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## Bankruptcy—Labor Contribution by Juror Interest Satisfies Fair and Equitable Standard for Cram Down

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**BANKRUPTCY — LABOR CONTRIBUTION BY JUNIOR INTEREST SATISFIES FAIR AND EQUITABLE STANDARD FOR CRAM DOWN.** *In re Ahlers*, 794 F.2d 388 (8th Cir. 1986).

The Ahlers financed the operation of their individually owned and operated farm through loans from the Federal Land Bank (FLB) and Norwest Bank of Worthington, Minnesota (Norwest). FLB held first mortgages on various parcels of the farm land, and Norwest held second mortgages on the land and first mortgages on the machinery, equipment, crops, livestock, and other farm proceeds. The value of the underlying collateral had decreased as a result of depressed market conditions, and the loans were substantially undersecured.

Norwest sued in Minnesota state court to replevy the equipment and machinery after the Ahlers missed several loan payments. The Ahlers then filed for reorganization under Chapter 11 of the Bankruptcy Code,<sup>1</sup> which automatically stayed the state court proceedings. Norwest and FLB petitioned for relief from the stay in bankruptcy court.<sup>2</sup> In an evidentiary hearing on the creditors' motion, the bankruptcy court found that the Ahlers would have to make monthly payments of interest on the current value of the collateral to provide the banks with adequate protection.<sup>3</sup> The court determined that the Ahlers would not be able to make such payments, and accordingly lifted the stay, allowing the creditors to proceed against the Ahlers. The Ahlers then removed the replevin suit from state court to the bankruptcy court, which granted a motion by Norwest allowing for seizure of the property.<sup>4</sup>

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1. 11 U.S.C. §§ 1101-74 (1982).

2. 11 U.S.C. § 362(d)(1) (Supp. III 1985) provides in relevant part:

(d) On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay . . .

(1) for cause, including the lack of adequate protection of an interest in property of such party in interest . . . .

3. U.S.C. § 361(1) (Supp. III 1985) provides in relevant part:

When adequate protection is required under section 362 . . . of an interest of an entity in property, such adequate protection may be provided by—

(1) requiring the trustee to make periodic cash payments to such entity, to the extent that the stay under section 362 . . . results in a decrease in the value of such entity's interest in such property . . . .

4. The motion by Norwest for prejudgment seizure of the property securing the equipment loan was essentially a request to lift the stay as applied to that particular piece of equipment. To maintain the stay under 11 U.S.C. § 362(d)(2)(B) (1982) the debtor, Ahlers, had to show that

The Ahlers appealed the orders removing the stay and allowing seizure of the property to the district court. The district court affirmed both orders and found that the Chapter 11 reorganization plan proposed by the Ahlers had no reasonable prospect of success.<sup>5</sup>

The Ahlers then appealed to the Eighth Circuit Court of Appeals, which reversed and remanded with directions. One of the issues addressed by the Eighth Circuit was whether it was possible as a matter of law for the Ahlers to propose a "fair and equitable" plan in which they retained any ownership interest in the farm, or whether such retention of ownership would be a violation of the absolute priority rule.<sup>6</sup>

The court analyzed the rule of absolute priority and found that it would allow confirmation of a plan in which the Ahlers retained an ownership interest. It determined that the Ahlers' commitment to operate the farm was a contribution of labor, skill, and experience that satisfied the rule. The court held that a plan proposed by the Ahlers could be confirmed as "fair and equitable," if on remand it was found that the contribution of labor, skill, and experience was equivalent to the value of the retained ownership interest. *In re Ahlers*, 794 F.2d 388 (8th Cir. 1986).

Historically, the term "fair and equitable" was used to indicate that a plan of reorganization met the necessary standards of fairness.<sup>7</sup> The term encompassed the judicially formulated rule of absolute prior-

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the property was necessary to an effective reorganization. Some courts, including the bankruptcy court in this case, also require the debtor to show that an effective reorganization is reasonably feasible as a threshold issue. The bankruptcy court granted Norwest's motion for prejudgment seizure based on the district court's determination that the Ahlers' plan was not feasible. *In re Ahlers*, 794 F.2d 388, 399 (8th Cir. 1986).

