. In fact, there are good reasons for believing that constitutional absolute priority doctrine is alive and ready to rise again. *Wright III*, however restrictive, still subsists as

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121. C. WARREN, *BANKRUPTCY IN UNITED STATES HISTORY* 9 (1935). Warren is referring, of course, specifically to the bankruptcy clause — as well he might have, prior to *Radford*. But the comment seems justified even more strongly by the later record of the Supreme Court, where the Court deployed due process (both “property” and “contract”) as well as states’ rights in evaluating bankruptcy law. See *infra* at Part II.B.d.

122. The classic statement of the strategies for avoiding constitutional questions is, of course, from a concurrence in *Ashwander v. Tennessee Valley Authority*, 297 U.S. 288, 341 (1936) (Brandeis, J., concurring). Not the least of the ironies in this account is that the author of the concurrence is Justice Brandeis. On the theory set forth in the text above, the real test of constitutionality would arise if anyone had tried to raise a constitutional challenge to Chapters 12 or 13 of the Bankruptcy Code, which clearly do permit the debtor to retain his property while leaving his creditors less than fully compensated. Justice White seems to have assumed that these are constitutional, see *supra* notes 18-22 and accompanying text, and the chances are he is right. But of course the issue was not squarely before him.



constitutional doctrine, largely unchallenged.<sup>123</sup> And *Radford*, however emasculated, has never been expressly overruled.<sup>124</sup> Quite the contrary; just recently *Radford*, in the hands of then Justice Rehnquist, has proven to have an extraordinary vitality. Justice Rehnquist used *Radford* to build his argument in at least two important recent cases. One of them need not concern us now,<sup>125</sup> but in the other, *United States v. Security Industrial Bank*,<sup>126</sup> decided just seven years ago, *Radford* played a critical motivational role, like the ghost of old King Hamlet, who makes a sinister entry to get the action going and then remains as a haunting presence throughout the rest of the drama.

*Security Industrial Bank* concerned a novel "consumer protection" provision in the 1978 Bankruptcy Code.<sup>127</sup> This provision permitted an individual debtor to invalidate certain liens on consumer goods. The question was whether the statute might be applied retroactively — that is, whether the debtor could invoke the statute to avoid liens granted before the enactment of the Code. All Justices agreed that it could not be applied retroactively, and all confined the issue to construing the statute. But there the agreement ended. Justice Blackmun, writing for himself and two others, held that the rule of construction had been set down in an earlier case, "and, unless the Court chooses to overrule it, [it] must control the present case."<sup>128</sup> But he said that were he writing on a clean slate, he would do otherwise.<sup>129</sup>

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123. Patrick Murphy wrote a pair of articles in the 1970s which proved highly influential in defining the structure of the 1978 Bankruptcy Code. Murphy treats *Wright III* as central to the constitutional structure of bankruptcy law. See Murphy, *Use of Collateral in Business Rehabilitations: A Suggested Redrafting of Section 7-203 of the Bankruptcy Reform Act*, 63 CALIF. L. REV. 1483, 1491 (1975); Murphy, *Restraint and Reimbursement: The Secured Creditor in Reorganization and Arrangement Proceedings*, 30 BUS. LAW. 15, 24-26 (1974).

124. The Supreme Court itself once said that it might have fallen into error in *Radford* and corrected itself in *Wright I*, although the Court now seems to have abandoned that position also. Professor Countryman also argues that *Radford* died with *Wright I*. Countryman, *Real Estate Liens in Business Rehabilitation Cases*, 50 AM. BANKR. L.J. 303, 335-36 (1976); Countryman, *Treatment of Secured Claims in Chapter Cases*, 82 COM. L.J. 349, 357-60 (1977).

125. *Armstrong v. United States*, 364 U.S. 40 (1960), whose implications are spelled out in *United States v. Security Indus. Bank*, 459 U.S. 70, 77-78 (1982).

126. 459 U.S. 70 (1982).

127. 459 U.S. at 71; 11 U.S.C. § 522(f)(2) (1982).

128. 459 U.S. at 85 (Blackmun, J., concurring).

129. 459 U.S. at 83. Justice Blackmun offered an intriguing catalog of reasons why it would be proper to apply it retroactively:

I would do so because the exemptions in question are limited as to kinds of property and as to values; because the amount loaned has little or no relationship to the value of the property; because these asserted lien interests come close to being contracts of adhesion; because repossessions by small loan companies in this kind of situation are rare; because the purpose of the statute is salutary and is to give the debtor a fresh start with a minimum for necessities; because there has been creditor abuse; because Congress merely has adjusted priorities, and has not taken for the Government's use or for public use; because the exemption provi-

Justice Rehnquist, writing for the Court, took the statutory path to avoid what he took to be a constitutional problem. He stated that he found “substantial doubt whether the retroactive destruction of the appellees’ liens in this case comports with the Fifth Amendment.”<sup>130</sup> The constitutional authority was, of course, *Radford*.

Justice Rehnquist’s analysis of *Radford* is remarkable in a number of respects. As a threshold matter, he recognized and embraced the contract/property distinction that got such inconsistent handling in the Depression-era case law. He conceded that the Court had “regularly construed” the bankruptcy power “to authorize the retrospective impairment of contractual obligations.”<sup>131</sup> But he stated that this concession “does not . . . obviate the additional difficulty that arises when that power is sought to be used to defeat traditional property interests.”<sup>132</sup> He continued: “The bankruptcy power is subject to the Fifth Amendment’s prohibition against taking private property without compensation,” citing, of course, *Radford*.<sup>133</sup>

Justice Rehnquist went on to declare that the Frazier-Lemke Act in *Radford* “permitted the debtor to purchase the property for less than its fair market value.”<sup>134</sup> A footnote at that point explains that the Act permitted the farmer “to purchase the property at its then-appraised value on a deferred payment plan.”<sup>135</sup> In fact, the statutory interest on the deferred payments was 1% per year. Justice Rehnquist states that “[g]iven the [statutory] interest rate of 1%, the present value of the deferred payments was much less than the value of the property.”<sup>136</sup> Apparently, he reasonably assumed that 1% was less than the market rate. On the other hand, by relying so heavily on the below-market statutory interest rate, Justice Rehnquist appears to reject the notion that appraised value is *per se* different from market

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sions in question affect the remedy and not the debt; because the security interest seems to have little direct value and weight in its own right and appears useful mainly as a convenient tool with which to threaten the debtor to reaffirm the underlying obligation; because the statute is essentially economic regulation and insubstantial at that; and because there is an element of precedent favorable to the debtor to be found in such cases as *Penn Central Transp. Co. v. New York City*, 438 U.S. 104 (1978), and *PruneYard Shopping Center v. Robins*, 447 U.S. 74 (1980).

130. 459 U.S. at 78.

131. 459 U.S. at 74.

132. 459 U.S. at 75. As if to allay any misunderstanding, he later wrote: “our cases recognize, as did the common law, that the contractual right of a secured creditor to obtain repayment of his debt may be quite different in legal contemplation from the property right of the same creditor in the collateral.” 459 U.S. at 75.

133. 459 U.S. at 75.

134. 459 U.S. at 76. It is better to abandon the distinction between Frazier-Lemke I and Frazier-Lemke II here; Justice Rehnquist never hints that there was a Frazier-Lemke II.

135. 459 U.S. at 76 n.7.

136. 459 U.S. at 77 n.7.

value.<sup>137</sup>

But all this is a distraction because the process he described is entirely voluntary: the creditor did not have to accept any part of it (just as, presumably, he might have arranged any other compromise with the debtor that he chose to arrange).<sup>138</sup> Justice Rehnquist continued:

If the mortgagee refused to assent, the court was required to stay all proceedings for five years, during which time the farmer could retain possession by paying a reasonable rent. After five years the property could be reappraised, but the farmer still had the right to purchase it free and clear for the appraised value regardless of the amount of the lien.<sup>139</sup>

This is all very well as far as it goes, but it ignores the fact that this is essentially the same process the Court later validated in the two *Wright* cases. The only obvious difference is that the "nominal" moratorium term was five years in *Radford* but only three years in *Wright I*. Justice Rehnquist doesn't mention that fact. Indeed, he doesn't cite any *Wright* case, or give any hint that *Radford* has been substantially defanged.

Justice Rehnquist's opinion is remarkable in at least two respects: one is its sheer gratuity, given the availability of the statutory argument (upon which, of course, he ultimately relied). The other is his highly selective reading of *Radford*, giving no hint of the ways in which it was impaired in its own time. Under the circumstances, it would be foolhardy to say that "constitutional" absolute priority is dormant, and awaiting its hour of need. On the other hand, if this was Justice Rehnquist's intention, his view has met with a spectacular lack of success. On at least two occasions last Term, the Supreme Court dealt with bankruptcy issues that invited treatment in the "constitutional" tradition. In *United Savings Association v. Timbers of Inwood*

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137. There are, however, at least three possible reasons why he might want to assert that appraised value does not equal market value. First, it might be that appraisers will consistently undervalue farm property. This is not inconceivable, though it is hardly a self-evident proposition. Second, it is arguable that anytime the creditor wishes to bid higher than the appraisal, then the appraisal is too low. This is beguiling, but it ignores the fact that the creditor is "credit-bidding." That is, at any bid up to the amount of the loan, the creditor parts with no cash: he simply writes off the corresponding portion of the loan. Faced with a debtor who will not be able to pay any deficiency claim, a creditor might well "credit bid" up to the full amount of his loan, just to give himself the option of holding the property for resale in a higher market. The third possibility is the mirror image of the second. That is, one might argue that anytime the debtor wants to keep the property while paying less than the full amount of the loan, he is admitting that the property is worth something beyond what the creditor is getting. This is essentially the position embraced by Justice White, rejecting the "no value" argument in *Ahlers*. See also *infra* text accompanying notes 253-57.

138. Presumably there may have been a residual problem with the supposed contractual rule of *Foakes v. Beer*, 9 App. Cas. 605 (1884), although courts even by the middle 1930s were showing ample ingenuity in evading the rule. See, e.g., *Brown Shoe Co. v. Beall*, 107 S.W.2d 456 (Tex. Civ. App. 1937).

139. *Security Industrial Bank*, 459 U.S. at 76-77 n.7.

*Forest, Ltd.*,<sup>140</sup> the issue was whether the law required the debtor to compensate the secured creditor for delay caused by the automatic stay. The facts of the case put it squarely in the tradition of "moratorium" lore, where cases like *Blaisdell* and *Wright II* (to say nothing of *Radford*) provided a ready body of constitutional precedent. But the Court chose not to invoke this constitutional authority.<sup>141</sup> *Ahlers* was of course the other case.

c. *The demise of property as possession.* Aside from its significance in its own right, the *Radford-Wright* group of cases stands as a chapter in a larger chronicle concerning the Supreme Court's treatment of "property rights" in debtor-creditor cases. Blackstone, in a memorable remark, described property as "sole and despotic dominion."<sup>142</sup> As rhetorical flourishes go, this was probably never entirely wrong, but from the start it was at least misleading. It ignored the whole history of mortgage law as an effort to restrain the powers of the "proprietary" creditor claimant against the debtor. And it said nothing about the priority struggle between the "original owner" and the "bona fide purchaser."<sup>143</sup> The history of Supreme Court bankruptcy doctrine discloses a trajectory, however halting, toward "monetizing" the claim of the secured creditor. This involved, first, breaking the nexus between "property" and "possession," and, second, establishing that what the secured creditor "owned" was not a particular piece of property but a claim to a particular sum of money, however defined.

*Wright III* is the keystone of this arch, holding that the secured creditor has a right to no more than payment of his claim or the value of his collateral, whichever is less. At an earlier time, it probably was thought that the bankruptcy court had no power at all to deal with "property" of a person other than the debtor, including the secured creditor.<sup>144</sup> But in 1931, the Supreme Court held that where the trustee obtained "possession" of the secured creditor's collateral, the

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140. 108 S. Ct. 626 (1988).

141. Indeed, the Court's avoidance of constitutional doctrine in *Timbers* is probably more remarkable than it is in *Ahlers*. *Ahlers* was a maverick, but *Timbers* represented an issue on which there was a sharp split in the circuits, and an extensive literature.

142. "[T]he right of property; or that sole and despotic dominion which one man claims and exercises over the external things of the world, in total exclusion of the right of any other individual in the universe." 2 W. BLACKSTONE, COMMENTARIES \*2 (1776).

143. This progress can be understood as a variant of the process, independent of bankruptcy, whereby the claim of the "original owner" came to yield to the claim of the "good faith purchaser." The process is outlined in a brilliant, seminal article by Professor Gilmore. See Gilmore, *The Commercial Doctrine of Good-Faith Purchase*, 63 YALE L.J. 1057 (1954).

