

**INDUBITABLY UNCERTAIN: PHILADELPHIA NEWSPAPERS  
AND THE ROLE OF VALUATION UNCERTAINTY IN  
ATTEMPTED CRAMDOWN OF ALL-EQUITY PLANS**

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ABSTRACT

*Chapter 11 of the Bankruptcy Code allows a debtor to confirm a plan over the objection of impaired creditors. This power, commonly known as “cramdown,” is constrained by the Fair and Equitable Rule. After enactment of the current Bankruptcy Code, one part of that rule has been a general prohibition against cramming down all-equity plans on prepetition secured creditors. But recent case law—specifically Philadelphia Newspapers—provides an opening to debtors who wish to strip away a secured creditor’s lien. This Article demonstrates that such all-equity plans should not be confirmed because valuation uncertainty exposes junior and senior creditors alike to unjustifiable risks that are not present in lien retention plans.*

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## INTRODUCTION

Secured creditors are often thought to hold a privileged position in chapter 11 bankruptcies.<sup>1</sup> In such cases, debtors must provide adequate protection to safeguard against the diminution of a secured creditor's collateral—and the terms secured creditors exact are often onerous.<sup>2</sup> Additionally, prepetition secured creditors are commonly the postpetition debtor in possession (“DIP”) lenders, and they are able to exact significant concessions in that position. As a practical matter, then, secured creditors are often in the driver's seat of chapter 11 bankruptcies.<sup>3</sup> This privileged position is arguably justifiable:<sup>4</sup> the secured creditor has bargained for first priority on its collateral, and has paid a price (in the form of modest return and lack of upside potential) in exchange for its relative certainty regarding repayment.<sup>5</sup>

Even in the rare case in which a secured creditor is not controlling the outcome, it has significant power in the plan confirmation process. The cramdown provisions applicable to a secured creditor require that, at a minimum, the creditor either (i) retain the lien on its collateral and receive deferred cash payments in the amount of its claim (“Retention Prong”); (ii) retain the lien on the proceeds of a sale of its collateral, subject to its right to credit bid (“Sale Prong”); or (iii) receive the “indubitable equivalent” of its secured claim (“Indubitable Equivalent Prong”).<sup>6</sup> In addition to these “mechanical requirements,” the fair and equitable rule—a background principle of the plan confirmation process—may impose some “uncodified”

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<sup>1</sup> See, e.g., Heather Lennox, Michelle M. Harner & Eric R. Goodman, *Reinstatement v. Cramdown: Do Secured Creditors Win or Lose?*, 16 NORTON J. BANKR. L. & PRAC. 459, 461 (2007).

<sup>2</sup> See, e.g., *id.*; see also Douglas G. Baird, *The New Face of Chapter 11*, 12 AM. BANKR. INST. L. REV. 69, 80–82 (2004).

<sup>3</sup> See Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 784–85 (2002) (noting that prepetition secured lenders typically “control the firm inside of [c]hapter 11 as well as out”).

<sup>4</sup> Supporters of alternative priority systems oppose the extent of the privilege accorded to secured creditors. See Anthony J. Casey, *The Creditors' Bargain and Option-Preservation Priority in Chapter 11*, 78 U. CHI. L. REV. (forthcoming 2011). The alternative systems are generally focused on the fact that the current priority system destroys the option value of junior creditors. *Id.* That discussion is beyond the scope of this Article.

<sup>5</sup> Although an affected creditor would probably be able to sell her claim, it may be the case that imposed risk-aversion will depress the value of risky claims, as secured creditors feel regulatory pressure to unload bad debts. See, e.g., Douglas G. Baird & Robert K. Rasmussen, *Antibankruptcy*, 119 YALE L.J. 648, 659 (2010) (detailing the rise of claims trading in bankruptcy); Heidi Mandanis Schooner, *Private Enforcement of Systematic Risk Regulation*, 43 CREIGHTON L. REV. 993, 999 (2010) (noting that the Dodd-Frank Act imposes “risk-based capital requirements and leverage limits”).

<sup>6</sup> 11 U.S.C. § 1129(b)(2)(A)(i)–(iii) (2006).

additional restrictions; but, in practice, the explicit statutory requirements govern.<sup>7</sup>

This Article explores whether a plan in which a secured creditor will be paid solely with equity<sup>8</sup> should be confirmable under the Indubitable Equivalent Prong, even though such a plan could not be confirmed under either the Retention Prong or Sale Prong. The Indubitable Equivalent Prong has been prominently featured in recent academic literature<sup>9</sup> due to the holding in *In re Philadelphia Newspapers* that a secured creditor need not retain precisely the same rights in a sale plan proposed under the Indubitable Equivalent Prong as it would retain under a § 1129(b)(2)(A)(ii) sale plan.<sup>10</sup> The same reasoning could be applied to allow for cramdowns of all-equity plans.<sup>11</sup> As this Article explains, valuation uncertainty poses significant risks in all-equity plans that are not present in lien retention plans, and these risks have significant *ex ante* and *ex post* affects. Accordingly, the Indubitable Equivalent Prong should not be read to allow for the cramdown of such plans.

Section I reviews the ruling in *Philadelphia Newspapers* and explains how the court's reading of the Indubitable Equivalent Prong can be expanded to allow for an all-equity plan. Section II explains the risks that all-equity plans pose due to valuation uncertainty. Sections III and IV examine past practice under the Indubitable Equivalent Prong (the "Step-Up doctrine" and the "New Value Exception") to demonstrate that valuation uncertainty has driven past

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<sup>7</sup> See generally Kenneth N. Klee, *Cram Down II*, 64 AM. BANKR. L.J. 229 (1990). This Article addresses the possible implication of one such "uncodified" requirement—the "Step-Up doctrine." See discussion *infra* Section IV.

<sup>8</sup> Referred to as an "all-equity" or "lien-stripping" plan throughout this Article.

<sup>9</sup> See generally Vincent Buccola & Ashley Keller, *Credit Bidding and the Design of Bankruptcy Auctions*, 18 GEO. MASON. L. REV. 99 (2010); Hollace T. Cohen, *Is the Philadelphia Newspapers, LLC Decision the Death Knell to Credit Bidding in a Sale Under a Plan?*, 20 NORTON J. BANKR. L. & PRAC. 3 (2011); Gregory F. Pesce, *The Irrelevance of Philadelphia Newspapers*, BANKR. LITIG. COMM. NEWSL. (Am. Bankr. Inst., Alexandria, Va.), May, 2011, <http://www.abiworld.org/committees/newsletters/litigation/vol8num3/philly.html>.

<sup>10</sup> *In re Phila. Newspapers, LLC*, 599 F.3d 298, 317–18 (3d Cir. 2010).

<sup>11</sup> It is true that *Philadelphia Newspapers* has been widely criticized. Indeed, after the main body of this Article's work was completed, the Seventh Circuit declined to follow *Philadelphia Newspapers*. See *River Rd. Hotel Partners, LLC v. Amalgamated Bank (In re River Rd. Hotel Partners, LLC)*, 651 F.3d 642, 653 (7th Cir. 2011) (declining to follow *Philadelphia Newspapers*), *petition for cert. filed*, 80 U.S.L.W. 3112 (U.S. Aug. 5, 2011) (No. 11-166). However, *Philadelphia Newspapers* is the law for chapter 11 cases filed in Delaware. Cohen, *supra* note 9, at 4 (discussing the potential effect of *Philadelphia Newspapers* in Delaware). To the extent the *Philadelphia Newspapers* reasoning grants debtors greater leeway in the cramdown process, the result will be an even more disproportionate number of chapter 11 petitions being filed in Delaware. *Id.* Furthermore, the mere threat of Indubitable Equivalent Prong mischief may be a valuable bargaining tool for distressed debtors.

practice and counsels against all-equity plans. This Article concludes that allowing creditors to invoke the Indubitable Equivalent Prong to cram down all-equity plans would be ill-advised.

## I. PHILADELPHIA NEWSPAPERS AND THE INDUBITABLE EQUIVALENT PRONG

### A. Philadelphia Newspapers May Lead to Successful Cramdown of All-Equity Plans

The *Philadelphia Newspapers* ruling on credit bidding<sup>12</sup> has resulted in significant negative commentary,<sup>13</sup> even though it may be an inconsequential issue.<sup>14</sup> But the case carries potential implications far beyond credit bidding. The true threat of *Philadelphia Newspapers* comes from the implications of the *reasoning* employed by the majority, rather than its specific result.

The ruling in *Philadelphia Newspapers* was premised on the court's understanding that the three provisions of § 1129(b)(2)(A) are distinct from each other.<sup>15</sup> Specifically, the court first held that the provisions of § 1129(b)(2)(A) are not exclusive; the mere fact that a proposed sale *could* be undertaken under the Sale Prong did not *preclude* a sale from being undertaken under the Indubitable Equivalent Prong.<sup>16</sup> Second, the court recognized that a secured creditor has the right to credit bid when a sale is conducted under the Sale Prong, but held that it did not follow that creditors have the right to credit

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<sup>12</sup> A process in which a secured creditor offers to “buy” the collateral, using the amount owed on his claim as payment. For a thorough explanation of the mechanics, see generally Buccola & Keller, *supra* note 9.

<sup>13</sup> See, e.g., *id.* at 101. See generally Cohen, *supra* note 9.

<sup>14</sup> As it turns out, aside from imposing considerable delay, the opinion had no practical impact in the case at bar: the secured creditors won the initial auction. See Maryclaire Dale, *Publisher: Creditors Win Bid for Philly Newspapers*, USA TODAY, Apr. 28, 2010, [http://www.usatoday.com/money/media/2010-04-28-philadelphia-newspaper-auction\\_N.htm](http://www.usatoday.com/money/media/2010-04-28-philadelphia-newspaper-auction_N.htm). However, the auction had to be held again when the creditors subsequently failed to close on the purchase. *Philadelphia Newspapers Auction-Bound Again*, WASH. POST, Sept. 15, 2010, <http://www.washingtonpost.com/wp-dyn/content/article/2010/09/14/AR2010091406948.html>. In the end, the creditors won the new auction as well. Steven Church, *Philadelphia Inquirer Lenders Beat Perelman in Court Auction*, BLOOMBERG BUSINESSWEEK, Sept. 24, 2010, <http://www.businessweek.com/news/2010-09-24/philadelphia-inquirer-lenders-beat-perelman-in-court-auction.html>. Despite the closing issues faced by the bidding creditors, at least one commentator has argued that the actual *Philadelphia Newspapers* holding is basically irrelevant because sophisticated creditor groups can simply write themselves a check if they so desire. See Pesce, *supra* note 9. Going forward, DIP lenders (who are normally the prepetition secured creditors) will insist on provisions in the DIP agreement that forbid proposal of a plan that seeks to strip credit bidding rights. See *id.*

<sup>15</sup> See generally *In re Phila. Newspapers*, 599 F.3d at 311.