5. The reported opinion does not contain the specifics of the Ahlers' plan. However, an appendix to the opinion contains a plan formulated by the Eighth Circuit for use as a guide to the lower courts as they consider the case on remand. The plan divides each of the undersecured debts into two claims, an allowed secured claim equal to the value of the underlying collateral and an unsecured claim for the balance of the debt. *See infra* note 78. The Ahlers' other unsecured debts are treated as unsecured claims as well. The plan then provides for holders of secured claims to retain first liens on the collateral and to receive new promissory notes in the amount of the allowed secured claim. The notes have adjusted interest rates and extended payment periods so that the net yearly payments made by the Ahlers are reduced. The plan further provides for yearly payments to be made on the unsecured claims so that they will be fully paid within 10 ½ years. *In re Ahlers*, 794 F.2d at 410.

6. The absolute priority rule requires that a plan fully satisfy claims senior in priority before junior claims or interests receive any compensation. The rule is codified in 11 U.S.C. § 1129(b)(2)(B)(ii) (Supp. III 1985). *See infra* note 74. The retention of an ownership interest by the Ahlers put them into a class of interests junior in priority to the claims of Norwest and FLB. *See infra* note 49.

7. W. NORTON, *NORTON BANKRUPTCY LAW AND PRACTICE* 63.21, at 25 (1986).

ity as one of the requisite standards to be satisfied.<sup>8</sup> The rule required a reorganization plan to fully compensate the most senior secured creditors before junior creditors received any compensation.<sup>9</sup> The United States Supreme Court formulated the rule of absolute priority as part of the statutory requirement that a reorganization plan be "fair and equitable."<sup>10</sup>

In *Louisville Trust Co. v. Louisville, N.A. & C. Ry.*,<sup>11</sup> a railroad reorganization case, the United States Supreme Court held that a mortgagee could foreclose and exclude inferior lienholders, unsecured creditors, and stockholders, but that if the foreclosure attempted to reserve any interest to the mortgagor-stockholders, the prior right of creditors must be preserved.<sup>12</sup> The Court applied this holding in *Northern Pacific Ry. v. Boyd*,<sup>13</sup> a subsequent railroad reorganization case, and first announced the rule of absolute priority.<sup>14</sup> The Court held that a creditor's right as against the stockholders' was absolute in its priority, so that the creditor's claim had to be fully satisfied before the stockholders retained any interest in the property transferred to the new company.<sup>15</sup> In dicta, the Court noted that cooperation between the

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8. *Id.* at 24-25.

9. Broude, *Cramdown and Chapter 11 of the Bankruptcy Code: The Settlement Imperative*, 39 BUS. LAW. 441, 442 (1984).

10. *Marine Harbor Properties, Inc. v. Manufacturers Trust Co.*, 317 U.S. 78 (1942) (held "fair and equitable" to be applicable in Chapter X reorganizations); *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106 (1939) (held "fair and equitable" applicable to § 77B reorganizations). The most common plan of reorganization in such cases provided for the assets of the insolvent debtor company to be acquired at the foreclosure sale by another company comprised of the secured creditors and stockholders of the debtor. The secured creditors would bid the amount owed by the debtor plus some nominal amount to provide cash to satisfy some of the unsecured creditors and prevent nuisance suits. The stockholders of the debtor would cooperate in the foreclosure proceeding allowing for a speedy transfer in return for stock issued by the acquiring company. The results of such plans were threefold. The secured creditors traded their claims against the old company for an ownership interest in the new company. The stockholders of the old company traded their worthless stock in the insolvent company for stock in the new company. And, the unsecured creditors were paid a nominal portion of their debt or were cut off entirely with no way to collect their claims. The courts found such results to be in direct conflict with the equitable principle that the stockholders' interest in the property of a corporation is subordinate to the rights of creditors. Blum & Kaplan, *The Absolute Priority Doctrine in Corporate Reorganizations*, 41 U. CHI. L. REV. 651 (1974). See also Anderson & Wright, *Liquidating Plans of Reorganizations*, 56 AM. BANKR. L.J. 29 (1982).

11. 174 U.S. 674 (1899).

12. *Id.* at 677.

13. 228 U.S. 482 (1913).

14. *Id.* at 504-05. Unlike the plan in *Louisville Trust*, which cut off all of the unsecured creditors and some of the secured creditors, the plan in *Boyd* provided for some, but not all, of the claims of the unsecured creditors to be paid. *Id.* at 488.