144. Persistence of this notion would account for the fact that the Bankruptcy Code today makes no explicit provision for the superior priority of secured creditors; it is one of those things that is the law because everyone knows it is the law, even though the Code does not say it.

trustee might retain it in order to superintend the liquidation, all subject to the secured creditor's claim.<sup>145</sup> The same year, the Court held that the bankruptcy court had no power to interfere with a secured creditor who had begun his liquidation before the bankruptcy.<sup>146</sup> But just four years later (in the same Term as *Radford*), the Court held that it was proper to enjoin a pledgee from selling securities that were in his possession prior to bankruptcy (at least in a corporate reorganization).<sup>147</sup> The leap to *Wright III* was not a great leap, provided one ignores some of Justice Brandeis' rhetoric in *Radford* and *Wright I*.

Insofar as these cases break the nexus between possession and property, they find their modern exemplar in *United States v. Whiting Pools*,<sup>148</sup> where the Court ordered the Internal Revenue Service, as a repossessing creditor, to return collateral to the bankruptcy estate. Insofar as they represent the idea of "monetizing" the secured claim, the logic of these cases is woven into the fabric of the present Bankruptcy Code.<sup>149</sup>

*d. Other constitutional strategies.* Farm bankruptcy was not the Court's only debtor-relief problem in the Great Depression. Moreover, the "property rights" analysis of *Radford* and the *Wright* cases did not represent the Court's only doctrinal approach. Quite the contrary, the Court encountered a variety of debtor-relief problems employing an almost embarrassing array of strategies.<sup>150</sup>

Paralleling its foray into farm bankruptcy, the Court sought to articulate standards for municipal debt relief. And here again, the Court first asserted itself by occupying a position that it found almost immediately to be untenable. Thus on May 25, 1936, just a year after *Radford*, the Court struck down the Municipal Bankruptcy Act.<sup>151</sup> That law authorized the federal courts to enforce composition agreements

145. *Isaacs v. Hobbs Tie & Timber Co.*, 282 U.S. 734 (1931). See also *Van Huffel v. Harkelrode*, 284 U.S. 225 (1931) (court may order property sold free and clear of liens, with liens attaching to proceeds).

146. *Straton v. New*, 283 U.S. 318 (1931) (creditor may continue foreclosure begun before bankruptcy).

147. *Continental Illinois Natl. Bank & Trust Co. v. Chicago, Rock Island & Pac. R.R.*, 294 U.S. 648, 675-78 (1935).

148. 462 U.S. 198 (1983).

149. See, e.g., 11 U.S.C. §§ 361-64, 506 (1982); H.R. REP. NO. 595, 95th Cong., 1st Sess. 338-40 (1977), reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 5963; S. REP. NO. 989, 95th Cong., 2d Sess. 49, 53-54 (1978), reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 5787.

150. Failure to recognize the plenitude of debtor-relief problems and strategies is a shortcoming of Professor Rogers' generally excellent review of the bankruptcy clause in competition with the fifth amendment. See Rogers, *supra* note 95.

151. *Ashton v. Cameron County Water Improvement Dist. No. One*, 294 U.S. 513 (1936).

between municipalities and their creditors. If accepted by creditors holding two thirds of the indebtedness, the composition would also be enforced on the dissenting minority. The Act, however, permitted only voluntary petitions; no municipality could apply for relief unless authorized by the laws of the state in which it was situated. Nevertheless the Court held, 5-4, that the law invaded the states' rights. Two years later, however, an almost imperceptibly different version of the Act won the Court's approval, 7-2.<sup>152</sup>

The Court also evaluated bankruptcy law by a direct application of the bankruptcy clause of the Constitution. Thus, in *Continental Illinois National Bank & Trust Co. v. Chicago, Rock Island & Pacific Railroad*,<sup>153</sup> the Court held that a corporate reorganization statute was a proper exercise of the bankruptcy power granted to Congress by the Constitution. There must be some constitutional limitation under the bankruptcy clause, however, as a matter of logical necessity; else Congress could do anything it wished, simply by purporting to invoke the bankruptcy power. On the other hand, the Court was never successful in finding any important limitation in the bankruptcy clause, and it has been no more so lately.<sup>154</sup>

Though it did not involve the Federal bankruptcy power, the Court faced a similar problem in evaluating state laws attempting to give debtor relief. The Constitution provides that no state shall pass any law impairing the obligation of contract.<sup>155</sup> In *Home Building and Loan Association v. Blaisdell*,<sup>156</sup> the Court upheld a Minnesota

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152. *United States v. Bekins*, 304 U.S. 27 (1938). While the Court examined the state's-rights issue, it ignored another, arguably more novel, feature of the Act. That is, the discharge was virtually the only substantive provision of the Act. There was no method for liquidation of the assets, nor was there any mechanism for court control of the estate. Thus the Act added an important new dimension to the notion of "bankruptcy" as the term is used in article I, section 8 of the Constitution. See generally Dimock, *Legal Problems of Financially Embarrassed Municipalities*, 22 VA. L. REV. 39 (1935); Note, *The Constitutionality of the Municipal Debt Readjustment Act*, 35 COLUM. L. REV. 428 (1935); Note, *Administration of Municipal Credit*, 43 YALE L.J. 924 (1934).

153. 294 U.S. 648 (1935). The particular issue in *Continental Illinois* was the power of the state to enjoin pledgees. See *supra* text accompanying note 148. But Justice Sutherland first considered the constitutionality of the statute and held that it was constitutional. 294 U.S. at 671-75. *Ashton*, 294 U.S. 513, the first municipal bankruptcy case, can also be read as a bankruptcy clause case, insofar as it holds that the tenth amendment trumps the bankruptcy clause. More intriguing, however, is the fact that the Court rejected an invitation to hold *Ashton* as violative of the bankruptcy clause on its own terms.

154. The Court did, of course, make one important excursion in search of the dimensions of bankruptcy law in *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982). *Northern Pipeline* holds that the Bankruptcy Reform Act of 1978 was unconstitutional insofar as it granted article III jurisdiction to non-article III bankruptcy judges. It could conceivably be read as standing for the proposition that article III "trumps" the bankruptcy power.

155. U.S. CONST. art. I, § 10, cl. 1.

156. 290 U.S. 398 (1934). *Blaisdell* did not signify clear sailing under the contracts clause. In *W.B. Worthen Co. v. Kavanaugh*, 295 U.S. 56 (1935), the Court, distinguishing *Blaisdell*, held

mortgage moratorium statute under the contracts clause. *Blaisdell* also held that the statute did not violate the due process clause of the fifth amendment, applied to the states via the fourteenth amendment. As if to tangle the threads further, the Court in *Wright II* used *Blaisdell*, the state case, as authority for constitutionality, rather than bringing it within the standards of *Wright I*.<sup>157</sup>

*Radford*, like *Continental Illinois*, refused a challenge under the bankruptcy power (although *Radford* invalidated the statute under the fifth amendment).<sup>158</sup> Both *Continental Illinois* and *Radford* recognized this impairment-of-contract theory.<sup>159</sup> They noted, correctly, that the impairment-of-contract clause itself did not apply to the Federal government. They held, somewhat less obviously, that nothing else limited the power of Congress to impair contract (as distinct from property) rights.<sup>160</sup> In any event, taken together, the Court's Depression-era bankruptcy cases represent a striking variety of efforts to articulate a theory to control debtor-creditor law. Today, the scope of bankruptcy clause powers remains a mystery; there must be some constitutional fences around the bankruptcy clause terrain, but they lie beyond current judicial horizons. Nevertheless, Congress certainly cannot do whatever it pleases under the rubric of the bankruptcy clause. On the other hand, contracts clause and state's rights challenges, at least as they concern the constitutional validity of bankruptcy laws, have been entirely discredited. The foregoing discussion of the various other constitutional constraints dramatizes the morass created by constitutional judicial review of bankruptcy legislation.

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that a procedure for enforcing payment of benefit assessments pledged as security for municipal bonds was an unconstitutional impairment of the obligation of contract. The Court stated that the destruction of "nearly all the incidents" making the assessments valuable as security was "oppressive and unnecessary." 295 U.S. at 62.

157. Compare *Wright II*, 304 U.S. at 515, with *Wright I*, 300 U.S. 440.

158. *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555 (1935). In *Radford*, both the district court and court of appeals had held that the Frazier-Lemke Act was within the scope of the bankruptcy power, and the creditor made this his primary argument on appeal to the Supreme Court. See *Louisville Joint Stock Land Bank v. Radford*, 74 F.2d 576 (6th Cir. 1935); *In re Radford*, 8 F. Supp. 489 (W.D. Ky. 1934); Brief for Louisville Joint Stock Land Bank at 9-23, *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555 (1935) (No. 717). The Court rejected the "bankruptcy power" argument. 295 U.S. at 586-89.

159. See 295 U.S. at 589; *Continental Illinois Bank & Trust Co. v. Chicago, Rock Island & Pac. R.R.*, 294 U.S. 680 (1935).

160. 295 U.S. at 589; 294 U.S. at 680. Other cases decided in the same period limited the power of the Federal government to abrogate contracts, by a kind of "reverse incorporation" into the due process clause. See *Lynch v. United States*, 292 U.S. 571 (1934). See also *Perry v. United States*, 294 U.S. 330 (1935). Neither of these cases remains viable on its own terms. See *Pension Benefit Guar. Corp. v. R. A. Gray & Co.*, 467 U.S. 717 (1984) (retroactive application of statutory withdrawal penalty does not violate fifth amendment due process clause); *Lichter v. United States*, 334 U.S. 742 (1948) (collection of excessive profits on war subcontracts after renegotiation does not violate fifth amendment due process property protection).

Under the circumstances, it is perfectly understandable that the Court would wish to steer safely clear of the Constitution and decide cases on statutory grounds; witness *Ahlers*.

### 3. Summary — *The Two Lines*

It requires no extensive analysis to recognize that the “statutory” doctrine of absolute priority, whose centerpiece is *Case v. Los Angeles Lumber Products*, addresses the same problem as the “constitutional” line, where *Radford* is the centerpiece. In each case, the ultimate question is whether the equity owner can retain the collateral without discharging all of his debts. *Case* and *Radford* are alike, of course, insofar as they answer that question negatively. But it surely is a matter worthy of remark that they do it with so little recognition of each other. *Case*, in particular, reveals no hint that there is any “constitutional” overtone to its doctrine.

Justice Brandeis, in a similar spirit, gives no hint that there is any relation between the claim of the bank against *Radford* and the claim of *Boyd* against the shareholders of the railroad. Justice Brandeis situates his doctrine in relation to the “other” body of reorganization law, namely, the law of composition. He concedes that in a composition, a debtor may be able to keep his property without paying all of his debt, but he argues that this is so because only a majority vote effects a composition.<sup>161</sup> Coming closest to the absolute priority line, he continues: “It is the same power, which a court of equity exercises when it compels dissenting creditors, in effect, to submit to a plan of reorganization approved by it as beneficial and assented to by the requisite majority of creditors.”<sup>162</sup> Of course, Justice Brandeis can hardly be expected to know that the Court via Justice Douglas just five years later would hold that majority rule has no place in absolute priority doctrine. Indeed, the only modern equity receivership case that Justice Brandeis cites for his proposition is *Kansas City Terminal Railway v. Central Union Trust Co.*<sup>163</sup> But Justice Douglas in *Case* would take great pains to separate *Kansas City* from majority-rule doctrine and

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161. *Radford*, 295 U.S. at 585-86. Justice Brandeis refers to §§ 77 and 77B as applying the principle of composition. 295 U.S. at 586 n.16. Spaeth and Winks, advocating the analysis that became the law in *Case*, say that Justice Brandeis was using the term “composition” “in an extremely loose sense,” and that “it is not one opposed to the strict priority theory.” Spaeth & Winks, *supra* note 57, at 789. Cf. Brief for the United States as Amicus Curiae at 34, *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555 (1935) (No. 717).

162. *Radford*, 295 U.S. at 585.

163. 271 U.S. 445 (1926). Justice Brandeis also cites *Shaw v. Railroad Co.*, 100 U.S. 605 (1879), which, of course, long predates *Boyd*, and so might fairly be regarded as outside the absolute priority arena altogether.



establish *Case* as the fountainhead of new-value lore.<sup>164</sup> The one place where absolute priority and the Constitution meet head on provides an ironic *obligato* to the whole process. The case is *In re 620 Church Street Building Corp.*,<sup>165</sup> where the complainant was an equity owner who was “squeezed out” under the absolute priority rule. He argued that it was unconstitutional, via the absolute priority rule, to exclude him from continued participation of the debtor. Happily for the sake of consistency, the Court rejected this claim on the grounds that the petitioner had no value to protect.<sup>166</sup>

“Statutory” and “constitutional” doctrine brushed against each other on one more occasion in the 1930s, though the terms of the encounter are so murky it is not entirely clear that either knew the other was there. The occasion was the problem of damages for the breach of a long-term lease where the tenant was a debtor in bankruptcy.<sup>167</sup> Under traditional landlord-tenant law, the lessor had no claim for rent until it was due. In bankruptcy, if the lease was burdensome, the trustee might reject the lease, but the tenant might not forfeit his estate. The practical result was that the landlord might take nothing from the estate, but might retain a claim against the debtor. Where the debtor was a liquidating corporation, that meant the landlord got nothing. Where the debtor was an individual or an enterprise that would survive the bankruptcy, that meant the debtor remained under the burden of the landlord’s claim. An aggravating difficulty was that real estate values collapsed in the Great Depression, and many tenants found themselves liable on long-term leases where landlords’ damages might dwarf all other claims.

