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Bankruptcy Poison Pills – New Attempts to Avoid Absolute Priority

INTRODUCTION

Recently, bankruptcy lawyers representing debtors, whether or not they are conscious of the parallels, have begun including provisions in their chapter 11 plans which can best be described as poison pills. These plan provisions are intended to deter creditors or interested third parties from bidding on the ownership of a debtor at an auction of the debtor's ownership interest as required by the so-called absolute priority rule codified in 11 U.S.C. § 1129(b)(2)(B)(ii) and decisional law. While there appears to be no reported opinions ruling on these types of provisions, they are becoming more common and the adoption or validation of these provisions could significantly weaken what has been a fundamental protection of creditors in bankruptcy for over a hundred years.

POISON PILLS IN THE CORPORATE LAW CONTEXT

"Corporations have long relied on so-called poison pills to protect themselves against hostile takeovers." Peter V. Letsou, *Are Dead Hand (and No Hand) Poison Pills Really Dead?*, 68 U. Cin. L. Rev. 1101, 1101 (2000). "Generally implemented by distributing rights to the corporation's existing shareholders to acquire new shares of common stock at below market prices, poison pills operate by threatening would-be acquirors with severe economic penalties should they proceed with offers while the rights remain outstanding." *Id.*

"The poison pill derives its effectiveness from this deterrence value--the incumbent management can remain in power because the hostile bidder cannot afford to trigger the poison pill." Julian Velasco, *The Enduring Illegitimacy of the Poison Pill*, 27 J. Corp. L. 381, 383 (2002). The essential purpose of a poison pill is to prevent buyers interested in a majority or large percentage of a company's stock from purchasing those shares at fair market value. The poison pull greatly increases the cost of purchasing those shares, and thereby entrenches and protects current management.

Lately, corporate lawyers have developed even more sophisticated poison pills, including so-called dead-hand provisions "which require redemptions of poison pills to be approved by 'continuing directors' (i.e., directors in office when the poison pill was adopted or directors who were elected with the support of such directors)." Letsou, 68 U. Cin. L. Rev. at 1101. Dead-hand poison pills are highly controversial and "condition the ability of full boards of directors to redeem [i.e. eliminate] poison pills on the approval of 'Continuing Directors,' [and] arguably restrict the fundamental management powers of [current] boards of directors . . . ." *Id.* at 1104. This type of poison pill prevents new directors appointed by a recent buyer of a majority of a company's shares from altering certain aspects of the company's by-laws, and instead, permanently delegates those powers to pre-takeover directors.

Similar to the "problem of the dead hand" in real estate law (addressed, in part, by the rule against perpetuities), dead-hand poison pills prevent current shareholders from taking desired actions with regards to their own property on account of the entrenched wishes of former shareholders. While this arrangement likely has no practical value in adding to effective corporate governance, the theory is that the arrangement will prevent unwanted hostile takeovers and increase the price for current shareholders by interested buyers. But this theory is not universally accepted, and many commentators believe that poison pills in fact only benefit current management, and that shareholders are damaged as they remove accountability and the incentive for management to maximize shareholder value, and they distort what should be a free market for the buying and selling of shares. *See, e.g.,* Julian Velasco, *The Enduring Illegitimacy of the Poison Pill*, 27 J. Corp. L. 381, 383 (2002).

USE OF POISON PILL PROVISIONS IN CHAPTER 11 PLANS

When, in the course of a bankruptcy, a debtor places its ownership interests up for auction, current owners and managers of the debtor have similar incentives to deter other potential bidders, especially adverse creditors, from purchasing that ownership and firing current management. To accomplish this, debtors in chapter 11 have begun proposing plans with poison pill-like provisions, plans that attempt to economically penalize a potential winning bidder, or plans that attempt to block that winning bidder from exercising control over the debtor post-reorganization. Rather than embed these restrictions in the debtor's bylaws, a debtor may codify these provisions in its plan and proposed confirmation order.

These provisions take various forms. Some plans require that the winning bidder operate the company as a going concern for some period after confirmation. Some plans require that the winning bidder retain current management unless and until certain conditions occur. Some plans require the winning bidder to pay a large break-up fee to current ownership should current ownership lose at the auction. Some plans require the winning bidder to provide a large deposit to debtor's counsel on very short notice. Some plans limit who may qualify as a bidder.

The list of potential poison pills is limited only by the creativity of debtors' lawyers. The effects of these provisions, however, are obvious. They distort the market for the ownership of the debtor and thereby prevent active bidding, favor insider bids, and therefore reduce the amount eventually brought into the estate for distribution to creditors.