15. *Id.* at 504.

stockholders and secured creditors may be the only way to effectuate the reorganization when the corporate property is of such enormous value that its purchase by others is not feasible.<sup>16</sup> The Court would not allow such joint efforts, however, to operate to deprive the unsecured creditors of their rights, while leaving the stockholders an interest in the property.<sup>17</sup> Subsequent cases indicated that the holding in *Boyd* was a "fixed principle" to be rigidly adhered to in evaluating a reorganization plan.<sup>18</sup>

However, the dicta in *Boyd* about cooperation between the owners and creditors caused inconsistent application of the rule among the circuit courts of appeal. The decisions varied because it was not clear under what conditions an ownership interest could be retained.<sup>19</sup> The Supreme Court discussed the conditions under which an ownership interest could be retained in *Case v. Los Angeles Lumber Products Co.*,<sup>20</sup> and essentially created an exception to the absolute priority rule.<sup>21</sup> The exception allows for an ownership interest to be retained when the debtor makes a substantial fresh contribution in money or money's worth necessary to effectuate the reorganization plan.<sup>22</sup>

In *Case* the Court considered a corporate debtor's plan to adjust the outstanding debt by reducing creditors' claims to the value of the assets and then satisfying the adjusted claims with shares of preferred stock in the reorganized corporation.<sup>23</sup> Under the plan, the stockholders in the old corporation, who by operation of the absolute priority rule would have no rights to the assets of the old corporation, were to receive stock in the new corporation equal to twenty-three percent of the

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16. *Id.*

17. *Id.* at 505.

18. *Kansas City Terminal Ry. v. Central Union Trust Co.*, 271 U.S. 445, 454 (1926).

19. *See In re Georgian Hotel Corp.*, 82 F.2d 917 (7th Cir. 1936) (plan held valid where mortgage bondholders received income bonds and old stockholders received common stock in the new company; viewed as a change in form but not substance); *Sophian v. Congress Realty Co.*, 98 F.2d 499 (8th Cir. 1938) (plan disapproved where bondholders to receive preferred stock and stockholders to receive common stock and retain control; viewed as a scheme by inept management to retain control). Some courts circumvented the results of the rule by their treatment of the valuation of the debtor company. Note, *Absolute Priority Rule Under Chapter X — A Rule of Law or a Familiar Quotation?*, 52 COLUM. L. REV. 900 (1952). *But see In re Barclay Park Corp.*, 90 F.2d 595 (2d Cir. 1937) (plan disapproved because bondholders were to receive preferred stock and stockholders to receive common stock; viewed as preferring the stockholders at the expense of the creditors).

20. 308 U.S. 106 (1939).

21. *Id.* at 121.

22. *Id.* at 121-22. The Court used the term "money or in money's worth" without defining it. The argument for a labor contribution is based on the implicit flexibility of the term "money's worth."

23. *Id.* at 111.

assets of the new corporation.<sup>24</sup> The Supreme Court held that, as a matter of law, the plan was not "fair and equitable."<sup>25</sup> The debtor had argued that the issuance of stock to the old stockholders was necessary to insure their continued participation as managers of the reorganized corporation.<sup>26</sup> Rejecting this argument, the Court went on to explain some of the conditions under which the stockholders could participate.<sup>27</sup> The Court summarized the exception to the absolute priority rules as follows: When the debtor is insolvent and the stockholders make a fresh contribution in "money or in money's worth," they can participate in the reorganized corporation to an extent reasonably equivalent to their contribution.<sup>28</sup> The Court then found on the facts of the case that financial standing and influence in the community and continuity of management could not possibly be translated into money's worth reasonably equivalent to the participation accorded the old stockholders.<sup>29</sup>

Congress used the term "fair and equitable" as the standard for confirmation of a reorganization plan in the 1934 Act,<sup>30</sup> which added section 77B to the Bankruptcy Act of 1933.<sup>31</sup> Since the term had "acquired a fixed meaning through judicial interpretations in the field of equity receivership reorganizations,"<sup>32</sup> the Supreme Court in *Case v. Los Angeles Lumber Products Co.*<sup>33</sup> viewed its use by the legislature as an indication of legislative intent to insert that fixed meaning into section 77B.<sup>34</sup> Congress again used the term "fair and equitable" in the Chandler Act,<sup>35</sup> which repealed section 77B and substituted Chapters X, XI, and XII as the three primary means for rehabilitating business enterprises.<sup>36</sup> The Supreme Court again held that the term incorpo-

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24. *Id.* at 112.

25. *Id.* at 114.

