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BANKRUPTCY: SUPREME COURT RESTRICTS NEW VALUE EXCEPTION

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The real estate collapse of the late 1980s resulted in a huge number of bankruptcy filings, as property owners sought to salvage some value from properties unable to support their mortgages. In many of the battles between borrower and lender, the borrower's crucial lever was the threat of a "cramdown" plan in bankruptcy. In a new decision, the Supreme Court has made it clear that cramdown will be a far less potent threat in the next recession.

The Absolute Priority Rule

In *Bank of America v. 203 N. LaSalle Street Partnership*, Justice Souter drafted a majority opinion severely limiting the use of the "new value exception" to the absolute priority rule. This rule says that a plan can be confirmed if all classes of creditors consent to the plan, but if at least one class does not approve of the plan (as is typically the case where there is a large undersecured mortgagee), the plan can only be approved if the bankruptcy court holds that it is "fair and equitable" with respect to the dissenting class. According to the Bankruptcy Code, a plan may be found to be fair and equitable only if the holder of any claim or interest that is junior to such class will not "receive or retain" any property under the plan on account of such junior claim or interest. In other words, partners in a debtor partnership cannot "receive or retain" anything on account of their partnership interests if a dissenting class of creditors has not been paid in full.

Debtors have avoided the strictures of the absolute priority rule by invoking the "new value exception." That is, a cramdown plan (i.e., one that is forced on the dissenting class of creditors) will provide for the equity holders to contribute value to the debtor in the form of new capital in exchange for retaining their equity interests. Thus, the argument goes, the equity holders are not receiving anything on account of their prior interests but only on account of the new value that is being contributed. This new value exception is not explicitly provided for in the Bankruptcy Code, but some courts have held that it is a natural corollary of the absolute priority rule as drafted.

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LaSalle Street's Bankruptcy Plan

The 203 North LaSalle Street Partnership owed Bank of America $93 million on a mortgage secured by its interests in an office building. The bankruptcy court valued the collateral at $54.5 million, leaving Bank of America with a $38.5 million unsecured claim. Under the partnership's proposed bankruptcy plan, the bank would have received its $54.5 million secured claim, with interest, over a 7 to 10 year period. However, it would have received payments with an estimated present value of just 16% of its unsecured claim. Other unsecured claims, which totaled just $90,000, were to be paid in full. Finally, partners in the debtor partnership would retain the equity interests in exchange for investment of $6.125 million over the course of five years.

Bank of America objected that the partners were receiving property on account of their junior interests even though its unsecured claim was not being paid in full, and thus the absolute priority rule was violated. The bankruptcy court rejected this argument, however, holding that the plan was valid under the new value exception. A divided panel of the Seventh Circuit affirmed, putting it in a league with the Ninth Circuit, which had approved the new value exception in 1994. On the other side were decisions from the Second and Fourth Circuits that had restricted the use of the new value exception. The Supreme Court granted certiorari to resolve the split in the Circuits.

Justice Souter, writing for six Justices, found it unnecessary to decide whether or not the new value exception exists, ruling that LaSalle's plan failed to satisfy the requirements of the Code regardless of whether or not new value plans were permissible. The opinion considers three possible meanings of the phrase "on account of." LaSalle argued that the prohibition against receiving anything "on account of such junior claims or interests" meant that the partners could not receive anything "in exchange for" their equity interests. Here, LaSalle argued, the partners were receiving new equity interests in exchange for their new capital contributions, not in exchange for their old equity interests.

The Court rejected the attempt to equate "on account of" with "in exchange for", reasoning that this was inconsistent with the phrase "receive or retain", since it would be "exceedingly odd" to speak of "retaining" an interest "in exchange for" that very interest. Moreover, this construction would render the absolute priority rule too manipulable, since equity holders could then retain an interest whenever substantial funds were paid in exchange. Determinations of whether the new value were adequate would be "measur[ed]] by the Lord Chancellor's foot, and an absolute priority rule so variable would not be much of an absolute."

Having rejected this reading of "on account of", the Court held that it must mean "because of." Thus, the question becomes whether any degree of causation should be enough to block confirmation of the plan, a conclusion that would mean that old equity holders "simply cannot take property under a plan if creditors are not paid in full." Alternatively, the court held that this language could be construed "to reconcile the two recognized policies underlying Chapter 11, or preserving going concerns and maximizing property available to satisfy creditors." Under this later reading, equity could receive or retain interests if the equity holders paid at least as much as anyone else would be willing to pay.