<sup>16</sup> *Id.* at 309–10.

bid when a sale occurs under the Indubitable Equivalent Prong.<sup>17</sup> In so holding, the court rejected the argument that the interplay between credit bidding rights and other sections of the Code evinced an intent to provide secured creditors maximum protection against losses due to undervaluation of the creditor's collateral—either by judicial valuation *or* by the market.<sup>18</sup>

Although *Philadelphia Newspapers* only directly dealt with the interaction between the Sale Prong and the Indubitable Equivalent Prong respecting credit bidding, nothing about the court's reasoning limits its holding to the credit bidding issue. More broadly, *Philadelphia Newspapers* arguably stands for the proposition that a plan proposed under the Indubitable Equivalent Prong need not provide all of the rights and protections for creditors contained in the other provisions of § 1129(b)(2)(A). The important inquiry, then, focuses on how the reasoning that led to the *Philadelphia Newspapers* opinion may be applied to the Indubitable Equivalent Prong more broadly. This Article's inquiry focuses on the interaction between the Indubitable Equivalent Prong and the lien retention requirement in the Retention Prong.<sup>19</sup>

The Sale Prong mandates that a plan must (i) provide for the sale of the collateral; (ii) provide for the attachment of a lien to the proceeds of such sale; and (iii) preserve the right of creditors to credit bid.<sup>20</sup> Similarly, the Retention Prong mandates that a plan must (i) provide for payments of the creditor's principal and an appropriate rate of interest and (ii) provide for the retention of the creditor's lien on the collateral.<sup>21</sup> If the *Philadelphia Newspapers* court correctly held that a debtor can *sell* under the Indubitable Equivalent Prong instead of the *Sale* Prong,<sup>22</sup> it is unclear why a debtor would be unable to

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<sup>17</sup> *Id.* at 309–12.

<sup>18</sup> *Id.* at 315–16 (“The import of [§§ 363(k) and 1111(b)], according to the [creditors], is that Congress clearly intended that any sale of collateral—whether under § 363 or a plan of reorganization—would permit credit bidding by secured lenders. This argument fails in light of the plain language and operation of the Code.”). It should be noted that the ruling was not on plan confirmation—it was an approval of auction procedures. *Id.* at 301 (noting that the opinion was “affirm[ing] the District Court’s approval of *proposed bid procedures*.” (emphasis added)). Indeed, the court specifically stated that it was possible that the auction would not lead to realization of the indubitable equivalent of the creditor’s claims. *See id.* at 309–12.

<sup>19</sup> Section 1129(b)(2)(A)(i) requires a plan to retain a creditor’s lien over the collateral when the debtor keeps the collateral under the plan. *See* 11 U.S.C. § 1129(b)(2)(A)(i) (2006). Section 1129(b)(2)(A)(ii) provides that if the collateral is sold, the creditor’s lien attaches to the proceeds of the sale, and that the resultant lien must be treated in accordance with either (i) or (iii). *See id.* § 1129(b)(2)(A)(ii). This Article is primarily concerned with situations where the plan contemplates the debtor’s retention of collateral.

<sup>20</sup> 11 U.S.C. § 1129(b)(2)(A)(i).

<sup>21</sup> *Id.* § 1129(b)(2)(A)(ii).

<sup>22</sup> Note that Judge Ambro—the only Court of Appeals judge who sits on the National Bankruptcy Conference—vigorously dissented on this point, arguing that all sales free of liens must be conducted under

retain the collateral in a plan under the Indubitable Equivalent Prong instead of the *Retention* Prong. And, if the right to credit bid under the Sale Prong need not be preserved under the Indubitable Equivalent Prong, then it is far from certain that the creditor's right to maintain its lien under the Retention Prong need be preserved.

### *B. A Brief Summary of the Motivations Behind Proposing All-Equity Plans*

Before determining whether a debtor has the ability to strip a secured creditor's lien under the Indubitable Equivalent Prong, it is necessary to determine why a debtor would seek to do so.<sup>23</sup> Among other possibilities, the debtor may have a desire to free up collateral so that the debtor can borrow additional funds; it may think decreasing leverage or immediate cash outflows will make the plan more likely to survive feasibility analysis or produce beneficial accounting results; or it may have inside information that leads it to conclude that stripping the creditor's lien will allow for greater returns. These possibilities are explored in turn.

#### *1. The Need to Obtain Additional Capital*

A chapter 11 debtor coming out of reorganization will, like any other business, have working capital needs, as well as a desire to fund capital project outlays. Indeed, for a plan to be feasible (a mandatory requirement for confirmation),<sup>24</sup> a debtor must demonstrate, among other things, that it has sufficient access to capital.<sup>25</sup> To the extent the debtor can emerge from bankruptcy unencumbered by prepetition liens, it will have greater access to

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the Sale Prong and all retention plans must be conducted under the Retention Prong. *In re Phila. Newspapers*, 599 F.3d at 325–27, 338 (Ambro, J., dissenting); List of National Bankruptcy Conference Members, NAT'L BANKR. CONF., <http://www.nationalbankruptcyconference.org/members.cfm> (last visited Sept. 26, 2011).

<sup>23</sup> Fully examining these business questions is far beyond the scope of this Article. They are presented here solely to provide some context for the legal question.

<sup>24</sup> See 11 U.S.C. § 1129(a)(11); *In re Smith*, 333 B.R. 94, 98 (Bankr. M.D.N.C. 2005) (“[T]he Bankruptcy Code requires as a precondition to confirmation that a court determine that ‘[c]onfirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan.’ The purpose of this feasibility requirement ‘is to prevent confirmation of visionary schemes which promises creditors and equity security holders more under a proposed plan than the debtor can possibly attain after confirmation.’” (citation omitted) (internal quotation marks omitted)); *In re Made in Detroit, Inc.*, 299 B.R. 170, 175 (Bankr. E.D. Mich. 2003) (“Feasibility is a mandatory requirement for confirmation.”). For a list of factors considered in feasibility analysis, see generally *Factors Considered in Determining Feasibility, in General*, 5 Bankr. Serv. L. Ed. (West) § 45:246 (July 2011).

<sup>25</sup> See, e.g., *In re Made in Detroit*, 299 B.R. at 176–77 (noting that plan was not feasible because of lack of assurances regarding exit financing).

secured credit going forward.<sup>26</sup> This is most important for working capital purposes—the terms of a revolving credit facility will be much more favorable if it is backed by a first position lien. Additionally, if a debtor seeks to make a significant capital outlay (say, for example, to build a new plant), then having unencumbered assets in addition to the plant may allow the debtor to receive more money on more favorable terms. Of course, any new secured credit will further subordinate the formerly secured creditor. Furthermore, having more unencumbered assets on the books may make lenders more willing to lend on an unsecured basis.

## 2. *Capital Structure Concerns*

Courts consider whether a debtor's proposed post-confirmation capital structure can be effectively serviced when determining whether a plan is feasible.<sup>27</sup> If the debtor cannot demonstrate that it will be able to service loan payments under the prepetition capital structure, among other things, it may (i) attempt to strip the creditor's lien and cram equity down on the creditor; (ii) cram down a significantly altered note that retains the creditor's liens, but includes functions like payment in kind ("PIK") toggles, negative amortization, balloon payments, and other methods of payment deferral; or (iii) strip the creditor's lien and cram down an unsecured note with payment deferral provisions.<sup>28</sup> Of these options, (i) raises fewer concerns with regard to feasibility, because it minimizes exposure to the increased interest rates that would result from the heightened riskiness of the loans proposed in (ii) and (iii).<sup>29</sup>

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<sup>26</sup> See Ronald J. Mann, *Explaining the Pattern of Secured Credit*, 110 HARV. L. REV. 625, 641–42 (1997) (discussing, generally, the benefits and burdens associated with secured credit).

<sup>27</sup> See *In re Repurchase Corp.*, 332 B.R. 336, 342 (Bankr. N.D. Ill. 2005) (noting that, among other things, a firm's capital structure is relevant to the feasibility analysis).

<sup>28</sup> For a general discussion of the ways a debtor can force a new capital structure through the cramdown process, see generally Patrick Halligan, *Cramdown Interest, Contract Damages, and Classical Economic Theory*, 11 AM. BANKR. INST. L. REV. 131 (2003).

<sup>29</sup> See Richard E. Mikels & Adrienne K. Walker, *The Developing Impact of Till v. SCS on Chapter 11 Reorganizations*, in COMMERCIAL REAL ESTATE FINANCING 2007, at 295, 298–301 (PLI Real Estate Law and Practice, Course Handbook Ser. No. N-536, 2007) (discussing determination of interest rates in cramdown and noting that a view endorsed by the Supreme Court is that interest rates determined in cramdown will be "not so high as to doom the plan" (internal quotation marks omitted)).

### 3. *Potential Abuse of Inside Information or Collusion Between the Debtor and the Secured Creditor*

A debtor proposing a lien-stripping plan may have inside information that is motivating the proposal.<sup>30</sup> A plan that proposes to strip a creditor's lien and cram down equity potentially exposes the creditor to significant overvaluation risk: the plan may allow junior claimants to receive more value from a cramdown than they are entitled to. Accordingly, a debtor (which is often being run by junior stakeholders, such as management with equity interests) will have a strong incentive to take advantage of information that allows it to accurately predict whether a judge will overvalue collateral in a cramdown proceeding.

It is arguable, however, that inside information does not pose a significant risk. As noted above, due to the operation of loan covenants, secured creditors are often in the driver's seat even before the debtor files a chapter 11 petition. Secured creditors have significant incentives to actively monitor debtors.<sup>31</sup> Additionally, once the bankruptcy case is filed, the judge has considerable informational access, though the judge might remain at an informational disadvantage compared to the debtor's management.<sup>32</sup> Thus, while there are procedural safeguards that might prevent the filing or confirmation of a plan that aims to take advantage of inside information,<sup>33</sup> those safeguards may be insufficient to protect against the risks posed by all-equity plans. Conversely, it is also possible that the debtor and secured creditors could be colluding in an effort to push out general unsecured creditors.<sup>34</sup> These concerns about informational disadvantages contribute to the conclusion that all-equity plans should not be confirmed under the Indubitable Equivalent Prong.

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<sup>30</sup> See Edward S. Adams, *Toward a New Conceptualization of the Absolute Priority Rule and its New Value Exception*, 1993 DET. C.L. REV. 1445, 1484–85 (1993) (noting concern about inside information in the context of the New Value Exception).

<sup>31</sup> See Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49, 55–56 (1982) (arguing that secured loans encourage secured creditors to monitor borrowers).

<sup>32</sup> See Christopher W. Frost, *The Theory, Reality and Pragmatism of Corporate Governance in Bankruptcy Reorganizations*, 72 AM. BANKR. L.J. 103, 134 (1998) (noting that “bankruptcy judges suffer an informational disadvantage vis-a-vis managers” that might impair the oversight role).

<sup>33</sup> See Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 YALE L.J. 1930, 1939–41 (2006).

<sup>34</sup> Indeed, the fact that this had occurred in the railroad reorganizations of the 1800s was one of the primary inspirations behind the Absolute Priority Rule. See C.R. Bowles & John Egan, *The Sale of the Century or a Fraud on Creditors?: The Fiduciary Duty of Trustees and Debtors in Possession Relating to the “Sale” of a Debtor's Assets in Bankruptcy*, U. MEM. L. REV. 781, 832–33 (1998); Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Auctions*, 44 STAN. L. REV. 69, 80–84 (1991).

C. *Theoretical Basis for Lien Stripping Under the Indubitable Equivalent Prong*

As a theoretical matter, as long as the creditor receives something that has the same present value as its allowed claim—which includes provision of an appropriate rate of interest to account for the risk of non-payment—the creditor has received the “indubitable equivalent” of its claim.<sup>35</sup> If the creditor is paid in cash, then there is a high level of confidence that the present value of the payout has been accurately determined—cash, after all, has a known value.<sup>36</sup> This is not, however, the end of the inquiry. For any number of reasons, a debtor may elect not to pay the secured creditor’s claim in cash, and may instead propose to pay the secured creditor with debt or equity. In this situation it matters whether the creditor receives debt secured by its prepetition collateral. When the creditor receives debt secured by its prepetition collateral, the creditor may, depending on the circumstances, be unimpaired (i.e., viewed as not having been harmed by the plan, and, thus, unable to dissent).<sup>37</sup> The more problematic situation occurs when a debtor proposes a plan to pay a prepetition secured creditor with (i) security interests in collateral other than the prepetition collateral (replacement lien cases) or (ii) entirely unsecured debt.<sup>38</sup> In either case, the lien retention requirement of the Retention Prong will not be met. Accordingly, the inquiry must then shift to whether the Indubitable Equivalent Prong will be satisfied.