26. *Id.* at 112.

27. *Id.* at 117.

28. *Id.* at 122.

29. *Id.*

30. Act of June 7, 1934, ch. 424, 48 Stat. 911. Section 77B was adopted to allow for the rehabilitation of industrial corporations. J. ANDERSON, CHAPTER 11 REORGANIZATIONS, § 12.26, at 12-105 (1983).

31. Act of March 3, 1933, ch. 204, 47 Stat. 1474.

32. 308 U.S. at 115.

33. 308 U.S. 106 (1939).

34. *Id.*

35. Act of June 22, 1938, ch. 575, 52 Stat. 840. "[Section] 221(2) provided that the court could only confirm a plan if it was satisfied that 'the plan is *fair and equitable*, and feasible.'" J. ANDERSON, *supra* note 30, § 12.26, at 12-107 (emphasis added).

36. Chapter X was intended to cover corporate reorganization, Chapter XI noncorporate business reorganization, though not expressly closed to corporations, and Chapter XII the individual

rated prior law, and extended the absolute priority rule to Chapter X reorganizations.<sup>37</sup>

Under the new Bankruptcy Code, which was fully revised by Congress in 1979,<sup>38</sup> the term "fair and equitable" is used as the standard for cram down<sup>39</sup>— confirmation of a reorganization plan when a class of impaired claims<sup>40</sup> does not accept the plan.<sup>41</sup> The new code codifies the absolute priority rule and its applicability when a plan is crammed down.<sup>42</sup> However, the code is silent as to the conditions under which an ownership interest may be retained when cram down is invoked.<sup>43</sup> The Supreme Court has not yet ruled on whether the new code incorporates either the existing case law of the absolute priority rule or the *Case* exception for fresh contribution. Lower courts have consistently relied on existing case law as authority when applying the absolute priority rule under the new code.<sup>44</sup> However, the lower courts are inconsistent

bankrupt. Congress later deleted the fair and equitable standard from Chapter XI and Chapter XII because it was thought to frustrate the purpose of the Act. J. ANDERSON, *supra* note 30, § 12.26, at 12-107 to -111.

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

38. 11 U.S.C. § 101 (1982 & Supp. III 1985). In 1970 Congress established a bankruptcy commission for the purpose of drafting a new bankruptcy act. Act of July 24, 1970, Pub. L. No. 91-354, 84 Stat. 468. The Commission filed reports with Congress on July 31, 1973 (Part I) and on August 6, 1973 (Part II). The new bankruptcy act was adopted in 1979.

39. "Cram down" is the colloquial term for confirmation of a plan over the dissent of an impaired class. "In many instances, the terms confirmation and cram down are used synonymously; however, this is not accurate since one of the objectives of the Code is to facilitate confirmations through negotiations and bargaining without the use of cram down provisions." J. ANDERSON, *supra* note 30, § 12.24, at 12-88. Eleven conditions must be met for a plan to be confirmed by the court. 11 U.S.C. § 1129(a) (1982 & Supp. III 1985). Paragraph 8 of 11 U.S.C. § 1129(a) (1982) requires that each class either accept the plan or not be impaired under the plan. *See infra* note 40. However, if paragraph 8 is the only one of the eleven conditions not satisfied then the plan may be confirmed under the cram down provision, 11 U.S.C. § 1129(b) (Supp. III 1985). *See infra* notes 41 and 75.

40. A class of claims is impaired when any of its legal, equitable, or contractual rights are altered under the plan. 11 U.S.C. § 1124 (Supp. III 1985).

41. 11 U.S.C. § 1129(b)(1) (1982) provides in relevant part:

(b)(1) . . . if all of the applicable requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of such paragraph if the plan does not discriminate unfairly, and is *fair and equitable*, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan. (Emphasis added).

42. 11 U.S.C. § 1129(b)(2)(B)(ii) and (C)(ii) (1982 & Supp. III 1985). *See infra* note 74.

43. *In re Marston Enters. Inc.*, 13 Bankr. 514, 517 (Bankr. E.D.N.Y. 1981).