Congress responded in 1934 with compromise legislation, allowing the landlord’s claim in bankruptcy, but subject to a cap. The language was scrutinized by the Supreme Court in *Kuehner v. Irving Trust Co.*<sup>168</sup> In *Kuehner*, the landlord did not contest the cap itself. He accepted it as a limitation of his claim against the estate, vis-à-vis other

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164. See *infra* at Part III.B.

165. 299 U.S. 24 (1936). *620 Church* was the only § 77B case to reach the Supreme Court before *Case*.

166. Justice Douglas did cite *620 Church* in *Case* for the proposition that “stockholders and other junior interests may be excluded from any plan of reorganization if the court finds that the debtor is insolvent.” 308 U.S. at 126.

167. The history is summarized by Justice Roberts in *City Bank Farmers Trust Co. v. Irving Trust Co.*, 299 U.S. 433, 437-42 (1937), a companion case to *Kuehner v. Irving Trust Co.*, 299 U.S. 445 (1937), decided the same day. A fuller treatment, with extensive citation to sources, is in *Oldden v. Tonto Realty Corp.*, 143 F.2d 916, 918-21 (2d Cir. 1944). The effort to cap the landlord’s claim may be seen in part as an attempt to evade the absolute priority rule. See Douglas & Frank, *Landlords’ Claims in Reorganizations*, 42 YALE L.J. 1003 (1933).

168. 299 U.S. 445 (1937).

creditors: apparently he recognized the proposition that the statute, even with the cap, gave him more out of the estate than he might have had before. He was disputing the treatment of his remaining damages, above the cap, vis-à-vis the reorganized debtor. He asserted that, as to these damages, he should have priority over the reorganized debtor.

Justice Roberts, for the Court, ruled against the landlord. In the process, the Court upheld the provision as a permissible exercise of the bankruptcy power, and not violative of the fifth amendment. But on closer scrutiny, Justice Roberts' reasoning presents a number of problems. Justice Roberts quite clearly understood that this was what he was doing in reaching this conclusion, but some of his reasoning seems to bear no relation to the result. In particular, he didn't understand the difference between the debtor and a competing creditor.

In *Radford*, Justice Brandeis stated that prior to Frazier-Lemke I "[n]o bankruptcy act had undertaken to supply [the debtor] capital with which to engage in business in the future."<sup>169</sup> The landlord pointed to this language in arguing that he ought to have priority over the debtor. "The short answer," said Justice Roberts in response, "is that the object of bankruptcy laws is the equitable distribution of the debtor's assets amongst his creditors . . . ."<sup>170</sup> That may be a short answer, but not to the question asked. The landlord wasn't complaining about other creditors at all; he was asserting a right as against the reorganized debtor.

Justice Roberts went on to acknowledge that the bankruptcy power was subject to the fifth amendment. The landlord conceded that he had "no lien upon, or property right in, the debtor's assets."<sup>171</sup> Justice Roberts next declared that there was "a significant difference between a property interest and a contract, since the Constitution does not forbid the impairment of the obligation of the latter."<sup>172</sup> He said the case might "therefore be regulated by a bankruptcy law which impairs the obligation of the debtor's contracts."<sup>173</sup> But then, quite unexpectedly, he continued:

While, therefore, the Fifth Amendment forbids the destruction of a contract it does not prohibit bankruptcy legislation affecting the creditor's remedy for its enforcement against the debtor's assets, or the measure of the creditor's participation therein, if the statutory provisions are conso-

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169. *Radford*, 295 U.S. at 582.

170. *Kuehner*, 299 U.S. at 451 (citation omitted). The sentence continues: "and the validity of the challenged provision must be tested by its appropriateness to that end." One page later, Justice Roberts speaks of "equitable distribution of those assets." 299 U.S. at 452.

171. 299 U.S. at 451.

172. 299 U.S. at 452.

173. 299 U.S. at 452.

nant with a fair, reasonable, and equitable distribution of those assets.<sup>174</sup> Up to this point, he had given no clear indication that there was any contracts-clause limitation in the fifth amendment at all. Apparently the reader was supposed to know that the impairment of a contract was different from the destruction of a contract, that destruction would not be permitted, and that impairment would be permitted if (perhaps only if) it is "consonant with a fair, reasonable, and equitable distribution of . . . assets."<sup>175</sup> Of course, as Justice Roberts had already indicated, he saw no unfairness here. That last quoted caveat notwithstanding, the practical result of *Kuehner* was to hammer home the principle that a property right could not be impaired in a bankruptcy proceeding, while a contract right was fair game. Moreover, because it is a contract, rather than property, apparently the landlord/creditor will indeed have to supply new capital to the debtor, *Radford* notwithstanding. In the same vein, *Kuehner*, though "constitutionally" rooted, can be understood as putting a large dent in the absolute-priority proposition that creditors must be paid in full before the debtor gets anything, because it permits the debtor to reorganize and continue without discharging an obligation that might bind him at state law. *Case*, of course, would not be decided until three years in the future.<sup>176</sup> But *Kuehner* has survived virtually unchallenged in the current Bankruptcy Code.<sup>177</sup>

There is one issue that might justify a distinction between "constitutional" and "statutory" strategies in deciding particular cases — the problem of retroactivity. That is, *Radford* construed a "retroactive" statute — the most retroactive statute possible because it applied by its terms only to mortgages entered into before its adoption.<sup>178</sup> This "retroactivity" problem was central to Justice Brandeis' thinking in deciding *Radford*.<sup>179</sup> In the nature of things, the only way to deal with this kind of retroactivity problem is through constitutional interpretation.<sup>180</sup> But the analysis is asymmetrical: you may need the Constitu-

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174. 299 U.S. at 452.

175. 299 U.S. at 452.

176. For whatever it is worth, neither Justice Brandeis nor Justice Douglas participated in *Kuehner*. Justice Brandeis is recorded in the opinion as not participating. 299 U.S. at 456. Justice Douglas was not yet on the Court.

177. See 11 U.S.C. § 502(b)(6) (Supp. IV 1986). Cf. *Oldden v. Tonto Realty Corp.*, 143 F.2d 916 (2d Cir. 1944). A possible defense of *Kuehner* might be structured around the uncertainty of the landlord's "actual" claim in a situation where the lease extends far into the future and the bankruptcy estate is to be distributed now. This problem is not, of course, restricted to landlords' damages; it is a problem with any long-term or contingent claim, made much more urgent by the greatly expanded definition of "claim" under present law. See 11 U.S.C. § 101(4) (1982).

178. *Frazier-Lemke I*, Pub. L. No. 73-486, 48 Stat. 1289 (expired 1949).

179. *Radford*, 295 U.S. at 589.

180. Justice Rehnquist, of course, "dealt with" the problem of retroactivity without reaching

tion to strike down a retroactive statute, but it does not follow that the Constitution is irrelevant when you uphold such a statute. The fact is that *Radford* is not the only "retroactive" case on stage. The *Wright* cases are "retroactive" in the same sense that *Radford* was: the legislature purported to apply the statute to transactions entered into before its enactment. Yet the *Wright* cases do no more than gloss the constitutional principles of *Radford*.<sup>181</sup>

For its part, *Case* is somewhat more complicated, but in the end it fits the same analysis. The Court in *Case* purported to "apply" a statute.<sup>182</sup> But to what? If the Court treated the statute as applied to the "composition" agreement, then it applies only prospectively. If the Court applied the statute to the underlying bond contract, then it was applied retroactively.<sup>183</sup> Nothing in the time sequence of *Case* requires that it be treated as a statutory, rather than a constitutional case. Finally, while retroactivity may be a necessary condition of a constitutional problem here, the point remains. That depends on whether there are some "inherent" property rights in secured creditors which cannot be taken away even prospectively. And while the Court has sidestepped all opportunities to decide that question, it has never clearly stated that there are none.<sup>184</sup>

These qualifications aside, why did the "statutory" and the "constitutional" approaches proceed as if in separate universes? What accounts for this discontinuity, whereby the Court creates two parallel bodies of law on the same topic? Several possibilities present themselves. Perhaps they are simply different cases that require different strategies. In this analysis, *Frazier-Lemke I* simply represents a failure of the legislature, compelling the Court to play the constitutional card, whereas nothing so drastic occurred in the development of the "statutory" doctrine. This cannot be rejected completely, but there is less merit to the proposition than might appear at first glance. Justice Douglas presents *Case* as being statutory only, but, as argued above, this is done largely with smoke and mirrors.<sup>185</sup> In any event, the predecessor to *Case* — *Boyd* — was not statutory at all: *Boyd* involved the

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the constitutional issue; but he did so by defining the problem out of existence. See *supra* note 130 and accompanying text.

181. Rogers makes an elegant effort to disconnect *Wright III* from its constitutional base, but it is against the tide of commentary. Rogers, *supra* note 95, at 973.

182. Act of June 7, 1934, Pub. L. No. 73-296, § 77B, 48 Stat. 911, 912-22 (amended 1938).

183. There remains, of course, the argument that the Court was applying the statute "retroactively," but only insofar as it "codified" prior law. This is attenuated enough to suggest how far all this must have been from Justice Douglas' mind when he wrote *Case*.

184. For an introduction to the problem of uncompensated takings and contract impairments, see L. TRIBE, AMERICAN CONSTITUTIONAL LAW 586-628 (2d ed. 1988).

185. See *supra* text accompanying notes 93-95.

Court exercising a roving commission as supervisor of the equity receivership within very loose limits, much as it does when it interprets the Constitution.<sup>186</sup> The same would be true of all other absolute priority cases, at least until the coming of reorganization statutes in the Great Depression. A second and more intriguing possibility is timing. *Radford* was decided in 1936, *Case* in 1939. By conventional understanding, 1937 is the year of the great doctrinal watershed in Supreme Court thinking — the year of the Roosevelt Court-packing bill, the year of Justice Roberts' apparent retreat, the year the Court ultimately abandoned its commitment to economic due process.<sup>187</sup> By this reading *Radford* stands on one side, and *Case* on the other, of the great divide.

The retreat from economic due process might explain why Justice Douglas in *Case* insisted on a narrow statutory result for what was, after all, an ambitious intrusion into bankruptcy law: he could have all the satisfaction of economic interference with none of the doctrinal embarrassment. It could equally well explain why *Wright III*, though decided in 1940, retains a constitutional strategy: after all, it is rooted in, and purports to be a gloss on, *Radford*.

Focusing on these decisions in terms of doctrinal history has a surprising bonus, in that it explains why Justice Brandeis laid such stress on the ideology of property rights in *Radford*. At first glance, this is surprising because virtually every prior inquiry into the limits of the bankruptcy power had turned on the bankruptcy clause. A year before, in evaluating a state mortgage moratorium, the Court had relied on the contracts clause.<sup>188</sup> The Court had already begun to experiment with using the contracts clause on Federal legislation.<sup>189</sup> Brandeis' use of the "property" approach was largely unprecedented. Why didn't he choose to work out *Radford* in contract, rather than property, terms?

One possible answer is that long before he came to the Court, Justice Brandeis established his public reputation by arguing in favor of the judicious (if not judicial) impairment of contract. In particular, he was the winning counsel in *Muller v. Oregon*.<sup>190</sup> *Muller* is by now

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186. Indeed, the equity receivership cases are a striking instance of the Court's exercising its role as the oracle of "federal" commercial law under the doctrine of *Swift v. Tyson*, 41 U.S. 1 (16 Pet.) (1842) (overruled by *Erie R.R. Co. v. Tompkins*, 304 U.S. 64 (1938)).

187. A summary of the doctrinal shift, with references to sources, may be found in L. TRIBE, *supra* note 184, at §§ 8-5 to 8-7.

188. *Home Bldg. and Loan Assn. v. Blaisdell*, 290 U.S. 398 (1934).

189. *Perry v. United States*, 294 U.S. 330 (1935); *Lynch v. United States*, 292 U.S. 571 (1934).

190. 208 U.S. 412 (1908).

almost legendary in constitutional lore:<sup>191</sup> how the Supreme Court, in *Lochner v. New York*,<sup>192</sup> held that a state law limiting the working hours of bakers was an unconstitutional interference with freedom of contract; how Justice Peckham in *Lochner* insisted that his decision was based on “common understanding”;<sup>193</sup> how Oregon passed a statute undertaking to limit the working hours of women; and how Brandeis, then a Boston lawyer, prevailed on the *Muller* Court to retreat from *Lochner* and defer to the presumed reasonableness of the legislative judgment. *Muller* is one of the great milestones in the history of establishment liberalism.<sup>194</sup> Having played so critical a role in defeating judicial interference with the “contract” judgments of the legislature, it would be at least excusable if Justice Brandeis wanted to avoid taking the “contract” route in striking down *Frazier-Lemke I*.