*Philadelphia Newspapers* evinces a flexible approach to the Indubitable Equivalent Prong: as long as the secured creditor receives the value to which it is entitled, it has no complaint even if it surrenders rights that are meant to protect its entitlement to payment. Credit bidding, for example, is a mechanism meant to guard against undervaluation of collateral or other inefficiencies in the market. If the secured creditor believes that its collateral is being undervalued, it is able to put its money where its mouth is. Thus, credit bidding

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<sup>35</sup> See *Bank of N.Y. Trust Co. v. Official Unsecured Creditor’s Comm.* (*In re Pac. Lumber Co.*), 584 F.3d 229, 246–47 (5th Cir. 2009).

<sup>36</sup> See *id.* at 247 (holding that a secured creditor received the indubitable equivalent of its claim when it was paid the full value of its claim in cash, notwithstanding the fact that it did not have the right to credit bid at the sale of its collateral).

<sup>37</sup> An unimpaired creditor cannot object to confirmation of a plan. See 11 U.S.C. § 1126(f) (2006). However, merely paying a secured creditor at 100 cents on the dollar is not sufficient to render a creditor unimpaired if any of the secured creditor’s legal or equitable rights are hindered by the plan. *Id.* § 1124(1). The remainder of the Article assumes that the secured creditor in question is, in fact, impaired, and that any proposed plan must be confirmed over its objection.

<sup>38</sup> See discussion *infra* Section III.

is simply a tool that allows the creditor to realize on its claim—a tool that the *Philadelphia Newspapers* court eliminated from the secured creditor's options. More broadly, cramdown analysis has long acknowledged that a creditor is not entitled to retain all of its prepetition contractual rights: courts regularly confirm plans that do not preserve prepetition loan covenants,<sup>39</sup> although some courts have refused to do so where removal of a particular covenant would expose a creditor to a significantly greater risk of underpayment.<sup>40</sup>

Some limitations notwithstanding, the fact that courts will cancel loan covenants<sup>41</sup> in a cramdown situation is significant. Modern secured creditors often exercise equity-like control through their lending covenants, particularly when a debtor is in distress.<sup>42</sup> Altering those covenants effects a fundamental change in creditors' prepetition rights. To wit, much of the debate surrounding reinstatement of prepetition loans<sup>43</sup> focuses on loans that have both low interest rates and lax covenants.<sup>44</sup> Indeed, as a theoretical matter, specific *ex ante* costs of credit can be tied to the presence of certain lending covenants.<sup>45</sup> Accordingly, the removal of covenants in the cramdown process, while perhaps less striking than canceling a creditor's lien, is a serious affair. In the end, covenants and liens serve the same purpose: they regulate the risk a

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<sup>39</sup> See, e.g., *In re Mesa Air Grp.*, No. 10-10018 (MG), 2011 WL 320466, at \*6 (Bankr. S.D.N.Y. Jan. 20, 2011). In a related context, a court has held that the provision of adequate protection does not require adherence to prepetition covenant arrangements. See *In re General Growth Props., Inc.*, 412 B.R. 122, 134–35 (Bankr. S.D.N.Y. 2009). In *General Growth*, the court held that the creditors' cash collateral was adequately protected, notwithstanding the fact that the debtor proposed to upend the prepetition covenants relating to cash flow and cash management amongst the various subsidiaries. *Id.* at 134–36. For general background on General Growth Properties Inc.'s prepetition cash flow systems, see Richard J. Corbi, *How Remote is "Bankruptcy Remote" for Special Purpose Entities*, NORTON BANKR. L. ADVISER, Nov. 2009, at 5. For examples of cases discussing permissible ways prepetition covenants can be altered or eliminated, see 7 COLLIER ON BANKRUPTCY ¶ 1129.04[2][a][v] nn.27 & 28 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010).

<sup>40</sup> For a thorough discussion of the cases on point, see 7 COLLIER ON BANKRUPTCY, *supra* note 39, ¶ 1129.04[2][a][v].

<sup>41</sup> Loan covenants are essentially contractual conditions on a loan that, if breached, allow a creditor to exercise a variety of remedies. See generally Frederick Tung, *Leverage in the Board Room: The Unsung Influence of Private Lenders in Corporate Governance*, 57 UCLA L. REV. 115, 135–40 (2009).

<sup>42</sup> See Baird & Rasmussen, *supra* note 3, at 784–85.

<sup>43</sup> Note that these types of loans occur under 11 U.S.C. § 1124(2). For an example of the high stakes involved with reinstatement, see JPMorgan Chase Bank v. Charter Commc'ns Operating, LLC (*In re Charter Commc'ns*), 419 B.R. 221, 230 (Bankr. S.D.N.Y. 2009) (addressing a situation in which a reinstatement resulted in hundreds of millions of dollars in annual savings). See also Jeffrey W. Levitan, *Ingredients for a Successful Cram Up Reorganization*, N.Y. L.J., Mar. 1, 2010, <http://www.newyorklawjournal.com/PubArticleNY.jsp?id=1202444588249&slreturn=1>.

<sup>44</sup> See Levitan, *supra* note 43.

<sup>45</sup> See 7 COLLIER ON BANKRUPTCY, *supra* note 39, ¶ 1129.04[2][a][v].

creditor assumes when making a loan. Covenants, therefore, are yet additional tools designed to assure full payment that are subject to alteration or removal in a cramdown.

A similar story can be told about a secured creditor's lien. Outside of bankruptcy, a lien enables a creditor to take possession of the collateral and sell it if the debtor defaults on its obligations.<sup>46</sup> The creditor has no interest in becoming the owner of the collateral: the lien is simply a tool that allows the creditor to realize on its claim.<sup>47</sup> However, even in the case of first-lien holders (sophisticated lenders who take security interests and have bargained for a right to first payment), the right to foreclose on and sell property is incidental to the creditor's interest in being paid.<sup>48</sup>

Indeed, security interests are not sacrosanct under the Code: notably, in the adequate protection context, the court can allow for priming liens (postpetition liens that have greater priority in given collateral than the prepetition lien in the same collateral) under certain narrow circumstances.<sup>49</sup> Additionally, as discussed, courts have recognized a variety of contexts in which the terms of a secured creditor's lien may be altered.<sup>50</sup> Finally, although the legislative history is informative, the bare assertion that "[u]nsecured notes as to the secured claim or equity securities of the debtor would not be the indubitable equivalent"<sup>51</sup> does not explain why that should be the case.

But a view of a security interest as just another contractual tool does not square with the Code. Judge Ambro noted in his *Phildelphia Newspapers*

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<sup>46</sup> See U.C.C. § 9-610 (2001).

<sup>47</sup> Given the prevalence of claims trading, it is not always accurate to say that creditors in today's chapter 11 world would rather receive payment than ownership of the collateral. See Baird & Rasmussen, *supra* note 5, at 661.

<sup>48</sup> See, e.g., Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97, 112 (1984); Omer Tene, *Revisiting the Creditors' Bargain: The Entitlement to the Going-Concern Surplus in Corporate Bankruptcy*, 19 BANKR. DEV. J. 287, 300-01 (2003). The foregoing sources treat the adequate protection context—in other words, these sources address how secured creditors should be protected during the pendency of the bankruptcy case. Baird & Jackson, *supra*, at 97; Tene, *supra*, at 300-01.

<sup>49</sup> For example, a priming lien may be granted if there is no other option available to secure postpetition financing. 11 U.S.C. § 364(d)(1)(A) (2006). Note that a secured creditor whose lien is primed must receive adequate protection. Adequate protection, of course, is the other Code provision that invokes the "indubitable equivalent" language. *Id.* § 361(3).

<sup>50</sup> See *supra* notes 39-40 and accompanying text.

<sup>51</sup> H.R. REP. NO. 95-595, at 546 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6544 (statement of Sen. Dennis DeConcini, Chairman, Subcomm. on Improvements in Judiciary Mach. of the S. Comm. on the Judiciary).

dissent that protection of secured creditors is prominent throughout the Code. The rights of secured creditors have been seen as property rights, deserving of higher protections than other types of contractual rights.<sup>52</sup> Furthermore, the legislative history of the Code reflects a position that lien stripping is impermissible under the Indubitable Equivalent Prong, though it remains silent as to less-protected contractual obligations.<sup>53</sup>

The inquiry, then, shifts to addressing how broadly the Indubitable Equivalent Prong should be read and whether the problem of valuation uncertainty should constrain the provision's application.

## II. THE PROBLEM OF VALUATION UNCERTAINTY

### A. *The Valuation Uncertainty Problem*

Many of the Code's protections for secured creditors are based on an arguably justifiable fear about the vagaries of the judicial valuation process.<sup>54</sup> Indeed, the cost, delay, and uncertainty that accompany this process are motivating factors behind the growing utilization of sales under § 363 and prepackaged plans.<sup>55</sup> However, in non-sale plans with objecting creditors, the judicial valuation process cannot be avoided.

Put simply, the valuation uncertainty problem as it relates to cramdown situations represents the idea that an unbiased judge may not assign the correct value to the debtor's assets in the cramdown process. If the actual value of the enterprise is 100, and symmetrical uncertainty of 20% exists, the judge could assign a value to the enterprise as low as 80 or as high as 120. Though judges recognize that they cannot be sure of the exact enterprise value, the Bankruptcy

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<sup>52</sup> See John D. Ayer, *Rethinking Absolute Priority After Ahlers*, 87 MICH. L. REV. 963, 978–82 (1989).

<sup>53</sup> See H.R. REP. NO. 95-595, at 546 (“Unsecured notes as to the secured claim or equity securities of the debtor would not be the indubitable equivalent.”).

<sup>54</sup> This Article does not attempt to fully model the issues surrounding valuation uncertainty. There is extensive literature that more thoroughly discusses the theoretical problems of valuation uncertainty. See, e.g., Baird & Bernstein, *supra* note 33, at 1935. Additionally, some attempt has been made to mathematically model valuation uncertainty. See generally Bo Huang, *Absolute Priority Rule and the Options Theory* (unpublished manuscript) (on file with author). This Article discusses the problem only in the level of detail necessary to illustrate the problem's interaction with the concept of lien stripping.

<sup>55</sup> Paul Steven Singerman & Paul A. Avron, *Bankruptcy Transformed: Are Reorganizations a Thing of the Past?*, BUS. REORGANIZATION COMM. NEWSL. (Am. Bankr. Inst., Alexandria, Va.), Mar. 2010, at 173, 174, <http://www.abiworld.org/committees/newsletters/busreorg/vol9num4/past.pdf> (noting continued trend toward § 363 sales).

Code requires the judge to pick a single value for cramdown purposes.<sup>56</sup> For the reasons discussed below, this uncertainty increases the risk that the secured creditor will not realize the full value of its claim if the debtor fails post-confirmation.

In a case where the judge knows the exact contours of his uncertainty, the judge can account for the variance by imposing a higher interest rate to account for the risk. Unfortunately, a far more common—and difficult—valuation uncertainty question arises when the judge has no way of knowing what he does not know: the judge is aware that there is uncertainty, but he does not know the exact parameters of that uncertainty. In such circumstances, there is no way to impose an interest rate that accurately accounts for the uncertainty.