44. "There is . . . nothing in the Code which precludes the case law which developed under Chapter X of the Bankruptcy Act . . . from application to Chapter 11 of the Bankruptcy Code." *Id.* at 518. *See also In re U.S. Truck Co.*, 47 Bankr. 932 (E.D. Mich. 1985), *aff'd*, 800 F.2d 581 (6th Cir. 1986), *cited in In re Pecht*, 57 Bankr. 137, 140 (Bankr. E.D. Va. 1986); *In re Butler*, 42 Bankr. 777, 785 (Bankr. E.D. Ark. 1984); *In re Genesee Cement, Inc.*, 31 Bankr. 442, 444 n.1

in their application of the *Case* rule when considering retained ownership interests.<sup>45</sup>

A New York bankruptcy court analyzed the conditions under which the new code would allow cram down of a plan providing for retained ownership in *In re Marston Enterprises, Inc.*<sup>46</sup> The suit involved a corporate debtor whose plan called for the old common stock to be cancelled and stock in the reorganized debtor to be purchased by the old common stockholders.<sup>47</sup> Relying on *Case*, the court held that the plan did not violate the "fair and equitable" standard because the stockholders were not retaining their ownership interest, but were purchasing their interest in the reorganized corporation.<sup>48</sup>

A Missouri bankruptcy court took the analysis a step further in *In re Landau Boat Co.*<sup>49</sup> Adopting the *Case* exception to the absolute priority rule, the court focused on defining the "substantial" element of the exception and developed criteria to determine when a proposed contribution is substantial enough to make a plan "fair and equitable."<sup>50</sup> It held the contribution to be substantial when it exceeded the value of the interest retained.<sup>51</sup> The court also ruled that the retained interest should be valued on the basis of expected income and then discounted by a business risk factor.<sup>52</sup> The court concluded that because of the business risks involved, the present investment of new value through a stock purchase by the old stockholders exceeded the retained value, and confirmed the plan.<sup>53</sup>

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(Bankr. E.D. Mich. 1983); *In re Pine Lake Village Apt. Co.*, 19 Bankr. 819, 833 (Bankr. S.D.N.Y. 1982); *In re Landau Boat Co.*, 13 Bankr. 788 (Bankr. W.D. Mo. 1981), cited in *In re East*, 57 Bankr. 14, 16 (Bankr. M.D. La. 1985).

45. For cases adopting the rule of contribution and holding a plan valid see *In re U.S. Truck Co.*, 47 Bankr. 932, 941 (E.D. Mich. 1985) (stock purchase); *In re Landau Boat Co.*, 13 Bankr. 788, 793 (Bankr. W.D. Mo. 1981) (stock purchase); *In re Marston Enters. Inc.*, 13 Bankr. 514, 518 (Bankr. E.D.N.Y. 1981) (capital contribution). But see cases adopting the rule but holding the plan invalid due to the nature of the contribution, *In re Pecht*, 57 Bankr. 137, 141 (Bankr. E.D. Va. 1986) (earnings of sole proprietor); *In re East*, 57 Bankr. 14, 19 (Bankr. M.D. La. 1985) (zero value of retained interest). See also cases not considering the rule, *In re Butler*, 42 Bankr. 777 (Bankr. E.D. Ark. 1984); *In re Genesee Cement, Inc.*, 31 Bankr. 442 (Bankr. E.D. Mich. 1983); *In re Pine Lake Village Apt. Co.*, 19 Bankr. 819 (Bankr. S.D.N.Y. 1982).

46. 13 Bankr. 514 (Bankr. E.D.N.Y. 1981).

47. *Id.* at 515-16. The Historical and Revision notes following 11 U.S.C. § 501 (1982) provide that "interest" includes the interest of . . . a proprietor in a sole proprietorship, or the interest of a common or preferred stockholder in a corporation."

48. 13 Bankr. at 518.

49. 13 Bankr. 788 (Bankr. W.D. Mo. 1981).

50. *Id.* at 792.

51. *Id.* at 793.

52. *Id.* at 792-93.

53. *Id.* at 793 (citing *Consolidated Rock Prods. Co. v. Du Bois*, 312 U.S. 510 (1941)). See

Unlike the courts in *Landau Boat* and *Marston Enterprises*, which impliedly held the *Case* exception to have been incorporated into the absolute priority rule as codified, the bankruptcy court in *In re Pine Lake Village Apartment Co.*<sup>54</sup> reached an opposite result on similar facts. It applied the absolute priority rule as codified, without considering the *Case* exception, and held a retained ownership plan unconfirmable.<sup>55</sup> The court did not expressly reject the contribution exception; rather, it failed to consider whether the proposed contribution of \$700,000 in cash by the partners of the limited partnership was sufficient to render the proposed plan in which they retained an ownership interest "fair and equitable."<sup>56</sup>