It is necessary to concede, of course, that there is no hard evidence to support this reading, however attractive. On the other hand, there is at least one additional, perhaps even more plausible, explanation for the discontinuity between *Radford* and *Case*. That is, the two bodies of doctrine grew up in two separate legal cultures: two different sets of lawyers who dealt with two different kinds of clients. They didn’t attend the same summer camps or play on the same volleyball teams, and no one told them that they were addressing what was, economically, the same kind of case.

### III. THE NEW VALUE RULE

#### A. Stating the “Rule” — Case Reprised

Questions as to the existence of a new value rule and its form make sense only insofar as there is an absolute priority rule — after all, if there is no such rule, there is no need for a new value corollary because junior interests that would normally be precluded from participating in the organization could do so without the need to contribute new value. Therefore, the place to begin the search for a new value rule is in the lore of the absolute priority rule — particularly in the

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191. The canonical popular account is Mason, *The Case of the Overworked Laundress*, in *QUARRELS THAT HAVE SHAPED THE CONSTITUTION* 193 (J. Garraty rev. ed. 1987).

192. 198 U.S. 45 (1905), *overruled in* *Day-Brite Lighting, Inc. v. Missouri*, 343 U.S. 921 (1952).

193. 198 U.S. at 59.

194. So many axioms of the establishment model are bound up in *Muller* that it is difficult even to enumerate them: the power of fact; the power of the legislature to do good; the virtues of meliorism; the capacity of reason to prevail, even in conflict with mossbacks like the majority of the *Lochner* Court; and (surely not least) the constructive social role open to highly trained “technical” lawyers. It is also entertaining to memorialize *Muller* as an artifact from an era when protective legislation for women was not yet regarded as an engine of repression.

opinions of Justice Douglas interpreting old Section 77B and old Chapter X. Justice Douglas in these cases did more than just reaffirm (or declare) the absolute priority doctrine. He also went a long way toward setting out its contours and limits. Thus, for example, in *Case v. Los Angeles Lumber Products Co.*,<sup>195</sup> Justice Douglas held that the absolute priority rule of Section 77B could not be overridden by a mere majority vote of creditors.<sup>196</sup> In *Consolidated Rock Products Co. v. Du Bois*<sup>197</sup> he articulated the Court's holding that in order to implement the absolute priority rule, the reorganization court must make a finding as to value. More important for present purposes, in *Consolidated Rock*, expanding on *Case*, he spelled out just how that valuation should be made. Specifically, he stated that valuation for purposes of the absolute priority rule should be made on the basis of the normally higher "going concern" value rather than the normally lower liquidation value.<sup>198</sup> Justice Douglas never fully justified this view, but he seemed to acknowledge that the Chapter X creditor loaned on the faith of the normally higher going concern value, and that if the business is to continue after reorganization, then the creditor ought to be able to look to value at least equal to the value in which he had an interest before the reorganization.<sup>199</sup>

The full import of this rule becomes apparent in *Marine Harbor Properties, Inc. v. Manufacturers Trust Co.*,<sup>200</sup> another opinion by Jus-

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195. 308 U.S. 106 (1939).

196. Presumably it could be overridden by unanimous vote, but that case never presented itself, which is hardly surprising. After all, who would complain?

197. 312 U.S. 510 (1941).

198. 312 U.S. at 526. There is room for a great deal of analytic confusion in the supposed distinction between "going concern" and "liquidation" values. The distinction seems to be based on the following propositions: (1) that the assets put to use in the business are worth more for that purpose than they would be if sold separately; and (2) that a liquidation sale is the norm in bankruptcy. Each of these may be generally true in practice, but neither is necessary as a matter of fact. Some businesses are worth far more in liquidation than as going concerns; the Penn Central Railroad, for example, a disaster as an operating company, turned out to be in control of a highly profitable inventory of valuable real estate. See generally Brown, *Introduction: A Review of the Penn Central Reorganization proceeding*, 36 BUS. LAWYER 903 (1981).

Similarly, while bankruptcy administration may be costly and inefficient, it is entirely conceivable in principle that an enterprising trustee may be able to keep assets together and sell them at a higher price than any private liquidator may be able to do. Many confuse the going concern/liquidation distinction with the quick-sale/careful-marketing distinction. The assumption is that a liquidation sale will be carried out "quickly," without taking time to seek out the best potential buyers, while a going concern sale will be carried out more carefully. But there is no necessity that this be so. A "careful" sale is likely to be more costly, and will be correspondingly inefficient if there are no buyers waiting. Finally, the distinction is often confused with the proposition that only the debtor (or the principals of the debtor corporation) can maintain the going concern value — again a possible, but hardly a necessary, scenario. For the most part, I maintain the conventional usage, despite all its confusions.

199. For a somewhat different statement of the rationale, see Pachulski, *supra* note 64, at 939.

200. 317 U.S. 78 (1942).

tice Douglas. Marine Harbor owned an apartment house. Manufacturers Trust held the first mortgage. There were also junior mortgages and other claims. It was conceded that the property was worth less than the amount necessary to satisfy the first mortgage debt. The creditor started a state court foreclosure proceeding, and the debtor filed a Chapter X claim. The court of appeals ordered dismissal of the petition, holding that it had been filed only to escape the jurisdiction of the state court. The Supreme Court affirmed the dismissal but rejected the reasoning. Justice Douglas stated that, other things being equal, it was entirely proper to file to escape the jurisdiction of the state court, but in this case, the debtor was unable to show sufficient "need for relief."<sup>201</sup> Justice Douglas based this analysis squarely on the absolute priority rule. Only mildly restated, his reasoning was that because the property was worth less than the senior debt, there would never, under the absolute priority rule, be anything left for juniors. The same result would obtain in state foreclosure anyway, so there was no reason for the reorganization court to take jurisdiction.<sup>202</sup> Under this logic, the equity owners of the debtor can never keep anything in a reorganization unless they pay the prior claims in full. For debtors, this considerably reduces the attractiveness of a statute like Chapter X. And that would explain why Justice Douglas, going back to *Case*, was so insistent on trying to make room for the new value rule.

### B. *Articulating the New Value Rule* — Kansas City Terminal

This analysis provides a basis for understanding why Justice Douglas, in *Case*, embraced the new value principle so enthusiastically. Admittedly in *Case*, it was the old shareholders who raised the new value issue. Recall that the plan was to distribute shares to the old shareholders even though senior claims remained unsatisfied. The old shareholders sought to justify their continued participation by offering " 'their familiarity with the operation' of the business and their 'financial standing and influence in the community,' " together with " 'continuity of management.' "<sup>203</sup> This contribution, they argued, justified their continued participation.

Conceivably Justice Douglas, in rejecting this plea, might simply

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201. 317 U.S. at 84.

202. The case may sound perplexing to a modern reader since the property in question is a single office building, for which it would appear that the going concern value and the liquidation value are the same. That being the case, a composition would not pass a "liquidation" test either; cf. 11 U.S.C. § 1129(a)(71) (1982) ("liquidation test" under Chapter 11). But Justice Douglas chose not to rest on that proposition. For the new value rule in *Marine Harbor*, see *supra* text accompanying note 61.

203. 308 U.S. at 112-13.



have shown that there was no new value rule under the absolute priority standard of Chapter X. Or he might have left the issue open, arguing that whether there was a new value rule or not, it didn't fit this case.<sup>204</sup> But he did neither. Quite the contrary, he embraced the new value principle with seeming enthusiasm and undertook to spell it out in some detail. "It is, of course, clear," he stated, "that there are circumstances under which stockholders may participate in a plan of reorganization of an insolvent debtor."<sup>205</sup> Where the necessity for new money exists, he continued, "and the old stockholders make a fresh contribution and receive in return a participation reasonably equivalent to their contribution, no objection can be made."<sup>206</sup>

Justice Douglas relied for this proposition on one previous case from which he quoted liberally, *Kansas City Terminal Railway Co. v. Central Union Trust Co. of New York*.<sup>207</sup> To understand fully what Justice Douglas was up to in *Case, Kansas City Terminal* deserves a careful reading, for, in fact, it stands for less than Justice Douglas made of it.

*Kansas City Terminal* was a classic equity railroad reorganization, involving the Missouri, Kansas & Texas Railway Company (the "Katy").<sup>208</sup> The property of the Katy was to be sold to a new corporation. The reorganizers offered compensation in new securities to all classes — secured creditors, unsecured creditors and stockholders. As to stockholders, the plan offered participation if they paid a cash assessment. As to unsecured creditors, the plan offered a choice between two options: one required payment of an assessment, the other did not.<sup>209</sup>

Central Union, an unsecured creditor,<sup>210</sup> challenged the plan as unfair, insofar as it compensated stockholders without fully compensating the unsecured creditors. The matter came before the Supreme Court in the form of three questions submitted by the court below — as it were, a request for an advisory opinion. The questions, as Justice

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204. This latter approach is, of course, the approach of Justice White in *Ahlers*. See 108 S. Ct. at 968.

205. 308 U.S. at 121.

206. 308 U.S. at 121.

207. 271 U.S. 445 (1926).

208. With customary lack of imagination, the new company was to be called the Missouri-Kansas-Texas Railroad Company.

209. Requiring a new contribution from old equity as a condition of continued participation seems to have been a standard device in reorganization cases: one infers that it is the preferred method of raising new capital. Such an assessment was required in the plan in *Northern Pac. Ry. v. Boyd*, 228 U.S. 482 (1913).

210. Central Union had sought to establish itself as a secured creditor, but without success. *Kansas City Terminal Ry. v. Central Union Trust Co.*, 294 F. 32 (8th Cir. 1923).

McReynolds stated in his opinion, "lack[ed] precision,"<sup>211</sup> but it is possible to extract some core of meaning from them anyway.

Question 1 asks whether the plan may be imposed on unsecured creditors if it "does not give precedence to the entire claim of the creditor over any part or interest of a stockholder."<sup>212</sup> In modern parlance, that is, the question asks whether the plan may be confirmed even though it violates the absolute priority rule. Justice McReynolds stated that this question "if interpreted strictly . . . must be answered in the negative."<sup>213</sup> In other words, he was reaffirming (or at least he thought he was reaffirming) the absolute priority rule. But his "explanation" raises complications, to which we will return in a moment.

Question 2 asks whether the plan may pay junior and senior classes with the same kind of security, given appropriate adjustments for value.<sup>214</sup> The question may sound odd to the modern mind, accustomed to treating the form of payment as irrelevant, so long as the payee gets adequate value. But it probably was an important question in Justice McReynolds' day, so this was probably important also. Nevertheless, it has no direct relevance to the new value problem, and we need concern ourselves no further with it here.

Question 3 needs to be set forth in full. It provides:

Is such offer as to such creditors fair and binding if it consists only of the same grade of securities as offered the stockholders, the difference being that the right of the stockholders to participate is conditioned upon the payment of an assessment or the payment of a relatively greater assessment than that asked of such creditors, provided the court shall be of the opinion that the offer tenders to such creditor[s] all that could reasonably be expected under all of the existing circumstances?<sup>215</sup>

Disentangled, this 85-word skein of rhetoric and argumentation probably contains at least five subquestions. Separately, they would go something like this: (a) Assuming a plan cannot be made binding by giving different classes the same securities, can it be made binding by making the junior class pay an assessment? (b) Assuming the same facts as in (a), can the plan be binding when both classes pay an assessment, provided the junior class pays a larger assessment? (c) If the proposals in (a) and (b) are not valid *per se*, can they be made valid by a court's finding that the offer is "all that could reasonably be expected"?

Even as differentiated, there are a number of problems with this

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211. 271 U.S. at 453.

212. 271 U.S. at 452.

213. 271 U.S. at 455.

214. 271 U.S. at 452-53.

215. 271 U.S. at 453.

list. Subquestions (a) and (b) become moot when the court decides (as it did decide) that it is permissible to pay two classes with the same kind of security. The best one can do to salvage them is to construct a new subquestion (“subquestion (d)”), which assumes that it is permissible to pay two classes with the same kind of security. It asks whether the plan is made any less permissible if one or more of the classes also contributes cash. This question has the virtue of clarity, but at the price of bordering on the frivolous: the answer must be that there is no objection to paying with both securities and cash; clearly, Justice McReynolds would have agreed. Meanwhile, subquestion (c) (“all that could reasonably be expected”) hovers like a minatory cloud over the whole analysis. What, exactly, could the concept of “reasonable expectations” add to, or subtract from, the formulations already set forth? The answer must be that it adds nothing — unless its purpose is to permit variations from the absolute priority rule.<sup>216</sup>

So far, none of this presents the new value issue with the precision of Justice Douglas in *Case*. In order to do that, it is necessary to formulate a separate question (“subquestion (e)”): Is it permissible for a junior class to participate, even though senior classes are not paid in full, provided that the junior class makes a contribution of new value corresponding to the value it retains?<sup>217</sup> If Justice McReynolds had asked it, the answer would, conceivably, have given authority to the new value issue.

This exercise in question framing may seem tedious and arcane, but there is a point to it all. The point is to make clear why it is not surprising that Justice McReynolds gave a muddled answer to the new value issue. The point is that he started with a muddled question, or questions. Given this muddle, Justice McReynolds repeatedly contradicted himself in his analysis. Like subquestion (c) above, he took away with one hand what he gave with the other.