There are two fundamental reasons why the increased risk of nonpayment due to valuation uncertainty should be minimized. First, as a normative matter, the bankruptcy process should protect the non-bankruptcy rights of the parties.<sup>57</sup> Outside of bankruptcy, a secured creditor has bargained for security to minimize its risk of nonpayment, and that position should be respected.<sup>58</sup> Second, if the Indubitable Equivalent Prong is interpreted in a way that increases a secured creditor's risk of not realizing the value of its claim *ex post*, then creditors will impose a higher cost of credit *ex ante* to compensate for that risk, and that higher cost will be borne by all parties seeking secured credit.<sup>59</sup>

The immediate response to this critique of all-equity plans is that secured creditors have upside potential from the imposition of valuation uncertainty.<sup>60</sup> If a secured claim on one hand and an equity share on the other both have an expected value of 100, then a risk-neutral creditor should be indifferent about which it receives. If a lien guarantees payment of 100, and a grant of equity,

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<sup>56</sup> See J. Bradley Johnston, *The Bankruptcy Bargain*, 65 AM. BANKR. L.J. 213, 282–84 (1991).

<sup>57</sup> See generally Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857 (1982). Jackson's is the seminal work on the issue.

<sup>58</sup> See *id.* at 871. This is a normative claim based on the idea that the creditors' bargain should be the driving force behind interpretation of the Code. See *id.* at 860. This vision of bankruptcy is not without its detractors. See Casey, *supra* note 4 (manuscript at 7) (citing Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336 (1993)). This debate is beyond the scope of this Article.

<sup>59</sup> This is a claim based on simple economic theory; unfortunately, little or no empirical work appears to have been done on the question of whether interpretation of a given bankruptcy provision has a noticeable impact on the credit markets. Certainly, if chapter 11 were abandoned in favor of a "fresh start" system for companies, no one would argue that the cost of credit would not generally go up, so it is not incredible to claim that credit markets are sensitive to the Code's contours. Furthermore, secured credit is generally cheaper than unsecured credit. Therefore, the thought that higher cost of credit would be the result of a Code interpretation that allows for lien stripping logically follows.

<sup>60</sup> See discussion *infra* Section II.A.1 and related payout tables.

due to valuation uncertainty, is worth either 0 or 200 with equal probability, then the creditor has no grounds for complaint because the expected payout is 100—precisely what the creditor bargained for.

It is true that a creditor whose claim is significantly<sup>61</sup> less than the value of the enterprise<sup>62</sup> stands to gain from valuation uncertainty when a judge assigns a total enterprise value that is too low.<sup>63</sup> Under these circumstances, a debtor would not propose, in good faith, an all-equity plan unless it were in dire need of balance sheet improvement to meet the feasibility confirmation requirement.<sup>64</sup> But a debtor whose secured creditors are significantly over-secured would probably not be concerned about feasibility unless there were also significant unsecured claims to service.<sup>65</sup> Of course, a judge should decline to confirm a plan where there exists a high risk that the secured creditor will receive a premium to the detriment of junior creditors.<sup>66</sup> Accordingly, it is difficult to see a situation in which a debtor, acting in good faith, would propose an all-equity plan where the secured creditor had a reasonable possibility of being overpaid.

That is not to say a debtor would never propose such a plan. A secured creditor may collude with the debtor—more precisely, the debtor’s management—in an effort to push out intermediary creditors. If an over-secured creditor, the debtor, or both, possess information suggesting that the judge will undervalue the enterprise, the secured creditor may offer out-of-the-money management (who are often equity holders) a position with the post-confirmation debtor, perhaps through promises of continuing employment or future equity participation. In exchange, the debtor management would agree to propose an all-equity plan in which the creditors are over-secured. Due to valuation uncertainty, the judge may not realize that the wool is being pulled

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<sup>61</sup> See discussion *infra* Section II.A.1 and related payout tables. The exact tipping point changes based on a number of variables.

<sup>62</sup> Either because the creditor has a lien on all of the assets and is significantly over-secured, or because it has a lien on only some of the assets and the enterprise as a whole is worth significantly more than its claim, and the additional enterprise assets are not burdened by another creditor’s lien.

<sup>63</sup> Or in the case of a creditor with a lien on only some of the debtor’s assets, if the judge assigns too high a value to the creditor’s collateral in relation to the enterprise as a whole.

<sup>64</sup> It is more likely that if all of the parties were aware of the fact that the creditor was over-secured, the debtors would propose a rights offering to raise the additional capital.

<sup>65</sup> This is because the fact that the existing secured creditors are over-secured (i.e., the collateral is worth more than the loan on the collateral) implies that the debtor has not tapped out its access to the credit markets because, at a minimum, it could obtain more secured credit.

<sup>66</sup> This is known as the “100% limitation” and is considered to be another “uncodified” aspect of the fair and equitable rule. See Klee, *supra* note 7, at 231–32.

over his eyes, and the secured creditor will walk away with a larger portion of the equity than had it not colluded with the debtor.

Therefore, the debtor will only be in the position to propose an all-equity plan if (i) its management has inside information that leads it to believe that the judge will overvalue the enterprise,<sup>67</sup> or at least not undervalue it enough that the secured creditor stands to benefit;<sup>68</sup> (ii) the debtor and secured creditors are acting in collusion; or (iii) it is not clear that the secured creditor is oversecured (i.e., even ignoring the possibility of inside information, there exists a reasonable range of enterprise values), and the debtor's management believes that it stands to gain more than it stands to lose. The key point is that the ball is in the debtor's court,<sup>69</sup> and that all-equity plans lend themselves to varieties of gamesmanship that lien retention plans do not.

Furthermore, there is a systemic point to be made. All-equity plans create risks of under- or over-payment that simply are not present in lien retention plans. This is true even assuming that the all-equity plans were proposed in good faith, and that secured creditors in the aggregate would stand to win as often as they would stand to lose under an interpretation of the Indubitable Equivalent Prong that allowed for all-equity plans. In any individual case, the secured creditor would probably receive either too much or too little on a present value basis. This risk simply does not exist if the lien is maintained.<sup>70</sup>

Both under- and over-payment are undesirable in any given case even if, in the aggregate, a reading of the Code that allowed for all-equity plans would benefit creditors and debtors at an approximately equal rate. Retention of the creditor's lien is also risk-neutral, and does not create the same chance of under- or over-payment (and the resultant *ex post* violations of the Absolute Priority Rule). While the dogmatic justification for the Absolute Priority Rule is generally phrased in terms of *ex ante* efficiency—a desire to lower the cost of credit—if two solutions have the same *ex ante* benefits (lien retention plans on one hand and all-equity plans in a zero-sum world on the other), basing policy on the path that has better *ex post* effects is fully justified. A pound of feathers and a pound of lead may weigh the same, but the feathers make a far

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<sup>67</sup> Or undervalue a creditor's collateral, if the creditor does not have a security interest in everything.

<sup>68</sup> This does not even need to be "hard" inside information that has been concealed from the creditor and the judge. It could simply be a better sense of the business.

<sup>69</sup> At least until the period of debtor exclusivity is over.

<sup>70</sup> As previously acknowledged, the current system does destroy the option value of junior creditors, but that is an argument against basing our system on present value analysis. If present value analysis is accepted, a secured creditor who retains its lien can never be paid more than what it is entitled to.

nicer pillow. *Ex ante* efficiency is not the only reason to desire “fair” payment waterfalls.

Accordingly, the Indubitable Equivalent Prong should generally not be read to allow all-equity plans if there is any risk of valuation uncertainty because, as demonstrated below, lien retention best minimizes the impact of that risk on all parties. Therefore, because bankruptcy judges generally cannot know the precise amount of valuation uncertainty present,<sup>71</sup> the Code should be interpreted to have a very strong presumption against all-equity plans.

### *1. Valuation Uncertainty and Creditors with a Lien over All the Debtor’s Assets*

When a creditor has a security interest in all of the debtor’s assets, the value that the bankruptcy judge assigns to the enterprise and the value assigned to the creditor’s collateral are the same.<sup>72</sup> The result is that any enterprise value at or below the face value of such a creditor’s claim should result in the creditor owning the entire business.<sup>73</sup> If the enterprise is worth more than the creditor’s claim,<sup>74</sup> junior creditors receive a payout.

When the creditor retains its lien over all of the debtor’s assets, she is protected against valuation uncertainty if the debtor is liquidated postconfirmation. Specifically, if the judge assigned too low a value to the enterprise, on a subsequent liquidation at a higher value the secured creditor will be paid in full. If the judge assigned too high a value to the enterprise, at a subsequent liquidation for a value below the judicial valuation, the creditor will be paid all the available funds.

On the other hand, if the creditor does not retain its lien and is instead given equity under the plan, it is exposed to dilution risk if the assigned enterprise

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<sup>71</sup> In other words, the judge—outside of the “lottery ticket” hypothetical context—is working with a range of plausible valuation. But (i) while the judge may be able to assign rough probabilities of any given outcome in that range, the judge is dealing with probabilities, not certainties; and (ii) there remains the possibility that, *ex ante*, the true value may fall outside what seems—at the time of confirmation—to be the plausible range of values.

<sup>72</sup> This fact eliminates the relevance of § 1111 for creditors with a security interest in all of the debtor’s assets.

<sup>73</sup> Subject to variation by operation of the New Value Exception, as discussed in Section IV, *infra*.

<sup>74</sup> Including post-petition interest, to which over-secured creditors are entitled during the pendency of the bankruptcy case. 11 U.S.C. § 506(b) (2006).

value is too high.<sup>75</sup> Regardless of whether  $v(\min)$  and  $v(\max)$  will be assigned with equal probability, or whether  $v(\min)$  and  $v(\max)$  will not be assigned with equal probability (that is, when the valuation variance is asymmetrical), the expected value of the equity received will only be higher than the expected recovery from retention of a lien when the creditor is sufficiently over-secured.<sup>76</sup> In either case, the amount of oversecurity necessary is a function of the amount of variance in the valuation—the greater the possible variance, the more over-secured the creditor must be in order to have upside potential.<sup>77</sup> This is because, in all cases, the creditor's upside is capped by the fact that it can never receive more than 100% of the equity regardless of the value of her claim and  $v(\min)$ . On the other hand, the downside risk from increasing  $v(\max)$  amounts is uncapped. Accordingly, because the set of circumstances that allow a creditor to receive as much or more under an all-equity plan as they would receive under a lien retention plan is narrow in scope and noticeable to the debtor, such plans are unlikely to be proposed. Therefore, when debtors propose all-equity plans, they disproportionately lead to lower recoveries for secured creditors.<sup>78</sup> Such plans should not be confirmed where valuation uncertainty is reasonably implicated.<sup>79</sup>

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<sup>75</sup> Please see the Appendix for payout tables illustrating these general principles. For an attempt to provide a proof model of valuation uncertainty that is not subject to the following simplifying assumptions, see Huang, *supra* note 54. Mr. Huang's work on modeling the effect of valuation uncertainty in all-equity plans significantly influenced this Article's efforts. Several important simplifying assumptions drive the payout tables in the Appendix. First, I adopt a lottery ticket model, such that  $v(\max)$  and  $v(\min)$  represent the only possible values, and each has an equal chance of occurring. Second, the assumption that  $v$  is the combination of all future possibilities is embraced by also assuming that subsequent liquidation realizes precisely  $v$ . Third, interest costs, court costs imposed by the bankruptcy process itself, and so on are ignored. Of course, firms generally have holdings other than lottery tickets, and so  $v$  may not be symmetrical, with  $v(\max)$  and  $v(\min)$  having unequal probability: for example, if  $v(\text{real}) = 60$ ,  $v(\min) = 51.43$  with 70% probability and  $v(\max) = 80$  with 30% probability. Further,  $v(\max)$  and  $v(\min)$  are not likely to be the only possible values: it is more likely that assigned value will be between  $v(\max)$  and  $v(\min)$ ; and any one of these values may be more or less likely to be applied than any other possible value. The same qualifiers apply to the amount realized at liquidation: there is a limitless range of possibilities that lead to  $v = 60$  at confirmation. Furthermore, if  $v(\text{real}) = 60$ , post-confirmation, the debtor could be liquidated for either  $v = 30$  or 90 (or 40/80; 20/100; 10/110; 0/120) at equal probability, and the actual payout would deviate from what was predicted based on  $v = 60$ ; and, to add one final complicating factor, the possibilities related to liquidation payout could also be asymmetrical. A full modeling of all of these possibilities is simply impractical here. I leave it to another author to propose a model that can capture all of the possibilities in a useful way.