POISON PILLS AND THE ABSOLUTE PRIORITY RULE

The absolute priority rule, codified in 11 U.S.C. § 1129(b)(2)(B)(ii), provides that a dissenting class of unsecured creditors must be paid in full in a chapter 11 plan before any junior class can receive or retain any property under the plan "on account of" the junior class's prior interest. *Northwest Bank Worthington v. Ahlers*, 485 U.S. 197, 202 (1988). This rule therefore prevents the current owners of a debtor from retaining their ownership on account of, or because of, their prior ownership interests, unless other creditors are paid in full.

There is, however, an exception to this known as the "new value" exception.[1] The new value exception allows old ownership of a debtor to retain that ownership while also not paying creditors in full. This retention is in exchange for a new capital contribution in the debtor. Essentially, if the debtor is not

[1] This new value exception is also known as the new value corollary to the absolute priority rule, but the distinction is mostly semantic.

paying its creditors in full under its plan, the old owners can receive the stock of the reorganized debtor if they purchase it.

The courts, however, are strict about what old ownership can justifiably contribute in exchange for retaining their ownership position. Any capital contributed in exchange for retaining ownership must be (1) new, (2) necessary to the reorganization, (3) substantial, (4) reasonably equivalent to the value retained, and (5) in the form of money or money's worth. *In re Bonner Mall Partnership*, 2 F.3d 899, 908-09 (9th Cir. 1993) cert. granted, 114 S. Ct. 681 (1994), motion to vacate denied, 115 S. Ct. 386 (1994). The *Bonner Mall* requirements ensure that the new value contributed by the old owners is not in the form of future promises, or sweat equity, or some other non-monetizable asset that is not certain to benefit creditors. Essentially, the new value must be cash or a cash equivalent.

Although the *Bonner Mall* elements explain that the new value must be "reasonably equivalent" to the value of the ownership, and that it must be paid in cash, courts have struggled to determine how much cash is enough in each circumstance. The United States Supreme Court, however, *Bank of Am. Nat. Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 457-58 (1999), added a market test for lower courts to use in deciding how much money is sufficient.[2]

First, the Court in *LaSalle* determined that "it would . . . be a fatal flaw if old equity acquired or retained [ownership] without paying full value." *Id*. at 457. The Court stated that, "[u]nder a plan granting an exclusive right, making no provision for competing bids or competing plans, any determination that the price was top dollar would necessarily be made by a judge in bankruptcy court, whereas the best way to determine value is exposure to a market." *Id.*

But the Court did not elaborate on what that exposure must entail, only that "some form of market valuation" must be used that must not be "free from competition." *Id.* at 457-58. Whether through a competing plan or an auction of the ownership, the Court would not decide. *Id.* at 458. The Court did, however, note that the underlying concern of the absolute priority rule in general was the belief "that creditors, because of management's position of dominance, [would not be] able to bargain effectively without a clear standard of fairness and judicial control." *Id.* at 444 (internal citations omitted).

Other courts have attempted to define what kind of process is necessary to properly expose the ownership interests to the market and to protect creditors for current management's position of dominance. For instance, in *In re Bjolmes Realty Trust*, 134 B.R. 1000, 1011-12 (Bankr. D. Mass. 1991), the bankruptcy court expressly told the debtor that, to confirm a plan where current ownership retains its interest, "[t]he plan and disclosure statement will have to be amended . . . [to] include an auction, attended by any interested bidders among the Debtor's creditors and shareholders, for the original issuance of a one hundred percent stock interest in the Debtor." The court in *Bjolmes* required these procedures in order to avoid giving current ownership any "undue leverage" which would be the direct result of the "absence of market forces." *Id.* at 1011.

Likewise, in *In re Ropt Ltd. P'ship*, 152 B.R. 406, 412-13 (Bankr. D. Mass. 1993), the bankruptcy court further required "as a condition of confirmation that the Debtor circulate to all creditors a notice of sale

[2] Interestingly, the Court refused to acknowledge whether the new value exception even existed; instead, it simply ruled that if the new value exception did exist, the necessary amount of new value would have to be determined by a market test. *LaSalle*, 526 U.S. at 458.

to the partners of all the equity interest in the Debtor, with provision for counteroffers and, if any are filed, for an auction by the submission of sealed bids."[3]

In cases like *Bjolmes* and *Ropt*, courts have fashioned rudimentary bidding procedures designed to fully expose the ownership interest to the market and provide judicial control of current management's leverage. But these cases do not discuss in any detail the far more sophisticated bidding procedures and plan provisions used by debtors today to chill bidding.[4]