Thus, as part of his general discussion, Justice McReynolds offered language which seemed to acknowledge the absolute priority rule. He declared: “Unsecured creditors of insolvent corporations are entitled to the benefit of the values which remain after lienholders are satisfied, whether this is present or prospective, for dividends or only for purposes of control.”<sup>218</sup> Note that, although a bit imprecise, this sounds like absolute priority. But Justice McReynolds didn’t stop there. Instead, he asserted that reasonable adjustments should be encouraged:

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216. The same proviso, and the same problem, presents itself in Question 2.

217. This is, of course, not the only possible way of stating the new value issue.

218. *Kansas City Terminal*, 271 U.S. at 455.

“Practically, it is impossible to sell the property of a great railroad for cash; and, generally, the interests of all parties, including the public, are best served by cooperation between bondholders and stockholders.”<sup>219</sup>

But what was there to cooperate about or adjust? Either absolute priority is the rule, or it is not. In any event he continued: “If creditors decline a fair offer based upon the principles above stated, they are left to protect themselves. After such refusal they cannot attack the reorganization in a court of equity.”<sup>220</sup>

That would make sense if we knew which of the “principles above stated” he was referring to. It could be he was referring to the absolute priority principle. Or it could be that he was referring to the “principle of cooperation,” which seems quite independent of it. Moreover, it is not clear what he could have meant when he said creditors “are left to protect themselves.” This is an equity receivership by compulsion of the court; the creditors have no other choice but to deal with the debtor in this proceeding.

Specifically addressing the questions certified, Justice McReynolds first addressed Question 1 — whether a plan may be confirmed if it violates the absolute priority rule. As we have already seen, “interpreted strictly,” Justice McReynolds answered this question negatively.<sup>221</sup> Using language that would be quoted by Justice Douglas in *Case*, he continued: “[T]o the extent of their debts creditors are entitled to priority over stockholders against all the property of an insolvent corporation.”<sup>222</sup> This sounds like pure absolute priority doctrine. In two succeeding sentences, he went on to say that creditors need not receive senior securities, and that it might be possible to compensate them in other ways — thus answering Question 2 which, strictly speaking, he hadn’t even posed yet. In addressing Question 1, Justice McReynolds went on to state that “[g]enerally, additional funds will be essential to the success of the undertaking, and it may be impossible to obtain them unless stockholders are permitted to contribute and retain an interest sufficiently valuable to move them.”<sup>223</sup>

This statement about new value<sup>224</sup> concerned neither absolute priority (Question 1) nor form of payment (Question 2). Instead, it seems to be preparing to respond to (hypothetical) subquestion (e) of Ques-

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219. 271 U.S. at 455.

220. 271 U.S. at 455 (citing *Northern Pac. Ry. v. Boyd*, 228 U.S. 482, 508 (1913)).

221. See *supra* text accompanying notes 212-13.

222. 271 U.S. at 455 quoted in *Case*, 308 U.S. at 116.

223. 271 U.S. at 455.

224. Justice Douglas cited it in *Case*, 308 U.S. at 117.

tion 3 — also not yet formally posed. In any event, Justice McReynolds, still answering Question 1, continued: “In such [!] or similar [?] cases the chancellor may exercise an informed discretion concerning the practical adjustment of the several rights.”<sup>225</sup> This can be read to stand for the proposition that in (a) cases where it is necessary to distribute the same securities to more than one class, or (b) cases where it is necessary to induce continued participation from the former shareholders, or (c) “similar situations,” then the chancellor is not bound by the absolute priority rule, which contradicts the first sentence of this same response. In the same vein, answering Question 3, Justice McReynolds stated: “Whenever assessments are demanded, they must be adjusted with the purpose of according to the creditor his full right of priority against the corporate assets, so far as possible in the existing circumstances.”<sup>226</sup> It is not clear which circumstances he was referring to, given the context of the opinion. In fairness to Justice McReynolds, I note that Justice Douglas quoted both of the two competing sentences last quoted.<sup>227</sup> But in the context of *Case*, it seems hardly to present the grounds for misunderstanding that are evident here.

The gist of this analysis is that Justice McReynolds’ opinion in *Kansas City Terminal*, while it does indeed contain intimations of an absolute priority rule and also of a new value exception, is equivocal at best, and can be read as supporting something quite different. All this is captious or fanciful in the absence of evidence that the opinion was actually (mis)read this way. Fortunately, evidence was already at hand in the interpretation by the lower court on remand, approving a revised reorganization plan.<sup>228</sup> The plan allocated value to all classes, including equity. Since neither absolute priority nor its recently-hatched new value corollary guided the Court, the governing principles of the case are obscure. There was no pretense of a valuation, no pretense of an allocation of value in terms of claims, and no pretense that shareholders were being compensated according to their contribution. The plan was simply confirmed, and the Supreme Court denied *certiorari*.<sup>229</sup>

The point of all this is that neither of the cases taken as seminal for

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225. 271 U.S. at 455 (exclamation added).

226. 271 U.S. at 456.

227. *Case*, 308 U.S. at 117.

228. *Kansas City Terminal Ry. v. Central Union Trust Co.*, 28 F.2d 177 (8th Cir. 1928). For a more detailed analysis of *Kansas City Terminal* on remand, see Billyou, *supra* note 51, at 553, 559-60.

229. 278 U.S. 655 (1929).

the new value doctrine can be read as an application of the new value doctrine. *Kansas City Terminal* "states" it, but in a self-contradictory manner, and accepts the ruling of the lower court when that court chose not to apply it. *Case* "states" it well enough (indeed, one is tempted to say that Justice Douglas understood Justice McReynolds' opinion far better than Justice McReynolds understood it himself) but then refuses to apply it on the particular facts. One gets the distinct impression that the real purpose of "restating" *Kansas City Terminal* with such force in *Case* was to take the sting out of what was otherwise a fairly radical interpretation. Only Justice White's opinion in *Ahlers* subsequently recognized the new value rule. But to assert that Justice White recognized the rule stretches a point, because he specifically refused to commit himself on whether any new value rule remains in the Code. On the other hand, *Case* and *Kansas City Terminal*, which Justice White recognized as the fountainheads of new value doctrine, didn't apply it either. We examine Justice White's nonapplication of the rule more exhaustively in the next section.

### C. Ahlers on New Value

*Ahlers* poses a two-fold issue: (1) whether there is a new value exception and, if the answer is "yes," then (2) whether the Ahlerses' farming efforts constitute sufficient new value to protect them from the absolute priority rule. For the moment, it is useful to restrict ourselves to the first of these questions — whether there is a new value rule.

#### 1. New Value After the 1978 Bankruptcy Code

The court of appeals in *Ahlers* had no trouble finding that there was a new value rule, relying chiefly on *Kansas City Terminal*.<sup>230</sup> The Solicitor General's appellate brief<sup>231</sup> granted that *Case* established a new value exception<sup>232</sup> but questioned whether it survived the 1978 Bankruptcy Code.<sup>233</sup> In a note, the brief stated that the lower courts seemed "to be divided on this question."<sup>234</sup> To support the existence of the rule, the brief cited five cases — two from circuit courts (the

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230. 794 F.2d at 401.

231. Brief for the United States as Amicus Curiae Supporting Petitioner, at 17-23, *Norwest Bank Worthington v. Ahlers*, 108 S. Ct. 963 (1988) (No. 86-958).

232. He recognized this exception as dictum. *Id.* at 23.

233. *Id.* He also stated that "the Code has changed prior law and that, under Chapter 11 of the Code, equity owners can never participate in a reorganized enterprise over the dissent of a class of creditors whose claims are impaired and who do not receive or retain property of a value equal to the allowed amount of their claims." *Id.*

234. *Id.* at n.15.

Sixth and the Seventh Circuits) and three from bankruptcy courts,<sup>235</sup> noting that “[s]ome bankruptcy courts have implied, if not held, that it is no longer possible for equity holders to retain ownership over the objection of a class of creditors whose claims are not fully honored.”<sup>236</sup> This somewhat clumsy choice of language was apparently intentional.<sup>237</sup> The brief based this concession on Justice Douglas’ acceptance, in *Case, of Kansas City Terminal*.<sup>238</sup> Arguing that the new value doctrine did not survive the 1978 Code, the Solicitor General made what amounted to two separate arguments — one of which I shall call the “statutory construction” argument and the other of which I shall call the “plausibility” argument.<sup>239</sup> As to statutory construction, he indicated that the 1978 Code, unlike its predecessors, clearly defined “fair and equitable,”<sup>240</sup> arguing that the comprehensive definition left no room for a new value principle. Second, the Solicitor General argued that “nothing in the legislative history suggests a congressional intention to maintain” the new value rule.<sup>241</sup>

Moving onto a somewhat more spacious plane, the Solicitor General argued that it was “not surprising” that the Code dropped the new value rule<sup>242</sup> in light of two conditions that do not exist at this time. One is the state of the law itself: under the present Code, unlike old Chapter X, the creditors may waive the absolute priority rule by an appropriate vote, meaning that the Congress opted to let creditors decide whether continued debtor participation is desirable. The second argument asserted that today’s capital markets differ from those of 1939, where the old shareholders might be the only source of new capital; today, this is “a much less realistic concern.”<sup>243</sup>

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235. *In re U.S. Truck Co.*, 800 F.2d 581 (6th Cir. 1986); *In re Potter Material Serv., Inc.*, 781 F.2d 99 (7th Cir. 1986); *In re Sawmill Hydraulics, Inc.*, 72 Bankr. 454 (Bankr. C.D. Ill. 1987); *In re Landau Boat Co.*, 13 Bankr. 788 (Bankr. W.D. Mo. 1981); *In re Marston Enterprises*, 13 Bankr. 514 (Bankr. E.D.N.Y. 1981).

236. Brief for the United States as Amicus Curiae Supporting Petitioner, at 18 n.15, *Norwest Bank Worthington v. Ahlers*, 108 S. Ct. 963 (1988) (No. 86-958). He cited *In re Pine Lake Village Apartments Co.*, 19 Bankr. 819 (Bankr. S.D.N.Y. 1982), and *In re Pecht*, 57 Bankr. 137 (Bankr. E.D. Va. 1986).

237. See *infra* text accompanying notes 244-45.

238. Brief for the United States as Amicus Curiae Supporting Petitioner, at 19, *Norwest Bank Worthington v. Ahlers*, 108 S. Ct. 963 (1988) (No. 86-958).

239. The Solicitor General did not structure the argument precisely this way; I am restating it for convenience in understanding.

240. Brief for the United States as Amicus Curiae Supporting Petitioner, at 20 n.17, *Norwest Bank Worthington v. Ahlers*, 108 S. Ct. 963 (1988) (No. 86-958).

241. *Id.* at 21.

242. *Id.* at 22.

243. *Id.* The Solicitor General is tantalizingly noncommittal. The Court was right in its former perception of capital markets, and contrastingly affirmative that capital markets are fluid today.

The Supreme Court refused to find that the new value rule has been abolished, ruling instead that Ahlers' efforts would not in any event constitute sufficient new value under the rule. Justice White wrote that "our decision . . . should not be taken as any comment on the continuing vitality of the [new value rule]."<sup>244</sup> The Court dismissed the Solicitor General's argument on the rule in one moderately detailed footnote. In it, Justice White states that the issue "has divided the lower courts since passage of the Code in 1978."<sup>245</sup> Supporting this proposition, he curiously offered a "*compare, e.g.,*" citation, citing two cases that do not deliver what the citation seems to promise.

## 2. *New Value Case Law in the Lower Courts*

Justice White cited *In re Sawmill Hydraulics, Inc.*<sup>246</sup> to support the new value rule when, in fact, *Sawmill Hydraulics* cites the rule, but then refuses to apply it.<sup>247</sup> *Sawmill Hydraulics* does cite some (but not all) of the relevant case law in its footnote 1,<sup>248</sup> to which Justice White adverts, but that is another story.

The second case cited, *In re Pine Lake Village Apartment Co.*,<sup>249</sup> lacks an identifiable holding. In *Pine Lake Village*, the shareholders of the debtor proposed to make a new value contribution to retain their interest,<sup>250</sup> and the judge refused confirmation. But it is altogether unclear what relation, if any, the judge saw between new value and confirmation. He seems to have relied simply on the basis that the creditor was not being fully compensated, without seeming to grasp that the debtor was trying to take himself outside the rule. *Pine Lake Village* seems to have worked its way into Justice White's thinking via the brief of the Solicitor General; but, in fact, the Solicitor General was unwilling to assert that *Pine Lake Village* flatly rejected the rule. The most the Solicitor General was willing to do was argue that *Pine Lake Village* "implied, if not held" that new value was no longer viable.<sup>251</sup>

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244. *Ahlers*, 108 S. Ct. at 967 n.3.

245. 108 S. Ct. at 967 n.3.

246. 72 Bankr. 454 (Bankr. C.D. Ill. 1987).