<sup>76</sup> In order for the secured creditor to actually do better under an all-equity plan, the judge must undervalue the enterprise in cramdown. Furthermore, any payout in an all-equity plan is ultimately subject to uncertainty. See Huang, *supra* note 54, at 29.

<sup>77</sup> Where the variance is asymmetrical, a sufficiently low risk of undervaluation will minimize the amount of over-security needed to have upside potential.

<sup>78</sup> This Article does not make an effort to provide a model for the not-uncommon situation where a creditor has a lien on only a part of the debtor's assets. Similar valuation uncertainty problems exist and are

### III. INDUBITABLE EQUIVALENCE BEFORE *PHILADELPHIA NEWSPAPERS*: REPLACEMENT LIEN AND “DIRT FOR DEBT” PLANS

As previously noted, it is entirely unclear what “indubitable equivalent” means in the context of the cramdown provisions. The “indubitable equivalent” language itself has its genesis in an adequate protection ruling by Judge Hand:

[A] creditor who fears the safety of his principal will scarcely be content with that; he wishes to get his money or at least the property. We see no reason to suppose that the statute was intended to deprive him of that in the interest of junior holders, unless by a substitute of the most indubitable equivalence.<sup>80</sup>

*Philadelphia Newspapers* and *In re Pacific Lumber Co.* were not the first cases in which the Indubitable Equivalent Prong was invoked. But courts have always narrowly construed the provision,<sup>81</sup> and the provision has historically been invoked only in narrow circumstances: abandonment, purported “dirt for debt” plans (which are rarely confirmed), and replacement lien plans. In each circumstance, courts have acknowledged the role that valuation uncertainty plays in their analysis. Therefore, past practice under the Indubitable Equivalent Prong is consistent with the idea that the provision should not be read to allow for cramdown of all-equity plans.<sup>82</sup>

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compounded by the fact that the judge must engage in separate valuation exercises—for both the creditor’s collateral and the enterprise as a whole. In general, under such plans,  $v(\text{max-collateral})$  allows a creditor to receive a greater proportion of the equity payout. However, there is one caveat: if  $v(\text{max-collateral})$  exceeds the creditor’s claim (most likely to occur for over-secured creditors, but possible for any creditor depending on the degree of valuation variance), equity value is shifted to the other party. Therefore, the absolute best case for the creditor in all cases is  $v(\text{max-collateral})$  and  $v(\text{min-other})$  where  $v(\text{max-collateral})$  equals to the value of the creditor’s claim. This state of the world most closely resembles that of a debtor with a single over-secured creditor and, if  $v(\text{max-collateral})$  equals the value of the creditor’s claim, the creditor would actually be overcompensated. The worst case for the creditor is  $v(\text{min-collateral})$  and  $v(\text{max-other})$ , which dilutes the creditor in a similar fashion to an undersecured creditor where the enterprise is overvalued. An over-secured creditor stands to see a better payout under  $v(\text{min-collateral})$  and  $v(\text{min-other})$  than  $v(\text{max-collateral})$  and  $v(\text{max-other})$  because the creditor’s benefit from  $v(\text{max-collateral})$  is capped to the value of its claim while its exposure to  $v(\text{max-other})$  is not capped. Many of these calculations are subject to possible modification by the operation of § 1111(b)—if the election could be taken in all-equity plans. The relationship between  $v(\text{collateral})$  and  $v(\text{other})$  can become even more complex where  $v(\text{collateral})$  and  $v(\text{other})$  are co-dependent.

<sup>79</sup> For an example of a situation where valuation uncertainty is probably not implicated, see discussion *infra* Section IV.B.

<sup>80</sup> *Metro. Life Ins. Co. v. Murel Holding Corp. (In re Murel Holding Corp.)*, 75 F.2d 941, 942 (2d Cir. 1935); see also 7 COLLIER ON BANKRUPTCY, *supra* note 39, ¶ 1129.04[2][c].

<sup>81</sup> For example, one court noted simply that “[i]ndubitable’ means ‘too evident to be doubted.’ We profess doubt on the facts of this case.” *Arnold & Baker Farms v. United States (In re Arnold & Baker Farms)*, 85 F.3d 1415, 1421 (9th Cir. 1996) (citation omitted) (declining to confirm a “dirt for debt” plan).

<sup>82</sup> Indeed, one commentator has proposed that even under the traditional paradigm, valuation uncertainty counsels that the Indubitable Equivalent Prong be used only where the debtor can demonstrate with near-

A. *The Indubitable Equivalent Prong's Clearest Use Is Where Collateral Is Abandoned*

The Indubitable Equivalent Prong is most clearly and easily applied in cases of abandonment. Where the debtor abandons the secured creditor's collateral, the Indubitable Equivalent Prong is satisfied.<sup>83</sup> This is not surprising because abandonment replicates a secured creditor's non-bankruptcy right to foreclose on and sell its collateral. Courts have applied a tautology to explain this rule: "Since the value of [the secured creditor's] secured claim is equal to the value of [its collateral], a plan which provides that [the secured creditor] will realize the indubitable equivalent of [its collateral] will satisfy the requirements of [the Indubitable Equivalent Prong]."<sup>84</sup> Where a plan provides for abandonment, "common sense tells us that property is the indubitable equivalent of itself," and the plan satisfies the Indubitable Equivalent Prong.<sup>85</sup>

Viewed from the perspective of valuation uncertainty, this result makes eminent sense in the case of a creditor with a lien on all of the debtor's assets. Allowing such a creditor to exercise its non-bankruptcy rights completely removes judicial valuation uncertainty from the equation. As discussed in the context of valuation uncertainty generally, if the creditor is undersecured, it receives the entire value of the company, which is all that it is entitled to. Accordingly, there is no better way for a court to dampen the possible effect of valuation uncertainty.

On the other hand, in instances where creditors hold liens on only some of a debtor's assets, the valuation uncertainty issue may still create some concern.

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certainty that the creditor will get "at least as much" as she would have received under § 1129(b)(2)(A)(i) or (ii). See Neil Wyland, *Towards Protection of Creditors and Estimated Claims in Cram Down: How Indubitable Should the Equivalence Be?*, 42 UCLA L. REV. 1389, 1423 (1995). However, that interpretation is not convincing because it essentially reads the provision out of the Code: if the Indubitable Equivalent Prong can only be utilized where the debtor can demonstrate that the creditor will get "at least as much" as he would have received under the other provisions, a debtor would never invoke the provision, even in the "traditional" abandonment plans, because abandoning the collateral to the creditor imposes all of the transactions costs of sale—costs that would otherwise be borne by the debtor—on the creditor. Furthermore, it is itself subject to significant judicial discretion and uncertainty—can "near certainty" slip to "more likely than not" and then "likely"? An approach that focuses on certain kinds of plans (in this case, all-equity plans) is both more precise and more in line with the Code.

<sup>83</sup> See 7 COLLIER ON BANKRUPTCY, *supra* note 39, ¶ 1129.04[2][c] (citing 124 CONG. REC. 32,407 (1978) (statement of Rep. Don Edwards) ("Abandonment of the collateral to the creditor would clearly satisfy indubitable equivalence."); *id.* (citing 124 CONG. REC. 34,007 (1978) (statement of Sen. Dennis DeConcini))).

<sup>84</sup> *Sandy Ridge Dev. Corp. v. La. Nat'l Bank (In re Sandy Ridge Dev. Corp.)*, 881 F.2d 1346, 1350 (5th Cir. 1989).

<sup>85</sup> *Id.*

As *In re Sandy Ridge* itself notes, the “such claim” language in the Indubitable Equivalent Prong refers to secured claims.<sup>86</sup> If a secured creditor does not take the § 1111(b) election,<sup>87</sup> the judge may still have to value its collateral for the purposes of determining the creditor’s statutory deficiency claim.<sup>88</sup> In order to eliminate judicial valuation uncertainty, the plan would need to be structured in a way that allows the creditor to sell the collateral after it takes possession of it and before final enactment of the plan. But if an immediate sale is contemplated, the sale should be conducted pursuant to the various procedures afforded to sales under a plan, and “abandonment” would be a misnomer. Even in this case, the secured creditor has no room for complaint: having been given the right to exercise its non-bankruptcy rights to foreclose upon the collateral, if an immediate sale is not possible, it is no worse off than it would have been outside of bankruptcy.

*B. Asset Payment Plans Are Viewed with Skepticism, and Courts Explicitly Cite Valuation Uncertainty as the Primary Concern*

“Dirt for debt” or “asset payment” plans are, in essence, partial abandonment plans. Instead of allowing a secured creditor to foreclose on all of its collateral, the plan proposes to satisfy the secured creditor’s entire claim by surrendering enough of the collateral to pay the secured creditor in full.<sup>89</sup>

These plans are entirely reliant on judicial valuation, and they expose creditors to a variety of risks.<sup>90</sup> First, there is the basic valuation risk at the time the valuation occurs: the secured creditor may not be over-secured—or not as over-secured as the debtor claims. Second, if the debtor is proposing an

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<sup>86</sup> See *id.* at 1349.

<sup>87</sup> It is entirely unclear whether a secured creditor should be able to take the § 1111(b) election in abandonment plans. See 11 U.S.C. § 1111(b) (2006). Section 1111(b) is generally understood to protect secured creditors against low-ball sales of their collateral. That concern is not present in abandonment plans. As a theoretical matter, it may be appropriate to look at abandonment plans as a “sale” where the secured creditor is deemed to have bid the judicially assessed value of the collateral. The creditor would remain entitled to a deficiency claim for the difference between the judicially set value of its collateral and the face value of its claim, which is the state of the world where the § 1111(b) election is not taken.

<sup>88</sup> See 11 U.S.C. § 506(a)(1) (stating that a claim is secured only “to the extent of the value of such creditor’s interest in the estate’s interest in such property . . . and [the remainder] is an unsecured claim”).

<sup>89</sup> 7 COLLIER ON BANKRUPTCY, *supra* note 39, ¶ 1129.04[2][c], at 1129–28. Such plans are only possible where the secured creditor is over-secured. By way of illustration: the face value of the secured creditor’s claim is 80, and the collateral is worth 100. Instead of selling 80% of the collateral for 80 and turning the proceeds over to the secured creditor, or allowing the creditor to retain its lien on all of the property, the debtor proposes to abandon 80% of the collateral.

<sup>90</sup> See Wyland, *supra* note 82, at 1394–95.

asset payment plan in good faith<sup>91</sup> instead of simply selling the collateral in question to pay the secured creditor, the collateral must be illiquid at the time of confirmation; otherwise, the debtor is proposing to enter an impermissible forced “sale”-leaseback transaction as part of the plan. In either case, the risk of decreases in the transferred collateral’s value has been shifted to the secured creditor—and the creditor has lost the cushion formerly provided by the full lien on the original collateral. Because asset transfer plans typically do not provide for the retention of any lien, there is no way to impose a higher interest rate to account for the increased risk.