APPLICATION OF PRINCIPLES OF NEW VALUE EXCEPTION TO BANKRUPTCY POISON PILLS

The purpose of the absolute priority rule is to prevent current ownership from retaining control and ownership of the reorganized debtor without either paying its creditors in full, or paying full fair market value for retaining ownership through a capital contribution. When debtors introduce poison pill-like arrangements in chapter 11 plans, they are attempting to distort fair market value. The dearth of published opinions on this issue most likely reflects the courts' general refusal to sanction these schemes over the objections of creditors.[5]

The first and most obvious problem with bankruptcy poison pills is that they are almost certainly designed to frustrate the requirement of *LaSalle* to expose the ownership to the general market. Restrictions on who can bid, onerous requirements to qualify as a bidder, requirement of payment of large deposits to be held by adverse counsel, and large break-up fees payable to current ownership are just a few provisions that appear to add no value to the bankruptcy estate but certainly deter parties from actively bidding. Even more troublesome are requirements that the winning bidder retain current management, or that the winning bidder maintain the reorganized debtor as a going concern entity. These requirements, if enforceable, would certainly deter bidders and would reserve to current ownership certain exclusive rights which the Court in *LaSalle* was so keen to eliminate. In fact, if liquidation of a debtor's assets would bring the most value, these poison pill provisions, by restricting that ability, lower the amount that another party will pay to own the reorganized debtor, thereby bringing less money in for creditors.

The second problem with these provisions is very similar to the problem inherent in dead-hand poison pills in the corporate law context. Provisions requiring the winning bidder to retain current management prohibit the new owners of the company from exercising the most important power of corporate ownership, that of appointing management, essentially reserving that power for the old owners. Provisions prohibiting the winning bidder from liquidating the debtor are even more onerous, as they prohibit future owners from disposing of their own property as they deem most economical. A debtor

[3] In both *Bjolmes* and *Ropt*, the court required that the winning bidder cause the Debtor to consummate the plan of reorganization." *Ropt,* 152 B.R. at 413.

[4] The closest case on point appears to be *In re OCA, Inc.*, 357 B.R. 72, 91-92 (Bankr. E.D. La. 2006) where the debtor attempted to restrict bidding to only certain parties who had, prior to the bankruptcy, owned stock in the debtor. Although technically not current equity, the court found the scheme a violation of absolute priority and *LaSalle* as an improper limitation on the market. *Id.*

[5] There are, however, a number of trial level documents available on Westlaw where creditors have objected to these types of schemes without citing to specific case law but relying on general principles of absolute priority. *See, e.g., In re Scottsdale,* 2010 WL 2822605 (Bankr. D.Ariz.) (Trial Filing); *In re U.S. Development Land, LLC*, 2010 WL 2822595 (Bankr. D.Ariz.) (Trial Filing); *In re Elantic Telecom, Inc.*, 2005 WL 521333 (Bankr. E.D. Va.) (Trial Filing); *In re Fulton Homes Corp.*, 2009 WL 8540629 (Bankr. D. Ariz.) (Trial Filing).

may argue that this is counterbalanced by the underlying purposes of bankruptcy being to reorganize companies, maintain employment, and preserve going concern, but those purposes, while laudable, cannot be the pretext for favoring current ownership with exclusive rights unavailable to creditors and other bidders, and it would certainly be an improper enforcement of those purposes to require unwilling owners to operate a company rather than liquidate it.

While this issue is one of policy, it is also one of jurisdiction. If the winning bidder disregards the plan provisions and begins liquidation of the reorganized debtor, who would be there to stop it? Could old ownership, now divested of its interests in the debtor, have standing to seek an injunction? Could creditors under the plan petition the bankruptcy court to mandate that the debtor cease liquidation? Would the bankruptcy court even have jurisdiction or the legal power to mandate current ownership of the reorganized debtor to continue operations?

These questions raise serious issues, but they should never have to be answered. *LaSalle* makes clear that exposure to the market and open competition are the *sine qua non* for the new value exception. Any schemes or poison pills used by current management to frustrate that requirement should be rejected out of hand. Rejection of these provisions as essentially anti-market and anti-competitive eliminates the need to answer troubling questions about the extent of dead-hand control and improper leverage. Instead, the procedures for bankruptcy ownership auctions should be open, competitive, and as the court in *Bjolmes* stated, free of any undue leverage on the part of current management.

CONCLUSION

LaSalle established that reasonably equivalent value should be determined by the market, not by a bankruptcy judge. Poison pill provisions, by creating an ersatz market, are an attempt to avoid a judicial determination of equivalent contribution, and at the same time avoid a fair market determination of equivalent contribution, providing an opportunity for current management to retain ownership for even less than it would have paid pre-*LaSalle*. Creditors in chapter 11 should be careful to review plans of reorganization that rely on the new value exception for provisions that improperly benefit the debtor's current owners.

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