247. The *Sawmill Hydraulics* court held, first, that labor and services will not constitute new value — *i.e.*, essentially the same result Justice White would reach in *Ahlers*. 72 Bankr. at 457. The court went on to hold that a shareholder guaranty of debt not previously guaranteed might constitute new value, but that the debtor had failed to establish that his contribution equaled or exceeded the value of the retained interest. 72 Bankr. at 458.

248. 72 Bankr. at 456 n.1.

249. 19 Bankr. 819 (Bankr. S.D.N.Y. 1982).

250. 19 Bankr. at 823.

251. See Brief for the United States as Amicus Curiae Supporting Petitioner, at 18, *Norwest Bank Worthington v. Ahlers*, 108 S. Ct. 963 (1988) (No. 86-958).



Justice White could have taken the alternative approach that there are at least four courts (two circuits and two bankruptcy courts) that have ordered confirmation of plans where the creditors were not fully compensated, on the strength of contributing new value.<sup>252</sup> Moreover, there is no contrary authority, although *Pine Lake*, on its facts, may be teased into that result. That ended Justice White's direct encounter with the new value problem.

### 3. *New Value and the Going Concern*

Later in the opinion, Justice White addressed another argument which he treated as separate from the new value analysis, but which, as we shall see, may be closely related to it. The debtors argued that "the property which the [debtors] wish to retain has no value to the senior unsecured creditors."<sup>253</sup> The debtors further asserted that "because the farm has no 'going concern' value (apart from their own labor on it), any equity interest they retain in a reorganization of the farm is worthless, and therefore is not 'property' under [the cram-down rule]."<sup>254</sup> According to this view, the debtors' retained equity interest in the farm would have value only in their hands, and thus their interest could never detract from the value properly accorded to senior claims.

Justice White rejected the argument, stating that

Even where debts far exceed the current value of assets, a debtor who retains his equity interest in the enterprise retains 'property.' . . . Indeed, even in a sole proprietorship, where 'going concern' value may be minimal, there may still be some value in the control of the enterprise; obviously also at issue is the interest in potential future profits of a now-insolvent business.<sup>255</sup>

Justice White joined "with the overwhelming consensus of authority" in rejecting the "no value" argument.<sup>256</sup> For the moment, it is probably useful to note that the "no-value" argument seems to involve two separate issues: one is the question of who may enjoy the "going con-

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252. *Teamsters Natl. Freight Indus. Negotiating Comm. v. U.S. Truck Co.* (*In re U.S. Truck Co.*), 800 F.2d 581 (6th Cir. 1986); *Official Creditors' Comm. v. Potter Material Serv.* (*In re Potter Material Serv., Inc.*), 781 F.2d 99 (7th Cir. 1986); *Brown v. Brown's Indus. Uniforms, Inc.* (*In re Brown's Indus. Uniforms*), 58 Bankr. 139 (Bankr. N.D. Ill. 1985); *In re Landau Boat Co.*, 13 Bankr. 788 (Bankr. W.D. Mo. 1981). A fifth case, *Buffalo Savings Bank v. Marston Enters.* (*In re Marston Enters.*), 13 Bankr. 514 (Bankr. E.D.N.Y. 1981), is often cited as the "first" new value case under the 1978 Code. But in fact, the court in *Marston Enterprises* refused confirmation for lack of a consenting class. See *infra* note 289 and accompanying text.

253. *Ahlers*, 108 S. Ct. at 969.

254. 108 S. Ct. at 969. See *infra* text accompanying notes 262-69 for an explanation of the cramdown rule.

255. 108 S. Ct. at 969.

256. 108 S. Ct. at 969.

cern premium" in a Chapter 11 case; the other is whether one can ever impute different "values" to the property in the hands of different parties. Just about everyone talked about the new value issue as if it involved the going concern premium. It is better understood as involving the second, more abstract, question. Thus, the court of appeals explicitly treated the matter as a controversy over "going concern" and "liquidation" values:

[T]he reorganization value of the [Ahlerses'] farm exceeds its liquidation value — if the plan is rejected, the unsecured creditors will get nothing, whereas they will receive annual payments if the plan is approved and is successful. The [Ahlerses'] farm operation and management skills are something of a value which would disappear if their farm was liquidated. Because that value cannot be captured for creditors in the event of liquidation, fairness is not violated if their Chapter 11 plan leaves that value in their hands.<sup>257</sup>

This may be attractive as a pragmatic matter, but the court of appeals was simply wrong. In fact, this issue was vigorously debated in the development of the current Bankruptcy Code. Under the original proposed draft, a court might have been permitted to do just exactly what the Eighth Circuit proposed to do here — *i.e.*, allow the former equity holder to participate on the strength of future contribution alone.<sup>258</sup> The matter was vigorously debated in the law reviews,<sup>259</sup> and the act adopted contains no such provision.<sup>260</sup>

The difficulty with this "going concern premium" approach is that it is, as a matter of history at least, conceptually irrelevant to the new value argument. Justice Douglas, who insisted that there was indeed a new value exception to the absolute priority rule, also formulated the principle that the creditor in an old Chapter X case had the right to the entire going concern premium.<sup>261</sup>

#### D. *Can There Be a New Value Rule?*

Recall that in *Ahlers*, the Solicitor General argued that the new value rule had been "repealed" by the adoption of the new Chapter 11, but the Court refused to rule on the issue. But close scrutiny of the opinion yields two surprising inferences. First, Justice White may indeed have "overruled" the new value exception, whether he intended

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257. *In re Ahlers*, 794 F.2d at 402.

258. COMMISSION REPORT, *supra* note 77, at 277. See *supra* note 82 and accompanying text.

259. See generally Blum & Kaplan, *supra* note 83, at 651; Brudney, *supra* note 79, at 306; Trost, *supra* note 72, at 542.

260. On the going concern premium, see particularly Pachulski, *supra* note 64, at 939.

261. The convergence is most obvious in a case like *Marine Harbor Properties*, where it would seem the going concern value and the liquidation value are very likely the same. Justice Douglas insisted nonetheless that the absolute priority applies.

to or not. And second, new value may have been an illusion all along — or less dramatically, there may never have been an adequate doctrinal basis for the new value rule, as articulated by Justice Douglas. Of course, there were later lower court cases that purported to “apply” the rule.<sup>262</sup> But a careful reading of *Ahlers*, together with *Case* and its kin, suggests that they may never have been well founded.

Consider the following example. John Debtor is president and majority shareholder of Debtorco, a closely-held corporation. Debtorco sedulously observes corporate formalities, and there is no doubt that Debtor and the corporation are separate entities. Debtorco owes \$100 to Loanco, a creditor that holds a security interest in all Debtorco assets. Debtorco also owes a total of \$50 to a total of five unsecured creditors. The court “finds” the value of Debtorco’s assets to be \$85. The balance sheet of Debtorco thus looks like this:

Assets	Liabilities	Shareholders’ Equity
\$85	\$100 (Loanco secured debt)	(\$ 65)
	\$ 50 (trade creditors)	

In behalf of Debtorco, John Debtor proposes the following plan: Debtorco will give Loanco a note with a present value of \$85 secured by all the assets of Debtorco, satisfying Loanco’s secured claim.<sup>263</sup> The \$15 deficiency on Loanco’s secured claim will be grouped with the \$50 worth of trade debt into a single class of unsecured claims. Debtorco proposes to satisfy the claim of this class by a single cash payment of \$10. The \$10 payment for unsecured creditors will come from John Debtor, who will make the payment in exchange for new shares. All old Debtorco shares will be cancelled, and all creditors holding unsecured claims vote on the plan. All except Loanco vote in favor; Loanco votes against. May the plan be confirmed?

On the information given, the answer would appear to be clearly “yes,” except for a question over the \$10 payment, which I shall address below.<sup>264</sup> Debtorco has divided the obligation of Loanco into secured and unsecured claims.<sup>265</sup> On the secured claim, it seems clear that Loanco is “impaired.”<sup>266</sup> Since Loanco is impaired and does not accept, the treatment of the secured claim makes the plan

262. See *infra* notes 284-300.

263. That is, a note conforming to the standards of 11 U.S.C. § 1129(b)(2)(A)(i) (1982).

264. Loanco may be able to defeat the plan by making the election under 11 U.S.C. § 1111(b) (1982), but, practically speaking, it isn’t likely and, in any event, it is irrelevant to the analysis set forth here. See generally Klee, *All You Ever Wanted To Know About Cram Down Under the New Bankruptcy Code*, 53 AM. BANKR. L.J. 152-56 (1979).

265. 11 U.S.C. § 506(a) (1982).

266. 11 U.S.C. § 1124 (1982).

nonconfirmable, unless Debtorco can effect a cram-down.<sup>267</sup> In fact, Debtorco seems to have brought itself within the cram-down “exception” of section 1129(b), which permits confirmation over the dissent of an impaired class. That is, Loanco keeps its lien<sup>268</sup> and appears to receive the “value” for its secured claim provided under the cram-down rule.<sup>269</sup> Thus, Loanco may be bound even without its consent, and the unsecured claims are treated together as a class. The class is clearly “impaired,”<sup>270</sup> but as to a particular class, a plan may be binding if it receives the consent of that class.<sup>271</sup> Acceptance requires the consent of a majority in number and two thirds of those voting.<sup>272</sup> All creditors except Loanco vote in favor; thus, since the plan has won the requisite acceptances from this class, the dissent of a minority of that class is irrelevant.<sup>273</sup>

There is one further relevant confirmation standard, of course. That is, the plan may be confirmed over the dissent of an individual creditor (as distinct from a class of creditors) if that individual creditor will not receive less than he would receive in liquidation.<sup>274</sup> But no individual creditor in the foregoing example will receive less than he would in liquidation because the \$10 payment to fund the payment to the unsecured class will come not from corporate funds, but from personal funds of the shareholder. These funds will be available only in Chapter 11, and would not be available in liquidation.

Thus, on all points discussed here, the plan would appear to be confirmable. And so we turn to the presence of new value — the contribution from the shareholder. But here is the problem: What is it that the shareholder purports to be “buying” with his \$10? The obvious answer has to be the residual equity in the company. But the balance sheet after confirmation, and before the \$10 contribution, looks like this:

Assets	Liabilities	Shareholders' Equity
\$85	\$85	\$0-

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267. 11 U.S.C. § 1129(a)(8) (1982).

268. 11 U.S.C. § 1129(b)(2)(A)(i)(I) (1982).

269. 11 U.S.C. § 1129(b)(2)(A)(i)(II) (1982) (“deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder’s interest in the estate’s interest in such property”). This problem of “value” is a critical consideration; it is discussed *infra* in the text accompanying notes 278-282.

270. 11 U.S.C. § 1124 (1982).

271. 11 U.S.C. § 1129(a)(8) (1982).

272. 11 U.S.C. § 1126(c) (1982) (the class of unsecured claims).

273. If all creditors vote, it will be impossible for Loanco to defeat the “class” confirmation under § 1129(a)(8). There are five other creditors; thus Loanco is outvoted, 5-1. Two thirds of the \$65 worth of claims would be \$43.33. The five other creditors hold claims totalling \$50.

274. 11 U.S.C. § 1129(a)(7)(A)(ii) (1982).

Given that no one would pay \$10 for a company with a net worth of zero, then the offer of a \$10 payment has to be taken as an "admission" that the company is worth more than \$85. But if it is worth more than \$85, then Loanco's secured claim is undervalued, and Loanco is not being fully compensated on that secured claim. That being the case, cram-down is not available, and the plan may not be confirmed.

The same logic forbids confirmation at any valuation until Loanco either (a) consents or (b) receives full value for its claim. The plan as sketched is one possible Chapter 11 new value plan. It is modeled roughly on cases like *Radford* and *Wright III*, where the issue was one of compensation to a secured class.

Other variations are possible. For example, it is possible to design a plan similar to the one in *Ahlers*, where confirmation may turn on compensation for the unsecured class. Thus, in the above example, suppose Loanco were the only creditor. Suppose the court "finds" that the value of Debtorco is \$85. Suppose the shareholders propose to give Loanco a secured note with a present value of \$85, to pay nothing to the unsecured, to cancel the old shares, and to issue new ones in consideration of a new value payment of \$10. Debtorco will argue that Loanco has been fully compensated on its secured claim as required by section 1129(b). Debtorco will concede that the unsecured class (*i.e.*, Loanco as the holder of a \$20 claim) is deemed not to have accepted<sup>275</sup> but will argue that the plan may be imposed on this dissenting unsecured class because no junior class will "retain" anything under the plan.<sup>276</sup> True, the "junior" shareholder class will wind up with the reorganized company but will achieve it not by "retention," but by its \$10 new value contribution. Once again, the rejoinder will be that if the old shareholders are willing to pay \$10 for the reorganized company, then they are conceding that it is worth something more than \$85. If it is worth something more than \$85, then Loanco as the sole creditor is being undercompensated.<sup>277</sup>

In another hypothetical, suppose that Loanco is a sole creditor, has a claim of \$100, and that the claim is entirely unsecured. Suppose the court "finds" that the value of Debtorco is \$85, and that it undertakes to give a note for that amount to Loanco in full satisfaction of its

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275. 11 U.S.C. § 1126(f) (1982). For whatever it is worth, Debtorco will make the same concession to "old" equity. But since "old" equity is receiving 100% of the residual interest in the reorganized company, old equity will not complain.