Some courts have allowed asset transfer plans where the assets transferred provide a cushion to account for the uncertainty.<sup>92</sup> This amounts to an “in kind” step-up, and the approach suffers from the same shortcomings as the Step-Up doctrine itself: there remains no way to know whether the additional “cushion” has either (i) adequately compensated the secured creditor, or (ii) overcompensated the secured creditor at the expense of junior interests.<sup>93</sup> Furthermore, unlike complete abandonment plans, asset payment plans do not provide a secured creditor with the same rights she would have had outside of bankruptcy because the creditor is not entitled to foreclose on and sell *all* of the collateral. Accordingly, the valuation uncertainty problem counsels against confirmation of asset payment plans for the same reason it counsels against confirmation of all-equity plans more generally.

### *C. Replacement Lien Cases Are Dominated by Whether the New Collateral Has a Similar Risk Profile*

In a lien replacement plan,<sup>94</sup> the debtor attempts to strip the secured creditor of its lien over the originally bargained-for collateral and replace it

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<sup>91</sup> As noted previously, a debtor may use the judicial valuation process in an effort to extract value from judicial overvaluation. If a judge knows with certainty that a debtor has proposed a plan with the intent to underpay creditors through manipulation of the valuation process, the judge should hold that the plan has not been filed in good faith. Such a plan cannot be confirmed regardless of any other considerations. 11 U.S.C. § 1129(a)(3) (mandating that a plan of reorganization may only be confirmed if filed in good faith).

<sup>92</sup> For a general discussion of such cases, see 7 COLLIER ON BANKRUPTCY, *supra* note 39, ¶ 1129.04[2][c].

<sup>93</sup> See discussion *infra* Section IV.

<sup>94</sup> Such plans can obviously be proposed only when the secured creditor does not have a lien on all of the assets. Because this Article does not attempt to fully model these situations, the complete dynamics of lien replacement plans will not be considered here. However, it should be noted that the valuation problems with lien replacement plans apply with even greater force when, instead of receiving a new lien, the creditor is forced to accept all equity.

with a lien over different collateral.<sup>95</sup> Such plans may only be confirmed if the new lien adequately protects the creditor's principal and provides for a market rate of interest.<sup>96</sup> Importantly, if the creditor is over-secured, the new lien need not provide the same level of oversecurity;<sup>97</sup> while some reduction in oversecurity is permissible, it is unclear how much reduction would render a plan unconfirmable.

There are a variety of reasons why a debtor would propose such a plan. It may be because the secured creditor has a lien on the debtor's most saleable assets, and the creditor wants to replace that lien with a lien on less liquid assets. Illiquid assets are the ones that are likely to be most bound up in the success or failure of the firm. Imagine a manufacturing company that holds both illiquid capital assets (e.g., a plant and unique parts that only it uses in its manufacturing process) as well as liquid inventory (e.g., completed goods, raw resources that could be resold to other companies) and liquid investment assets (e.g., stocks, cash). Outside of bankruptcy, unless a company is seeking to permanently reduce its output, it will turn first to its saleable assets to provide working capital before cannibalizing its illiquid capital assets. If the creditor has a lien on the liquid non-capital assets, it may be able to prevent such a sale in order to assure it is paid before the enterprise fails. On the other hand, because the value of illiquid assets—such as a plant—is more thoroughly entangled with the going-concern value of an enterprise, if the creditor's lien is shifted to such assets, when the enterprise fails, the value available to the secured creditor will be lower.

More insidiously, the debtor probably has more information about the proposed new collateral than any other party. Because the new collateral was previously unencumbered, it has probably been subject to less scrutiny as to value than encumbered assets. Accordingly, the debtor may think that the judge will overvalue the new collateral. On subsequent liquidation, when the judge's error is realized, the secured creditor will be underpaid.

In either case discussed above, a creditor in a lien replacement plan faces valuation uncertainty risk both as it relates to its original collateral and as it

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<sup>95</sup> See 7 COLLIER ON BANKRUPTCY, *supra* note 39, ¶ 1129.04[2][c].

<sup>96</sup> *Id.*

<sup>97</sup> Wyland, *supra* note 82, at 1410 (“Usually, however, the substitute collateral is worth considerably less than the original collateral.”).

relates to the new collateral.<sup>98</sup> This increased exposure to valuation uncertainty has made courts hesitant to confirm lien replacement plans.<sup>99</sup>

*1. A Special Set of Replacement Lien Cases: Cases in Which Some of the Prepetition Collateral Is Removed from the Lien and No Replacement Collateral Is Provided*

In one recent Southern District of New York case, a bankruptcy court confirmed a plan under the Indubitable Equivalent Prong that simply removed some of a prepetition secured creditor's collateral from the post-confirmation lien.<sup>100</sup> Additionally, the terms of the lien itself were made more onerous: a PIK toggle function was added, and the maturity date was significantly extended.<sup>101</sup>

The court made clear that its ruling was largely based on the fact that the secured creditor was highly over-secured.<sup>102</sup> As discussed above, where a creditor is highly over-secured, he does not face significant downside potential from losing his lien. Accordingly, although the court did not address the valuation uncertainty problem, because there was essentially zero risk that the secured creditor would go unpaid, valuation uncertainty was a non-factor. It is entirely unclear just how over-secured is "over-secured enough" for this line of argument to prevail.

The *In re DBSD* decision is troubling, in that, even though the decision did not address valuation uncertainty directly, it represents a line of reasoning that

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<sup>98</sup> See *supra* Section II.A.1 and related payout tables for a brief introduction on the valuation uncertainty issues that arise where there are multiple points of valuation.

<sup>99</sup> For a listing and discussion of cases, see 7 COLLIER ON BANKRUPTCY, *supra* note 39, ¶ 1129.04[2][c].

<sup>100</sup> *In re DBSD N. Am., Inc.*, 419 B.R. 179 (Bankr. S.D.N.Y. 2009), *rev'd in part on other grounds*, *Network Corp. v. DBSD N. Am. Inc. (In re DBSD N. Am. Inc.)*, 634 F.2d 79, 107–08 (2d Cir. 2011) (affirming the decision of the lower court with regards to the Indubitable Equivalent Prong). It should be noted that the treatment of the Indubitable Equivalent Prong proved to be dicta because the bankruptcy court properly designated the secured creditor's vote. *Id.* at 204 (noting that the secured creditor's vote was designated, but going on to discuss cramdown as an additional ground for affirmation); see *Network Corp.*, 634 F.3d at 104–06 (finding that the secured creditor's vote was properly designated and ignored for class voting purposes and accordingly declining to reach the Indubitable Equivalent Prong argument). However, the Indubitable Equivalent Prong language in *In re DBSD* has been recognized as being potentially more important in the long run than the vote designation issue. See, e.g., Ben Feder, *The Dog that Didn't Bark—Second Circuit's Opinion in DBSD North America Disallows Gifting, But Is Silent on Cramdown of Secured Creditor*, BANKR. L. INSIGHTS (Mar. 2, 2011, 10:18 AM), <http://www.bankruptcylawinsights.com/articles/chapter-11/>.

<sup>101</sup> *In re DBSD*, 419 B.R. at 189–95 (discussing the proposed changes to the capital structure in the context of determining feasibility of the plan).

<sup>102</sup> *Id.* at 208–09.

allows a judge to exercise discretion regarding the impact his own valuation uncertainty will have. It is entirely unclear just how over-secured is “over-secured enough” for the *DBSD* line of argument to prevail—in other words, how certain must the judge be that there is no risk of non-payment before the judge can invoke *DBSD*? *DBSD* itself was a clear case, and it turns out the cram-down aspect of the decision was dicta.<sup>103</sup> It remains to be seen whether future debtors will push the Indubitable Equivalent Prong reasoning in *DBSD*, but this Article illustrates that the courts should apply *DBSD*’s reasoning only in the clearest of cases.

#### IV. VALUATION UNCERTAINTY IN THE CONTEXT OF THE STEP-UP DOCTRINE AND THE NEW VALUE EXCEPTION

As previously noted, technical compliance with one of the provisions of § 1129(b)(2)(A)(i)–(iii) is necessary, but not necessarily sufficient, to satisfy the fair and equitable rule. There are several uncodified aspects of the fair and equitable rule that may operate to block confirmation of a plan that meets the technical requirements of § 1129(b)(2)(A)(i)–(iii).<sup>104</sup> This Section demonstrates that: (i) the Step-Up doctrine should be viewed as an attempt at addressing valuation uncertainty but that the doctrine should not allow for all-equity plans because it inadequately addresses the problem; and (ii) the New Value Exception should not be combined with an all-equity plan because valuation uncertainty would result in secured creditors being systematically exposed to increased underpayment risk.

##### *A. The Step-up Doctrine Should Not Be Employed as a Way of Condoning Lien-Stripping Plans*

The Step-Up doctrine provides that if a creditor is going to be forced to accept “inferior” (i.e., lower in priority) securities under a plan, then the creditor must be given a bonus payment above the face value of its claim.<sup>105</sup>

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<sup>103</sup> See *supra* note 100 and accompanying text.

<sup>104</sup> See generally Klee, *supra* note 7.

<sup>105</sup> *Id.* at 232–33. The doctrine is said to have its genesis in *Consolidated Rock Products Co. v. Du Bois*, 312 U.S. 510, 528–29 (1941) (“[W]hile creditors may be given inferior grades of securities, their ‘superior rights’ must be recognized. Clearly, those prior rights are not recognized, in cases where stockholders are participating in the plan, if creditors are given only a face amount of inferior securities equal to the face amount of their claims. They must receive, in addition, compensation for the senior rights which [sic] they are to surrender. If they receive less than that full compensatory treatment, some of their property rights will be appropriated for the benefit of the stockholders without compensation. That is not permissible.”); see also 7 COLLIER ON BANKRUPTCY, *supra* note 39, ¶ 1129.03[4][b].

While it is not entirely clear that the doctrine survived enactment of the Code,<sup>106</sup> the legislative history does support its continued vitality.<sup>107</sup> Although the doctrine has been applied in all-equity plan circumstances, it has not been invoked in any published plan confirmation since the enactment of the Code.<sup>108</sup> Nonetheless, the potential utilization of the doctrine in connection with a proposed all-equity plan under the Indubitable Equivalent Prong merits consideration.

On initial examination, the Step-Up doctrine seems to be at odds with the prohibition against paying a senior creditor more than the full value of its claim.<sup>109</sup> If a secured creditor is owed 100, and is given securities with a “real” present value of 110, it has received 10 more than what it is entitled to receive. This is an unjustifiable result. To the extent that the creditor is exposed to greater nonpayment risk due to the loss of its lien, if it received a debt security or preferred stock, the appropriate way to account for the risk is through imposition of a higher interest rate. If it receives equity, the equity’s value is a summation of all future possibilities—including nonpayment risk—and the creditor has still been overcompensated.

In order to address this possible problem, commentators and courts have suggested that the bonus payment is essentially a payment in redemption for the loss of priority.<sup>110</sup> In other words, the argument is that the “priority right” itself has an independent value, subject to valuation by the judge, and that

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<sup>106</sup> 7 COLLIER ON BANKRUPTCY, *supra* note 39, ¶ 1129.03[4][c].

<sup>107</sup> H.R. REP. NO. 95-595, at 377 (1977), *reprinted in* U.S.C.C.A.N. 5963, 6370 (“The partial codification of the absolute priority rule here is not intended to deprive senior creditor [sic] of compensation for being required to take securities in the reorganized debtor that are of any equal priority with the securities offered to a junior class. Under current law, seniors are entitled to compensation for their loss of priority, and the increased risk put upon them by being required to give up their priority will be reflected in a lower value of the securities given to them than the value of comparable securities given to junior [sic] that have not lost a priority position.”).