In the end, the Court found it unnecessary to decide between these two alternatives, holding that the plan failed to satisfy either. LaSalle's plan was "doomed . . . by its provision for vesting equity in the reorganized business in the Debtor's partners without extending an opportunity to anyone else either to compete for that equity or to propose a competing reorganization plan." The Court held that the partners' exclusive opportunity to purchase the equity in the reorganized debtor is property received or retained on account of their junior interests, in violation of the absolute priority rule. Only if the price to paid reflected the fullest possible value would it be possible for the plan to satisfy the new value exception (assuming it exists) and, the Court reasoned, there was no way to know if the partners were paying the full value unless the price were tested in the market. "Whether a market test would require an opportunity to offer competing plans or would be satisfied by a right to bid for the same interest sought by old equity, is a question we do not decide here. It is enough to say, assuming a new value corollary, that plans providing junior interest holders with exclusive opportunities free from competition and without benefit of market valuation fall within the prohibition" of the absolute priority rule.

Other Views

Justice Thomas wrote a concurrence in which Justice Scalia joined, arguing that much of the majority opinion was unnecessary. "Regardless of how direct the causal nexus must be, the prepetition equity holders here undoubtedly received at least on form of property—the exclusive opportunity—"on account of" their prepetition inter-

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est. . . . That conclusion . . . is sufficient to resolve this case."

A lone dissent, filed by Justice Stevens, would have affirmed the Seventh Circuit's decision.

Observation: This decision is likely to result in a dramatic shift in bargaining leverage between borrowers and lenders. The threat of a bankruptcy filing will not carry anyway near the same weight s before once lenders realize that cramdown is extremely unlikely. Moreover, by raising the bar on a cramdown plan, the *LaSalle* case may make it easier for lenders to get relief from the automatic stay if the borrower does file for bankruptcy, by arguing that no reorganization is reasonably in prospect.

APARTMENTS: EQUILIBRIUM IN 1999

A prediction of equilibrium in U.S. apartment markets through the end of 1999 is the conclusion of a study by PaineWebber done in conjunction with Regional Financial Associates. The study projects new supply this year of 356,000 units, somewhat lower than the forecasted demand of 409,000 units. This would mean that the national vacancy rate will decline from the 8.4% at 1998 year-end to 8.2%.
Overall, the increase in multifamily household demand should be driven by continued household growth; an expected increase in the renter population; and a slight boost from immigration. Somewhat offsetting these is likely to be a continuing high level of single-family affordability, rather than the slight decline originally projected.

Household Growth

According to the census bureau, new household growth has reached its highest level in the past three years. About 1.5 million new households were formed last year, a 1.5% increase over 1997.

Renter Population Growth

Not only are the number of new households on the rise, but much of the increase reflects growth in the 20 - 29 age group, the ones most likely to choose apartment living. About 70% of households under age 30 are renters, while only 30% of older households choose this type of living. It is true, however, that young householders are more sensitive to economic conditions due to lower incomes, lesser savings and reduced credit options. Consequently, an economic downtown would encourage many in this age group to return to the parental home.

Immigrants Favor Rentals

Immigration has been rising by about 45,000 each year over the past four years, and this is likely to continue for another several years. About half of new immigrants reside in apartments initially, a higher percentage than any other category.

New Construction

The pipeline of new units currently is expanding, implying increasing completions in the second half of the year. Housing starts in March for buildings of five or more units (seasonally adjusted) came in at 325,000 units, an 8% increase over last year. As noted above, PaineWebber projects a total of 356,000 new units in the course of this year.

Observation: About 15% of new starts are intended for sale as condominiums or cooperatives. This percentage has been in a steady decline since 1982, when it was at a high of about 35%.

DEDUCTIONS: FLOOD RESTORATION COSTS ARE REPAIRS

The IRS applied general principles distinguishing losses, repairs and capital expenditures in a situation where a property owner incurred expense in restoring flood damaged business property (Ltr. Rul. 199903030). The property in question was uninsured when damaged by severe flooding in 1997. The owner asked IRS how to treat outlays to restore the property to its pre-flood condition.

Loss Deduction

Code Section 165 permits the deduction of any loss not compensated for by insurance. The deduction is the difference between the fair market value of the property before and after the casualty (but in no event can the deduction exceed the property's adjusted basis in the hands of the taxpayer). In any event, the casualty loss does not include repair or restoration expenses (although these may be some indication of the amount of the loss). For reasons not explained, the taxpayer in this situation did not decide to claim a loss.

Repair Deduction

Code Section 162 permits the deduction of incidental repair costs that neither materially add to the value of the property, nor appreciably prolong its life, but merely keep it in ordinary, efficient operating condition. Prior rulings have permitted taxpayers to deduct repair costs of property damaged in a casualty if the costs otherwise meet the requirements of Section 162.

Capital Expenditures

However, outlays for capital expenditures are not deductible under