276. 11 U.S.C. § 1129(b)(2)(B)(ii) (1982).

277. This is the case either in its role as secured claimant or in its role as unsecured claimant; from the point of view of Loanco, it comes down to the same thing.

claim, retaining the residual equity interest in exchange for a \$10 payment. The same reasoning seems to follow: Debtorco argues that cram-down is possible because it is not “retaining” any interest, per section 1129(b)(2)(B)(ii), while Loanco will argue that its desire to pay for the asset amounts to a concession that it is worth something more than \$10.

In the abstract, it might be possible to argue that there is more than one “value” that may be relevant to a bankruptcy case, and that a court might, without inconsistency, impute one “value” to the creditor’s interest and another to the debtor’s interest in the same property.<sup>278</sup> From the standpoint of doctrine, however, there is a difficulty in that this is precisely the argument that Justice White seems to have rejected in *Ahlers* — specifically, when he rejected the so-called “no value” argument, summarized above.<sup>279</sup> To recall, the Ahlerses had argued that they should be permitted to retain their farm because the creditor had been deprived of nothing of value. Justice White roundly rejected this argument, stating that he was joining “the overwhelming consensus of authority” on this issue:<sup>280</sup> “Indeed, even in a sole proprietorship, where ‘going concern’ value may be minimal, there may still be some value in the control of the enterprise; obviously, also at issue is the interest in potential future profits of a now-insolvent business.”<sup>281</sup> Restated, this seems to mean that anything retained by the debtor must be “value” for purposes of Section 1129(b). If that is the case, then there is no basis for letting the shareholder participate on the basis of new value. If this is true, then at least it is the case that the new value strategy is impermissible under the new Code. But it seems that under the same theory, new value was impermissible under Chapter X as well. The difficulty is that in applying the absolute priority rule under Chapter X, it is clear that creditors had the right to the entire “going concern value” of the business. We have this on the authority of no less an arbiter than Justice Douglas himself.<sup>282</sup> This has always been accepted as the unvarying Chapter X rule.<sup>283</sup> But if the going concern value belongs to the creditor and not to the equity owners, then it is impossible to imagine what there can be for the equity owners to “buy.” And if there is nothing for the equity owners to buy, then the new value rule,

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278. The case for multiple values is set forth at length in Pachulski, *supra* note 64, at 951-64.

279. See *supra* text accompanying notes 255-57.

280. *Ahlers*, 108 S. Ct. at 969; see also *supra* text accompanying notes 256-57.

281. 108 S. Ct. at 969.

282. *Consolidated Rock Prods. Co. v. Du Bois*, 312 U.S. 510 (1941).

283. See Pachulski, *supra* note 64, at 938-39.

just as it does not exist under Chapter 11, did not exist under Chapter X. At first blush, the point may seem frivolous: after all, Justice Douglas, who insisted that the creditors owned the going concern value, also insisted on the new value rule. But recall: Justice Douglas in *Case* did not implement the rule, nor did he in *Marine Harbor Properties*, nor did he ever implement the new value rule, at least not under Chapter X. What he did in *Case* was to take an older, well-nigh unintelligible decision, handed down before the absolute priority rule had truly crystallized, and dress it up in respectable garments, where it served to dignify the absolute priority pronouncement. In order to understand this, it is desirable to take one more look at the cases, and to identify those instances where the new value principle has in fact been applied.

### E. *Applying the Rule*

#### 1. *Pre-1978, Under Chapter X*

The courts apparently applied the new value rule under old Chapter X. There appears to be no reported case in the entire period in which the court expressly permitted the "debtor," or former equity owners, to retain assets on the strength of a new value contribution and for no other reason. But the fact is that Justice Douglas' supposed "exception," born of the confusion of the *Kansas City Terminal* opinion and matured in *Case v. Los Angeles Lumber*, is nowhere present as a rule of decision in Chapter X cases. New value under Chapter X, then, is an illusion.

#### 2. *Post-1978, Under Chapter 11*

Under Chapter 11, unlike Chapter X, a handful of cases purports to apply the new value principle, but they are instructive in their own way. In particular, the genesis of new value doctrine under the 1978 Code represents a remarkable instance of doctrinal circularity, where law was created out of nearly nothing.

The sequence begins with *In re Landau Boat Co.*,<sup>284</sup> a Chapter 11 case heard in the winter of 1981. The debtor first proposed a plan whereby shareholders would retain an interest although creditors were not paid in full. The court rejected that first offering as a violation of the absolute priority rule (*Landau I*). The scene then shifts to New York and the case of *In re Marston Enterprises*,<sup>285</sup> where the debtor sought to fend off foreclosure on an apartment building. In *Marston*,

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284. 8 Bankr. 436 (Bankr. W.D. Mo. 1981).

285. 13 Bankr. 514 (Bankr. E.D.N.Y. 1981).

the equity owners proposed to fund the plan through *pro rata* contributions of new value. The plan proposed to cancel all the old shares, but to issue all new stock to the old owners in proportion to their contributions. The court discussed the proposal with citations to *Case*, *Louisville Trust*, and *Landau Boat*:<sup>286</sup>

There is no statutory prohibition against original shareholders making a substantial necessary capital contribution in consideration for which they received shares of stock in the reorganized corporation. There is also nothing in the Code which precludes the case law which developed under Chapter X of the Bankruptcy Act, relating to corporate reorganization, from application of Chapter 11 of the Bankruptcy Code.<sup>287</sup>

Then the court makes a startling assertion: "The case of *In re Landau Boat Co.* . . . adapts these principles to the Code."<sup>288</sup> Concededly, *Landau I* talked about the new value problem. But in fact, of course, the only way in which *Landau I* "adapted" the principles to the Code was by refusing to apply them. Nevertheless, the court in *Marston* used *Landau I* as authority for validating the new value principle in *Marston*.

Having done as much, however, the court in *Marston* refused confirmation on other grounds.<sup>289</sup> Thus, while *Marston* does purport to rule on the new value issue, it ultimately provides no more support for the principle than *Landau I*. The privilege of actually implementing the new value principle was left, rather, to a new round of litigation in the *Landau* case, where the court at last approved a debtor's plan (*Landau II*).<sup>290</sup> In this plan, the owners proposed to cancel all old stock and issue new stock to purchasers who would give cash and loan commitments. The owners offered to take up all of the new issue, but, in a novel departure, they also expressed their willingness to share *pro rata* with creditors if the court saw fit. The court approved the plan, relying on *Marston*! The court cited the language that the *Marston* court had drawn from its analysis of *Landau I*.<sup>291</sup>

Since then, at least three other courts — two circuits and a district court — have approved new value plans. The most recent — and the most intriguing — is *In re U.S. Truck Co.*,<sup>292</sup> a panel opinion from the Sixth Circuit. The proponent, an investor who had taken control of

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286. 13 Bankr. at 517-18.

287. 13 Bankr. at 518.

288. 13 Bankr. at 518.

289. The issue was whether there was a "consenting class" within the statutory definition. The court held that there was not. 13 Bankr. at 520-21.

290. *In re Landau Boat Co.*, 13 Bankr. 788 (Bankr. W.D. Mo. 1981).

291. 13 Bankr. at 792.

292. 800 F.2d 581 (6th Cir. 1986).



the company after the Chapter 11 filing, proposed to cancel the old equity and buy up the new shares for \$100,000. The panel affirmed a district court confirmation order in a brief and somewhat elliptical opinion, treating the district court findings as not clearly erroneous. The court treated the law on new value as settled, citing *Case* and *Kansas City Terminal*.<sup>293</sup> A fuller exposition is available in the opinion of the district court, where the plan is set forth in full.<sup>294</sup> What is evident in the district court opinion is the very unusual nature of the underlying dispute. The objecting creditor was the Teamsters National Freight Industry Committee, purportedly speaking in the interest of union truck drivers. From a reading of the opinion, two novelties appear: First, the union was not as concerned with money as with the terms of a collective bargaining agreement that the court had earlier authorized the debtor to reject. The National Committee took the position that it would object to any plan until the earlier collective bargaining agreement was accepted in full.<sup>295</sup> Second, the labor apparatus did not speak with one voice on the plan. Thus, while the National Committee persisted in its objections throughout the case, the local union and the debtor at several points reached agreement on how the case was to be conducted. It seems clear that the district court, at least, was treating the National Committee's objection as a complaint about the integrity of the collective bargaining process, and irrelevant to the issue of confirmation.

Just a few months earlier, the Seventh Circuit had reached the same conclusion in *Official Creditors' Commn. v. Potter Material Service, Inc.*<sup>296</sup> The debtor proposed a plan whereby unsecured creditors stood to receive three percent of their claims. The sole shareholder proposed to pay \$14,800 of his own funds toward the three percent. He also undertook to pay the debtor's attorney's fees and to renew a personal guarantee on some pre-Chapter 11 debt.<sup>297</sup> Once again the circuit said the trial court finding was not clearly erroneous. As in

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293. 800 F.2d at 588.

294. *In re* U.S. Truck Co., 47 Bankr. 932 (Bankr. E.D. Mich. 1985). The plan is in an appendix. 47 Bankr. at 944-52.

295. *See* 47 Bankr. at 935-41. The National Committee's strategy seems clear from its approach to the plan. By the terms of the plan, the employee-claimants would have the right either to 70% on the effective date of the plan or to 100% over three-and-a-half years. But, at least as represented in the opinion, the objector directed all its attention to the collective bargaining agreement and none to the size of the payment.

296. *In re* Potter Material Serv. Inc., 781 F.2d 99 (7th Cir. 1986).

297. Not the least puzzling point of the opinion was the court's conclusion that he "renewed" the guarantee. 781 F.2d at 102. On the facts presented, it seems he had no choice; otherwise, the guaranteed creditor probably would have been impaired and could have rejected the plan.

*U.S. Truck*, the court treated the principle of new value as settled law, relying on *Case*, *Marston*, and *Landau II*. One district court reached a similar result, concluding with similarly minimal discussion that the bankruptcy court's decision was not clearly erroneous.<sup>298</sup> One bankruptcy court has also applied "new value" as settled law.<sup>299</sup>

Thus, two circuits and one district court now accept the new value principle, relying on what *Marston* drew from *Landau I*, and what *Landau II* drew from *Marston*, together with citations to *Case* or *Kansas City Terminal* as needed. What is striking about all these cases is that almost no one challenged the existence of the new value principle *per se*. The courts discuss related issues like the question whether the value offered is sufficient to the case, or whether the contribution of the old equity is "essential," but the principle is taken as a matter of authority. The only clear exception is *Marston*, where the court attempts to justify the new value principle this way:

If \$300,000 to \$400,000 of new money were needed to fund the plan, and the consideration came from new investors who were not shareholders, it would not violate the fair and equitable rule to permit them to contribute capital and receive shares of stock in the reorganized corporation. There is no reason why investors of new capital who happen to be shareholders, whose equity interest as old shareholders is extinguished, should be disqualified from investing in the reorganized corporation, where their contribution is substantial, as is the case herein. It would not violate the fair and equitable standard.<sup>300</sup>

With all due respect to the court, this completely misses the point. Of course it is true that an outsider might pay \$300,000 to \$400,000 for the equity in a particular case. But under ordinary circumstances, that money would go straight through to creditors, with the old equity getting none of it — a sale, as it were, by the creditors, of their stake. Undoubtedly, the outsider's willingness to pay \$300,000 or \$400,000 signals the outsider's belief that the asset is worth at least as much as the sum paid. But in the case of the outsider, the price is arrived at by competitive bargaining. It is one thing to let the outsider buy the asset in such a market transaction, quite another to let the old equity acquire it by a sort of "eminent domain."

### 3. *Some Comparisons*

Lest the point be forgotten, it is important to emphasize again that Justice White in *Ahlers* treated the issue as statutory only, rejecting

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298. *Brown v. Brown's Indus. Uniforms, Inc.* (*In re Brown's Indus. Uniforms*), 58 Bankr. 139 (Bankr. N.D. Ill. 1985).

299. *In re Jartran*, 44 Bankr. 336 (Bankr. N.D. Ill. 1984).

300. 13 Bankr. at 518.

any suggestion of a constitutional taint. This point comes into focus when one examines the various approaches undertaken by Congress in various chapters of the Bankruptcy Act and Code.