The *Marston Enterprises/Landau Boat* analysis of the *Case* exception as a mechanism to allow stockholders to buy back into the reorganized debtor is consistent with the Supreme Court's holding in *Case* and with the relevant dicta as well.<sup>57</sup> However, courts have been hesitant to extend the application of the contribution exception to a noncorporate individual or partnership.<sup>58</sup>

In *In re East*<sup>59</sup> the insolvent individual debtor attempted to "cram down" a plan in which he would retain an ownership interest. He argued that since he could not divest himself of ownership in the way that a corporation could by cancelling and then reissuing stock, he suffered a discriminatory effect based on the substantive difference between an individually held business and a corporation.<sup>60</sup> The court re-

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also *In re U.S. Truck Co.*, 47 Bankr. 932 (Bankr. E.D. Mich. 1985) which reached similar results based on the business risks assumed by the stockholders in investing.

54. 19 Bankr. 819 (Bankr. S.D.N.Y. 1982).

55. *Id.* at 834.

56. *Id.* at 823, 831, 834. The court raised the issue sua sponte and may have decided it without benefit of brief or oral argument. See also *In re Butler*, 42 Bankr. 777 (Bankr. E.D. Ark. 1984) (the court held that fair and equitable was applicable as the standard for evaluating the treatment under a reorganization plan of an individual creditor. However, by the terms of the statute "fair and equitable" is applied only to evaluate the treatment of a class of claims, not of an individual creditor; and it is applied only when cram down is invoked. 11 U.S.C. § 1129(b)(1). The statute assures the individual creditor in a reorganization plan only the treatment he would have received if the debtor had liquidated rather than reorganized. 11 U.S.C. § 1129(a)(7).) and *In re Stoffel*, 41 Bankr. 390, 392-93 (Bankr. D. Minn. 1984) (court used the plain meaning of the words fair and equitable in rejecting a plan as "simply not fair" and "simply not realistic treatment of the debt").

57. *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106, 121-22 (1939).

58. See cases cited *supra* note 45.

59. 57 Bankr. 14 (Bankr. M.D. La. 1985).

60. *Id.* at 15, 18. In more detail the debtor's argument was that: 1) Individuals cannot give up their retained ownership interest in the manner that a corporation can by cancelling and reissuing stock; 2) since individuals are unable to do this they are denied cram down in every instance that they cannot pay the unsecured creditors in full for their claims. This is anomalous because if

jected his argument and held that as a matter of law mere insolvency was insufficient to permit "cram down" where the debtor is an individual.<sup>61</sup> The court explained the options available to the individual debtor as paying all his debts and keeping all his property, giving up his property and being released from his debts, or reaching a compromise to which his creditors agreed. "[W]hat he cannot do is keep all of his property while paying only part of his debt."<sup>62</sup>

In another noncorporate case, *In re Pecht*,<sup>63</sup> the debtor argued that since the earnings he derived as an individual from the business operation were not part of his bankruptcy estate,<sup>64</sup> he would make fresh contribution by pledging to apply them to the unsecured debt.<sup>65</sup> The court refused to accept this argument, inventing the requirement that new value must be contributed up front as a condition precedent to confirmation of the plan.<sup>66</sup> The court saw this as necessary to be consistent with the "spirit" of the "cram down" provision.<sup>67</sup> Also, the court reasoned that to accept the contribution of an individual's earnings as new value would permit the individual a "much better treatment than a corporate debtor could obtain."<sup>68</sup>

In *In re Ahlers*<sup>69</sup> the Eighth Circuit Court of Appeals held that a

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the unsecured creditors were paid in full they would not be impaired and cram down would not be needed; 3) it was not the intent of Congress that individuals be denied cram down; and 4) to deny individuals cram down places them under a heavier burden than corporations and is discriminatory.

61. *Id.* at 19. In a well researched and reasoned opinion, the court addressed each part of the debtor's argument. It concluded that: 1) there is nothing in the legislative history to indicate that Congress expressly intended to make "cram down" available to individuals; 2) there is nothing to indicate that Congress intended for individuals to have a lighter burden than corporations; and 3) "cram down" is not completely denied to individuals because they can purchase their retained interests. The court cited *In re Marston Enters.*, 13 Bankr. 514 (Bankr. E.D.N.Y. 1981), as authority for this last point. *Id.* at 18-19.