<sup>108</sup> In fact, the doctrine does not appear to have been invoked under any circumstance in recent years. Notably, in *In re Calpine*, a senior unsecured creditor opposed confirmation of a subordinated creditor’s plan of confirmation, invoking the Step-Up doctrine to argue that the consideration being received was insufficient. *See* Objection of Certain 6% Convertible Noteholders to Confirmation of Debtors’ Fourth Amended Joint Plan of Reorganization at 39, *In re Calpine Corp.*, No. 05-60200 (BRL), 2007 WL 4661093 (S.D.N.Y. Nov. 30, 2007). The *Calpine* court approved the plan notwithstanding the step-up argument; it appears that the waterfall payment schedule—which was tied to a later judicial valuation—resulted in zero payment to the subordinated creditor, which rendered the senior unsecured creditor’s step-up argument moot. *See* Order Confirming Sixth Amended Joint Plan of Reorganization, *In re Calpine Corp.*, No. 05-60200 (BRL), 2007 WL 456522, at \*16 (Bankr. S.D.N.Y. Dec. 19, 2007). Accordingly, it is unclear whether *Calpine* can be seen as giving any sense of the doctrine’s continuing vitality.

<sup>109</sup> *See* 7 COLLIER ON BANKRUPTCY, *supra* note 39, ¶ 1129.03[4][b][i][A]; Klee, *supra* note 7, at 232–34.

<sup>110</sup> *See* 7 COLLIER ON BANKRUPTCY, *supra* note 39, ¶ 1129.03[4][b][i][A]; Klee, *supra* note 7, at 234.

payment of the bonus amount is in consideration of the loss of the right to priority. But that explanation is nonsense. It assumes that a priority right has value independent of the underlying right to payment. If that were the case, one would expect that outside of bankruptcy, a secured creditor owed 100 would be willing to cancel its lien in exchange for an unsecured note with a face value of 10 and an increased interest rate on both the original (now unsecured) loan and the new compensatory loan, *and* that a debtor would be willing to engage in such an exchange. However, under what circumstance would a debtor who is able to service payments—at a lower rate of interest—on a claim of 100 be willing to incur an additional 10 of debt in order to secure release of a lien? Furthermore, that explanation itself injects valuation uncertainty into the equation: if a bankruptcy judge faces a difficult task in valuing collateral, he faces an even more difficult task in valuing a right to payment priority.<sup>111</sup>

The same question can be asked where the secured creditor receives all equity instead of an unsecured note under a plan: under what market conditions would a secured creditor conceivably be willing to exchange its 100 secured claim for a 110 equity interest? Presumably, only where sufficient information is available that would allow the creditor to conclude that the equity interest is actually worth 110.

Therefore, instead of viewing the Step-Up doctrine as a method for directly compensating a secured creditor for its loss of priority, the doctrine should be viewed as an attempt to address the valuation uncertainty problem. Providing a bonus payment is a way of accounting for the fact that the “unknown unknowns” prevent a judge from setting an interest rate that adequately accounts for increased risk.

Unfortunately, the Step-Up doctrine fails to adequately solve the valuation uncertainty problem.<sup>112</sup> The step-up reduces, but does not eliminate, the

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<sup>111</sup> One commentator has attempted to provide a model to address the fact that judges pick the amount of the bonus payment as a “theoretical construct” not necessarily connected to market value. Thomas H. Jackson, Note, *Giving Substance to the Bonus Rule in Corporate Reorganizations: The Investment Value Doctrine Analogy*, 84 YALE L.J. 932, 936–37 (1975). But the model’s focus on determining reasoned step-up amounts does not address the fact that, as demonstrated below, there is no way to implement a step-up without creating either under- or over-payment risk.

<sup>112</sup> An illustration is in order. A secured creditor is owed 100,  $v(\text{real}) = 120$ ;  $v(\text{min}) = 80$ ;  $v(\text{max}) = 160$ . In an all-equity plan, the creditor should receive 83% of the equity. Without a step-up, the creditor receives 100% of the equity, worth 120, at  $v(\text{min})$ , or 62.5%, worth 75, at  $v(\text{max})$ , for an expected payout of 97.5. With a 10% step-up in the equity received, the creditor’s expected payout is 103.5. This is unsurprising because the step-up mimics a greater amount of over-security and, as demonstrated earlier, where a creditor is sufficiently

secured creditor's overvaluation risk, unless the step-up meets or exceeds the possible overvaluation variance amount. Of course, there is no way to know that precise amount. Additionally, even if the judge could precisely account for overvaluation variance, such a large step-up significantly increases the risk of overpaying the secured creditor, to the detriment of junior creditors. Accordingly, the Step-Up doctrine is an inferior solution for valuation uncertainty, when compared to maintenance of the lien.

### *B. A Brief Excursion into the New Value Exception*

Simply stated, the New Value Exception allows a junior creditor (often, but not always, an equity holder) to obtain an interest in the reorganized company by contributing sufficient money or money's worth.<sup>113</sup> Like the Step-Up doctrine, the New Value Exception is a carryover from pre-Code practice; but unlike the Step-Up doctrine, the New Value Exception has been extensively employed in post-Code practice.<sup>114</sup>

The New Value Exception does not appear to have been utilized simultaneously with an all-equity plan proposal. However, after *Philadelphia Newspapers* a debtor may attempt to simultaneously strip a creditor's lien and invoke the New Value Exception. Courts should not confirm such plans because of valuation uncertainty concerns. The senior creditor's downside risk is due to undervaluation of the enterprise, which poses dilution risk for the senior creditor in the new value context.<sup>115</sup> As with all-equity plans generally, there is a possibility that the senior creditor would be overpaid: if the judge assigns too high a value to the enterprise initially, the junior creditor's new

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over-secured, she may be overpaid in all-equity plans. If the same facts are assumed, but the creditor is owed 120, the creditor's expected payout with a 10% step-up is only 111.

<sup>113</sup> 7 COLLIER ON BANKRUPTCY, *supra* note 39, ¶ 1129.03[4][c]. See generally, Charles W. Adams, *New Capital for Bankruptcy Reorganizations: It's the Amount that Counts*, 89 NW. U. L. REV. 411 (1995); S.W. O'Donnell, *Toward a Better Understanding of New Value*, 108 PENN ST. L. REV. 703 (2004); Tene, *supra* note 48, at 328–31.

<sup>114</sup> The issue of whether the exception has vitality is a contested one. 7 COLLIER ON BANKRUPTCY, *supra* note 39, ¶ 1129.03[4][c], at 1129–94 (detailing circuit split). The Supreme Court has not decided the circuit split on the issue. *Bank of Am. Nat'l Trust and Savs. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 449 (1999).

<sup>115</sup> Assume that, before the contribution of new value,  $v(\text{real}) = 60$ ;  $v(\text{min}) = 40$ ; and  $v(\text{max}) = 80$ . After the junior creditor contributes 20 of new money,  $v(\text{real}) = 80$ ;  $v(\text{min}) = 60$ ; and  $v(\text{max}) = 100$ . In an all-equity plan, the junior creditor's "20" of equity is set: at  $v(\text{min})$  the junior and senior both receive 50%; at  $v(\text{max})$  the junior receives 20% and the senior receives 80%. The senior's expected payout is 65 even if his original claim was 100, 120, etc. Of course, the real relationship between the new money and the possible valuations are more complex. The junior creditor will probably argue that his contribution of 20 now means the enterprise will see significantly higher returns in the future, such that both  $v(\text{max})$  and  $v(\text{min})$  would be higher.

contribution would be diluted.<sup>116</sup> But it is unlikely such circumstances would occur because the junior creditor unilaterally decides to attempt to contribute new value. Therefore, the combination of new value with an all-equity plan poses even greater risks than all-equity plans generally, and such plans should not be confirmed.

### CONCLUSION

The Indubitable Equivalent Prong has historically been invoked only in a narrow set of circumstances. Successful invocation of the provision has been rarer still. As this Article has demonstrated, concerns about the effect of valuation uncertainty have driven this narrow application of the provision. If debtors (and colluding creditors) invoke the reasoning from *Philadelphia Newspapers* to propose all-equity plans in the future, courts would be wise to remember that they cannot know precisely what they do not know. Such plans create opportunities for gamesmanship that do not exist in lien retention plans, and even where there is no gamesmanship involved, such plans unjustifiably exacerbate the valuation uncertainty problem. *Ex ante* and *ex post* effects that result from increasing the risk of under- or over-compensating senior creditors outweigh the potential benefit of additional flexibility for debtors. Therefore, courts should not cram down all-equity plans proposed under the Indubitable Equivalent Prong.

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<sup>116</sup> For example, if, before new value is added,  $v(\text{real}) = 100$ ,  $v(\text{min}) = 80$ ,  $v(\text{max}) = 120$ . After 20 new value is added,  $v(\text{real}) = 120$ ,  $v(\text{min}) = 100$ ,  $v(\text{max}) = 140$ . If the judge assigns  $v = 140$ , the debtor putting in new value will receive only  $20/140 = 14.28\%$  of the equity, even though the debtor should have received  $20/120 = 16.67\%$ . If the company is subsequently liquidated for  $v(\text{real})$  (120) the debtor loses 2.97 due to the overvaluation.

## APPENDIX

For the following payout tables,<sup>117</sup>  $v(\text{real}) = \text{“actual” value}$ ;  $v(\text{max}) = \text{maximum overvaluation value}$ ;  $v(\text{min}) = \text{minimum undervaluation value}$ ;  $\text{Prob}(v(\text{min})) = \text{the probability that the judge will assign an enterprise value of } v(\text{min})$ ;  $\text{Prob}(v(\text{max})) = \text{the probability that the judge will assign an enterprise value of } v(\text{max})$ . Bolded is the equilibrium point, where the expected value of equity is equal to both (i) the claim; and (ii) the expected payout where the creditor retains her lien.

Throughout the calculations,  $v$  is kept constant at 60. Therefore,  $60 = (\text{Prob}(v(\text{min})) \times v(\text{min})) + (\text{Prob}(v(\text{max})) \times v(\text{max}))$ .

A. *Payout Tables for a Single Secured Creditor with a Lien on All of the Debtor's Assets*

1. *Payouts Where  $v'$  Is Symmetrical*

Where  $v(\text{min})$  and  $v(\text{max})$  are symmetrical,  $\text{Prob}(v(\text{max}))$  and  $\text{Prob}(v(\text{min}))$  are both 50%. Accordingly, there is only one variable: the symmetrical deviation from  $v$ . The calculated expected payouts are based on the prepetition claim amount; the claim amounts for each  $v'$  value vary slightly where necessary to show helpful information.

Payouts where $v = 60$ , $v(\text{min}) = 50$ , and $v(\text{max}) = 70$			
Amount of claim; payout if lien retained (% of claim realized)	% of equity at $v(\text{max})$ ; payout if equity received	% of equity at $v(\text{min})$ ; payout if equity received	Expected value of equity (% of claim realized)
10; 10 (100%)	14.29%; 8.57	20%; 12	10.29 (102.86%)
20; 20 (100%)	28.57%; 17.14	40%; 24	20.57 (102.86%)
30; 30 (100%)	42.86%; 25.71	60%; 36	30.86 (102.86%)
35; 35 (100%)	50%; 30	70%; 42	36 (102.86%)
40; 40 (100%)	57.14%; 34.29	80%; 48	41.14 (102.86%)
45; 45 (100%)	64.29%; 38.57	90%; 54	46.29 (102.86%)
50; 50 (100%)	71.43%; 42.86	100%; 60	51.43 (102.86%)
<b>52.5; 52.5 (100%)<sup>118</sup></b>	<b>75%; 45</b>	<b>100%; 60</b>	<b>52.5 (100%)</b>
55; 55 (100%)	78.57%; 47.14	100%; 60	53.57 (97.40)
60; 60 (100%)	85.71%; 51.43	100%; 60	55.71 (92.86%)
65; 60 (92.31%)	92.86%; 55.71	100%; 60	57.85 (89%)
70; 60 (85.71%)	100%; 60	100%; 60	60 (85.71%)

<sup>117</sup> For general discussion and conclusions based on these tables as well as simplifying assumptions, see *supra* note 75 and accompanying text.