Thus, while there may be no clear support for the new value principle in old Chapter X, it seems clear that it was available under Frazier-Lemke, as interpreted by the Supreme Court in *Wright III*.<sup>301</sup> As was set forth above, in *Wright III* the Court held that the debtor might retain his farm property, as long as the creditor got the "value" of his collateral.<sup>302</sup> The debtor, of course, will not want to retain the property unless it is worth his while to compensate the creditor in this way. That is, he will not want to retain the property unless he believes he can make something more out of it than what he will have to pay the creditor. In the typical case, it is hard to see how he will do this unless he contributes new value — e.g., his labor or experience at farming. Of course, Justice Douglas authored *Wright III*.<sup>303</sup>

The same can be said about both Chapter 12 and Chapter 13 of the present Bankruptcy Code. In each case, the Code permits the debtor to retain property that might otherwise go to creditors, even where creditors are not paid in full.<sup>304</sup> This is the process that Justice White seems to have been approving, at least in dicta, in *Ahlers*.<sup>305</sup> In Chapter 12 and Chapter 13 (as, indeed, in Frazier-Lemke before them), one principle is particularly noteworthy. Under both chapters, the success of the plan normally turns on a contribution of the debtor's "earnings." Post-bankruptcy earnings are not, typically, property of the bankruptcy estate.<sup>306</sup> This principle is anomalous to the extent that it treats earnings from human capital (i.e., wages) as different from earnings of other kinds of capital (which do become property of the estate). At the very least, it provides inescapable evidence that Congress regards itself as empowered to determine what is, and what is not, property in a particular case, within some limits.

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301. 311 U.S. 273 (1940).

302. See *supra* notes 117-20 and accompanying text.

303. The Court decided *Case* on November 6, 1939, and *Wright III* a bit over a year later, on December 9, 1940. No matter what anyone might say about Justice Douglas — and many have said a great deal — no one ever doubted his analytical ability. Although there is no cross-reference, it is inconceivable that he did not see the relationship between the two cases.

304. See 11 U.S.C. §§ 1225, 1325 (1982 & Supp. IV 1986).

305. See 108 S. Ct. at 970.

306. No one doubts this principle, but as a statutory matter, it must be derived indirectly. It can be gleaned from the fact that post-petition earnings will be included in the estate under Chapters 12 and 13, while there is no comparable provision in Chapter 7. See 11 U.S.C. §§ 1207, 1306 (1982 & Supp. IV 1986). For an effort to cope with the distinction under Chapter 11, see *In re Fitzsimmons*, 725 F.2d 1208 (9th Cir. 1984); cf. *In re Lynn*, 18 Bankr. 501 (Bankr. D. Conn. 1982).

The situation under Chapter 7 is more complicated, in some interesting ways. Suppose the debtor owns an auto that he uses for pleasure only, subject to a security interest. Suppose that the debtor owes \$15,000 to the secured party; that the car is worth \$9000, and that there is no relevant right of exemption. How, if at all, may the debtor keep the car in a Chapter 7 bankruptcy?

The first point to notice is that this question concerns only the debtor and the secured party. That is, because the collateral is worth less than the claim of the secured party, the trustee will typically abandon the estate's interest.<sup>307</sup> As against the secured party, the debtor may be able to keep the car. Section 722 of the Code gives him a limited right to redeem, upon certain conditions apparently met here. In order to redeem, he must pay the creditor "the amount of the secured claim" — by hypothesis in this example, \$9000.<sup>308</sup> The provision is limited, of course, to the kinds of property specified in section 722 and to requiring the debtor to pay cash — he cannot employ a time-payment schedule.<sup>309</sup> As with the other provisions sketched here, in order to make the provision intelligible, it is necessary to manipulate the concept of "value": thus, it must be the case that the debtor regards the car as worth more to him than the \$9000 value "found" by the court. The statute is thus theoretically limited; practice, of course, is another story. An individual creditor may choose to let the debtor retain other collateral on payment of something less than the outstanding debt, or even on time payments, and experience suggests that he often will. But aside from the statute, he does so only because he decides that it is in his interest — *i.e.*, he decides that the debtor, even with a scaled-down liability, is a better deal than any alternative.

#### F. *What Is New Value?*

There remains one issue central to *Ahlers* not directly addressed in this article so far. In a way, it is the most visible issue of all: Should the Ahlerses' "contribution" of their efforts constitute new value? Discussion of the issue in the context of this article is somewhat unreal, of course, because if there is no new value rule at all, it makes no sense to ask whether a thing does, or does not, constitute new value. Nevertheless, a discussion of the Court's approach to the new value problem may help to explain just why the concept is so elusive.

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307. The trustee may do so under 11 U.S.C. § 554(a) (1982).

308. See 11 U.S.C. § 506(b) (1982).

309. *In re Bell*, 700 F.2d 1053 (6th Cir. 1983).

The court of appeals enthusiastically embraced the idea that the Ahlerses' work constituted new value sufficient to let them keep the land. "Certainly," the court said, "a farmer's efforts in operating and managing his farm is [sic] essential to any successful farm reorganization, and this yearly contribution is measurable in money or money's worth."<sup>310</sup> The court defined this contribution as "the farmer's labor, including the value of his experience and expertise in farming the land."<sup>311</sup> As to value, the court of appeals distinguished between the value of the farmer's contribution and the value of the retained interest. The court stated that the value of his contribution "should not be overly difficult to determine."<sup>312</sup> The court conceded that "[v]aluing the retained equitable ownership interest . . . is a more difficult problem" but was confident that it could be done.<sup>313</sup>

Justice White, refusing to recognize the contribution as value, put the case within the ambit of *Case v. Los Angeles Lumber Products*.<sup>314</sup> Justice White didn't try to treat *Ahlers* as identical with *Case* on the issue; he called it "analogous."<sup>315</sup> Obviously, no two cases are identical, and in any instance where the court asserts a principle of "likeness," it must necessarily also recognize a principle of "difference." But the "differences" between *Case* and *Ahlers* are more than trivial. *Case* involved a corporate reorganization and *Ahlers* a farm. As argued above, *Ahlers* factually resembles *Radford* far more than it does *Case*. The shareholders in *Case*, hoping to retain an interest, offered their "continuity of management" and "financial standing and influence in the community."<sup>316</sup> Although Justice Douglas did not articulate it, the tenor of his opinion indicates that he did not believe that this constituted any "contribution" at all, either of new value or otherwise. Recall that the central problem in the old equity receivership cases was the problem of insider collusion. Justice Douglas, of all people, suspected a situation in which insider bondholders might conspire with insider shareholders to the expense of outsiders of whatever class. Insiders in this situation could hardly be expected to give reliable testimony as to what was "value" or not. That, after all, was implicit in the proposition that the absolute priority rule could not be waived by any majority, no matter how large. Certainly no one could argue that

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310. *In re Ahlers*, 794 F.2d at 402.

311. 794 F.2d at 402.

312. 794 F.2d at 402.

313. 794 F.2d at 402-03.

314. *Ahlers*, 108 S. Ct. at 967.

315. 108 S. Ct. at 967.

316. 308 U.S. at 122.

there was any risk of collusion between the debtor in *Ahlers* and any of his creditors.

By rejecting the "labor" argument, Justice White thought he was bringing himself within an unbroken tradition. He observed that "[P]revious attempts to qualify non-capital equity in the absolute priority context have been unanimously rejected."<sup>317</sup>

He was following the lead of counsel here, but, strictly speaking, he was wrong. In fact, there is one case, *Horowitz v. Kaplan*,<sup>318</sup> where a court of appeals authorized participation for a contribution of management skills, and the Supreme Court denied *certiorari*.<sup>319</sup> The court in *Horowitz* distinguished *Case* in three ways: First, the debtor in *Case* did not show any important contribution by management; second, there were some nonmanagement stockholders in *Case* who appeared to be making no contribution at all; and third, there was no binding commitment on management in *Case* to stay with the reorganized company. *Horowitz* thus can be read as a recognition that *Case* is not so much about an improper kind of value, but about something closer to the absence of value altogether.

Justice White made one other argument in rejecting the labor contribution that, while not wrong, is highly misleading and could be damaging if misunderstood. It is an argument from legislative history. Specifically, he argued that the Bankruptcy Commission, in its initial proposal, offered a provision which would have allowed continued participation on the basis of a nonmonetary contribution, but that the provision was stricken.<sup>320</sup> Justice White is right on this point, but he did not specify that the proposed provision would have allowed the court to order continued participation, whether the creditors agreed to it or not. The provision was supplanted by one that permits creditors as a class to accept less than full payment by an appropriate vote.<sup>321</sup> Justice White's statement could leave the incorrect impression that a dissenting creditor might block a plan, even if approved by a majority, if the shareholder's continued participation was based on management skills.

However, saying that *Ahlers* is different from *Case* is not the same as saying that *Ahlers* was wrongly decided. In saying the "value" in

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317. *Ahlers*, 108 S. Ct. at 967 n.4 (quoting Koger & Acconcia, *In re Ahlers: Capitalizing on Sweat*, 42 J. MO. BAR 455, 458 (1986)).

318. 193 F.2d 64 (1st Cir. 1951), *affg.* *In re Waltham Watch Co.*, 97 F. Supp. 189 (D. Mass. 1951).

319. 342 U.S. 946 (1952).

320. *Ahlers*, 108 S. Ct. at 968.

321. 11 U.S.C. § 1129(a)(8) (1982).

*Ahlers* was not sufficient, there were at least two approaches available to the Court. One, reflected in *Horowitz*, is to question whether the Ahlerses were bound to anything or whether, by contrast, they were undertaking to buy an option. To understand this point, consider what would have happened if the plan had been confirmed and the Ahlerses had decided not to follow through. What sort of remedy would the creditors have had against them? It is hard to identify a situation where any meaningful remedy would have been available. Presumably a plan, if confirmed, would have imposed personal liability on them for the unsecured debt, but they were for all practical purposes judgment-proof. This fact obviously impressed Justice White when he spoke of the contribution of future services as “intangible, inalienable, and, in all likelihood, unenforceable.”<sup>322</sup>

The second approach is to try to identify just what the Ahlerses’ “contribution” might be, apart from the “capital” of the bank. Both the court of appeals and the Supreme Court seem to have assumed that there was some sort of “going concern” value that would not be realized in “liquidation.” But it is not clear that this is so. Quite the contrary, it would seem that there is every reason to assume that another farmer could operate the farm as well as Ahlers.<sup>323</sup> If that is the case, then whatever “value” a farmer’s efforts might have is already reflected in the value of the farm.<sup>324</sup> If this is true, then what is the point of discussing new value at all? An answer could be that the “value” in *Ahlers*, is the product of human capital, exempt from bankruptcy administration, except when explicitly included. The validity of this distinction depends, of course, on the validity of the distinction between the products of human capital and the products of other kinds of capital — a distinction noted, although not defended, above.

#### IV. CONCLUSION: THE MEANING OF *Ahlers*

In this article I have tried to put *Ahlers* in the context of history and doctrine, showing that the new value doctrine, tested in *Ahlers*’ is, at best, highly evanescent. I have also shown how the Court, while

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322. *Ahlers*, 108 S. Ct. at 967.

323. I forebear to say “perhaps better.” One might make the argument that if the Ahlerses are in bankruptcy, it must be because they were, relatively speaking, bad managers, but it is not clear that this is so. It is perfectly possible to assume that they were doing as well as anyone else might have done.

324. The court of appeals talked about the Ahlerses’ contribution as if that contribution was necessary to protect the “unsecured” claimants (presumably excepting the deficiency claims of the mortgagees). It is true that they are “like” Ahlers in their rights to payment once the land is sold on foreclosure. But if the land has truly been undervalued, and if the sale price is high enough to pay all secured creditors’ claims, then the unsecured creditors have the right to any surplus.

skirting constitutional doctrine, has characteristically avoided putting the problem in any such framework, and Congress seems to have felt comfortable imposing results that are at least superficially inconsistent. Thus I have suggested a lack of controlling "theory" in this realm. On the other hand, I have not tried to supply any such theory, nor do I lament the possible absence of one. The effort to articulate "theory" for bankruptcy and kindred subjects is certainly alive and well,<sup>325</sup> but theorizing requires theoretical justification.<sup>326</sup> And at least in this realm, Congress and the courts have proven uniquely resistant to pressures to organize their work under any grand design. Their reasons for resistance may be better than our instincts might first suggest: once burnt, twice shy, might do for starters. Or more generously, the work product of both the courts and Congress may bespeak a conviction that bankruptcy law is too complex for facile categorization. Taken in context, the teaching of *Ahlers* may be: Congress can give the debtor leeway, but not too much. Properly understood, that may be a good enough rule until a better one comes along.

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325. The most obvious theoretical work is surely T. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* (1986); cf. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127 (1986). Other attempts at theorization, while few, are not entirely lacking. Among earlier items, see particularly Radin, *The Nature of Bankruptcy*, 89 U. PA. L. REV. 1 (1940); COMMISSION REPORT, *supra* note 77, at ch. 3, 75-96. The same instinct may be seen even more dramatically at work in the law of secured transactions where, as Professor Buckley has recently remarked, the traditional view "might have persisted, had not recent commentators sought to defend it." Buckley, *The Bankruptcy Priority Puzzle*, 72 VA. L. REV. 1393, 1393-94 (1986). Major recent theoretical work in the field is listed in Professor Buckley's article. See *id.* at 1394 nn.3-4.

326. A strong case for theory in commercial law studies may be derived from Clark, *The Interdisciplinary Study of Legal Evolution*, 90 YALE L.J. 1238 (1981).