<sup>118</sup> Equilibrium point: 14.29% over-secured.

Payouts where $v = 60$ , $v(\min) = 40$ , and $v(\max) = 80$			
Amount of lien; payout if lien retained (% of claim realized)	% of equity at $v+$ ; payout if equity received	% of equity at $v-$ ; payout if equity received	Expected value of equity (% of claim realized)
10; 10 (100%)	12.5%; 7.5	25%; 15	11.25 (112.5%)
20; 20 (100%)	25%; 15	50%; 30	22.5 (112.5%)
30; 30 (100%)	37.5%; 22.5	75%; 45	33.75 (112.5%)
35; 35 (100%)	43.75%; 26.25	87.5%; 52.5	39.375 (112.5%)
40; 40 (100%)	50%; 30	100%; 60	45 (112.5%)
45; 45 (100%)	56.25%; 33.75	100%; 60	46.875 (104.2%)
<b>48; 48 (100%)<sup>119</sup></b>	<b>60%; 36</b>	<b>100%; 60</b>	<b>48 (100%)</b>
50; 50 (100%)	62.5%; 37.5	100%; 60	48.75 (97.5%)
55; 55 (100%)	68.75%; 41.25	100%; 60	50.63 (92.05%)
60; 60 (100%)	75%; 45	100%; 60	52.5 (87.5%)
70; 60 (85.71%)	87.5%; 52.5	100%; 60	56.5 (80.36%)
80; 60 (75%)	100%; 60	100%; 60	60 (75%)
90; 60 (66.67%)	100%; 60	100%; 60	60 (66.67%)

Payouts where $v = 60$ , $v(\max) = 90$ , and $v(\min) = 30$			
Amount of claim; payout if lien retained (% of claim realized)	% of equity at $v(\max)$ ; payout if equity received	% of equity at $v(\min)$ ; payout if equity received	Expected value of equity (% of claim realized)
10; 10 (100%)	11.11%; 6.67	33.33%; 20	13.33 (133.33%)
20; 20 (100%)	22.22%; 13.33	66.66%; 40	26.66 (133.33%)
30; 30 (100%)	33.33%; 20	100%; 60	40 (133.33%)
35; 35 (100%)	38.89%; 23.34	100%; 60	41.67 (119.04%)
40; 40 (100%)	44.45%; 26.67	100%; 60	43.33 (108.33%)
<b>45; 45 (100%)<sup>120</sup></b>	<b>50%; 30</b>	<b>100%; 60</b>	<b>45 (100%)</b>
50; 50 (100%)	55.56%; 33.33	100%; 60	46.67 (93.33%)
55; 55 (100%)	61.11%; 36.67	100%; 60	48.33 (87.88%)
60; 60 (100%)	66.67%; 40	100%; 60	50 (83.33%)
70; 60 (85.71%)	77.78%; 46.67	100%; 60	53.33 (76.19%)
80; 60 (75%)	88.89%; 53.33	100%; 60	56.67 (70.83%)
90; 60 (66.67%)	100%; 60	100%; 60	60 (66.67%)

<sup>119</sup> Equilibrium point: 25% over-secured.

<sup>120</sup> Equilibrium point: 33% over-secured.

Payouts where $v = 60$ , $v(\max) = 100$ , and $v(\min) = 20$			
Amount of claim; payout if lien retained (% of claim realized)	% of equity at $v(\max)$ ; payout if equity received	% of equity at $v(\min)$ ; payout if equity received	Expected value of equity (% of claim realized)
10; 10 (100%)	10%; 6	50%; 30	18 (180%)
20; 20 (100%)	20%; 12	100%; 60	36 (180%)
30; 30 (100%)	30%; 18	100%; 60	39 (130%)
35; 35 (100%)	35%; 21	100%; 60	40.5 (115.71%)
40; 40 (100%)	40%; 24	100%; 60	42 (105%)
<b>42.855; 42.855 (100%)<sup>121</sup></b>	<b>42.86%; 25.71</b>	<b>100%; 60</b>	<b>42.85 (100.004%)</b>
45; 45 (100%)	45%; 27	100%; 60	43.5 (96.67%)
50; 50 (100%)	50%; 30	100%; 60	45 (90%)
55; 55 (100%)	55%; 33	100%; 60	46.5 (84.55%)
60; 60 (100%)	60%; 36	100%; 60	48 (80%)
70; 60 (85.71%)	70%; 42	100%; 60	51 (72.86%)
80; 60 (75%)	80%; 48	100%; 60	54 (67.5%)
90; 60 (66.67%)	90%; 54	100%; 60	57 (63.33%)

## 2. Payouts Where $v'$ Is Not Symmetrical

Where  $v(\max)$  and  $v(\min)$  are not symmetrical, there are two related variables (in other words, the solution of one variable depends on the value assigned to the other variable): (i) what is the difference between  $v(\min)$  and  $v(\max)$  (i.e., is  $v(\min) = v - 10$ ,  $v(\max) = v + 20$ ; or is  $v(\min) = v - 20$ ,  $v(\max) = v + 10$ ; with any number of variations?); (ii) what is the likelihood of  $v(\min)$  compared to  $v(\max)$  (i.e., is  $v(\min)$  a 30% chance and  $v(\max)$  a 70% chance, or vice-versa?). However, because  $\text{Prob}(v(\min)) + \text{Prob}(v(\max))$  must equal 1, if either  $v(\max)$  or  $v(\min)$  are known,  $\text{Prob}(v(\min))$  and  $\text{Prob}(v(\max))$  must both be known. Therefore, it is only possible to generate a payout table (without a more sophisticated model) where only  $v(\min)$  or  $v(\max)$  are “alterable” variables.

For example, in order to calculate  $v(\min)$ ;  $v(\max)$ ,  $\text{Prob}(v(\max))$ , and  $\text{Prob}(v(\min))$  must be known. For example, where  $v(\max) = 80$ ,  $\text{Prob}(v(\max)) = 30\%$ , and  $\text{Prob}(v(\min)) = 70\%$ , our equation is  $60 = .7(v(\min)) + .3(80)$ , and  $v(\min) = 51.43$ .

With those limitations in mind, the following payout tables are presented as illustrative examples with an acknowledgement that, without a more sophisticated model, it is impossible to capture even a representative sample of

<sup>121</sup> Equilibrium point: 40% over-secured.

possibilities for  $v = 60$ . This, of course, is striking, because most firms are not lottery tickets, and situations where  $v(\min)$  and  $v(\max)$  are asymmetrical are bound to be more common than situations where they are symmetrical.

v(real) = 60; v(max) = 80; Prob(v(max)) = 30%; v(min) = 51.43; Prob(v(min)) = 70%										
Lien Retained			v(max) & Equity Received			v(min) & Equity Received			Expected Value of Equity	
Amount of Claim	% of Claim	Pay-out	Equity %	% of Claim	Pay-out	Equity %	% of Claim	Pay-out	% of Claim	Pay-out
10	100%	10	13%	75%	8	19%	117%	12	104%	10
20	100%	20	25%	75%	15	39%	117%	23	104%	21
30	100%	30	38%	75%	23	59%	117%	35	104%	31
35	100%	35	44%	75%	26	68%	117%	41	104%	36
40	100%	40	50%	75%	30	78%	117%	47	104%	42
45	100%	45	56%	75%	34	88%	117%	53	104%	47
50	100%	50	63%	75%	38	97%	117%	58	104%	52
52	100%	52	65%	75%	39	100%	115	60	103%	54
54	100%	54	67%	75%	40	100%	112%	60	101%	54
54	100%	54	68%	75%	41	100%	111%	60	100%	54
<b>54<sup>122</sup></b>	<b>100%</b>	<b>54</b>	<b>68%</b>	<b>75%</b>	<b>41</b>	<b>100%</b>	<b>111%</b>	<b>60</b>	<b>100%</b>	<b>54</b>
55	100%	55	69%	75%	41	100%	109%	60	99%	54
60	100%	60	75%	75%	45	100%	100%	60	93%	56
70	86%	60	88%	75%	53	100%	86%	60	83%	58
80	75%	60	100%	75%	60	100%	75%	60	75%	60
90	67%	60	100%	67%	60	100%	67%	60	67%	60

v(real) = 60; v(max) = 80; Prob(v(max)) = 70%; v(min) = 13.33; Prob(v(min)) = 30%										
Lien Retained			v(max) & Equity Received			v(min) & Equity Received			Expected Value of Equity	
Amount of Claim	% of Claim	Pay-out	Equity %	% of Claim	Pay-out	Equity %	% of Claim	Pay-out	% of Claim	Pay-out
10	100%	10	13%	75%	8	75%	450%	45	188%	19
20	100%	20	25%	75%	15	100%	300%	60	143%	229
30	100%	30	38%	75%	23	100%	200%	60	113%	34
35	100%	35	44%	75%	26	100%	171%	60	104%	36
<b>38<sup>123</sup></b>	<b>100%</b>	<b>38</b>	<b>47%</b>	<b>75%</b>	<b>28</b>	<b>100%</b>	<b>158%</b>	<b>60</b>	<b>100%</b>	<b>38</b>
40	100%	40	50%	75%	30	100%	150%	60	98%	39
45	100%	45	56%	75%	34	100%	133%	60	93%	42
50	100%	50	63%	75%	38	100%	120%	60	89%	44
55	100%	55	69%	75%	41	100%	109%	60	85%	47
60	100%	60	75%	75%	45	100%	100%	60	83%	50
70	86%	60	88%	75%	53	100%	86%	60	78%	55
80	75%	60	100%	75%	60	100%	75%	60	75%	60
90	67%	60	100%	67%	60	100%	67%	60	67%	60

<sup>122</sup> Equilibrium point: 10.72% over-secured.

<sup>123</sup> Equilibrium point: 58.31% over-secured.

v(real) = 60; v(max) = 70; Prob(v(max)) = 40%; v(min) = 53.333; Prob(v(min)) = 60%										
Lien Retained			v(max) & Equity Received			v(min) & Equity Received			Expected Value of Equity	
Amount of Claim	% of Claim	Pay-out	Equity %	% of Claim	Pay-out	Equity %	% of Claim	Pay-out	% of Claim	Pay-out
10	100%	10	14%	86%	9	19%	113%	11	102%	10
20	100%	20	29%	86%	17	38%	113%	23	102%	20
30	100%	30	43%	86%	26	56%	113%	34	102%	31
35	100%	35	50%	86%	30	66%	113%	39	102%	36
40	100%	40	57%	86%	34	75%	113%	45	102%	41
45	100%	45	64%	86%	39	84%	113%	51	102%	46
50	100%	50	71%	86%	43	94%	113%	56	102%	51
52	100%	52	74%	86%	45	98%	113%	59	102%	53
54	100%	54	77%	86%	46	100%	111%	60	101%	55
<b>55<sup>124</sup></b>	<b>100%</b>	<b>55</b>	<b>78%</b>	<b>86%</b>	<b>47</b>	<b>100%</b>	<b>110%</b>	<b>60</b>	<b>100%</b>	<b>55</b>
55	100%	55	79%	86%	47	100%	109%	60	100%	55
60	100%	60	86%	86%	51	100%	100%	60	94%	57
70	86%	60	100%	86%	60	100%	86%	60	86%	60
80	75%	60	100%	75%	60	100%	75%	60	75%	60
90	67%	60	100%	67%	60	100%	67%	60	67%	60

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<sup>124</sup> Equilibrium point: 9.52% over-secured.