62. 57 Bankr. at 19. Another argument presented to the court was that when a debtor is insolvent, the value of the retained ownership interest is zero, and therefore it is not unfair or inequitable for the debtor to retain it. The court rejected the argument as "semantics without substance." *Id.* at 17. Another bankruptcy court in *In re Genesee Cement, Inc.*, 31 Bankr. 442 (Bankr. E.D. Mich. 1983), rejected this argument for reasons of equity and public policy.

63. 57 Bankr. 137 (Bankr. E.D. Va. 1986).

64. 11 U.S.C. § 541(a)(6) (Supp. III 1985). A similar earnings argument was presented in *In re Fitzsimmons*, 725 F.2d 1208 (9th Cir. 1984) (The court held the exemption to extend only to those earnings personally generated by the debtor, so that earnings attributable to invested capital, accounts receivable, good will, etc. accrued to the estate.), *cited in In re Brusseau*, 57 Bankr. 457 (Bankr. D.N.D. 1985).

65. *In re Pecht*, 57 Bankr. at 139.

66. *Id.* at 140.

67. *Id.*

68. *Id.* at 141.

69. 794 F.2d 388 (8th Cir. 1986).

farmer's contribution of labor, expertise, and skill satisfied the fresh contribution exception to the absolute priority rule.<sup>70</sup> The Eighth Circuit, the highest court to have addressed the issue, held that as a matter of law the plan would be "fair and equitable" if on remand the bankruptcy court found the value of the labor contribution to exceed the value of the retained ownership interest.<sup>71</sup> The court relied on the case law of the "fair and equitable" standard under previous bankruptcy statutes and impliedly held the *Case* exception of contribution to have been incorporated into the absolute priority rule as codified.<sup>72</sup>

Judge Heaney, writing for the court, noted the conditions necessary to confirm a plan over the dissent of an impaired class of claims.<sup>73</sup> The court determined that under the "cram down" provisions of the Bankruptcy Code<sup>74</sup> the court shall confirm a plan over the objection of

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70. *Id.* at 392.

71. *Id.* at 403.

72. *Id.* at 402.

73. *Id.* at 399-400. The "cram down" provision of the Bankruptcy Code, 11 U.S.C. § 1129(b)(2) (1982 & Supp. III 1985) sets forth three separate sets of requirements, one of which must be met for a plan to be considered "fair and equitable." See *infra* note 74. The particular set of requirements the court will apply depends upon the type of claim held by the dissenting class. The "rule of absolute priority" has been codified and made applicable when the objecting class holds unsecured claims or is a class of interests. See *infra* note 74, §§ 1129(b)(2)(B) & 1129(b)(2)(C). This differs significantly from the applicability of the rule under prior bankruptcy statutes. Formerly, the "fair and equitable" standard was the ultimate test applied by the court when individual creditors objected to the confirmation of a plan. Under the new bankruptcy act "fair and equitable" is applied only for "cram down" over a dissenting class of claims and only to the treatment of classes junior in priority to the dissenting class. "Therefore, . . . senior accepting classes are permitted to give up value to junior classes as long as no dissenting intervening class received less than the amount of its claims in full." J. ANDERSON, *supra* note 30 at § 12-98. Also, it is the treatment of the class of claims and not of the individual creditors to which the absolute priority rule applies.

74. 11 U.S.C. § 1129(b)(2) (1982 & Supp. III 1985) provides:

(2) For the purpose of this subsection, the condition that a plan be *fair and equitable* with respect to a class includes the following requirements:

(A) With respect to a *class of secured claims*, the plan provides—

- (i)(I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; *and*
- (II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property;
- (ii) for the sale, subject to section 363(k) of this title, of any property that is subject to the lien securing such claims, free and clear of such lien, with such lien to attach to the proceeds of such sale, and the treatment of such lien on proceeds under clause (i) or (iii) of

an impaired class when 1) requested by the proponent of the plan, 2) the plan does not discriminate unfairly, and 3) the plan is "fair and equitable" with respect to each class of creditors that has not accepted the plan.<sup>75</sup>

The court then concentrated on the conditions that would render the Ahlers' plan "fair and equitable." The court noted that under the "cram down" provisions the applicable standard defining "fair and equitable" depends on the type of claim held by the dissenting class.<sup>76</sup> Under the proposed plan Norwest and FLB, as secured creditors with undersecured claims, would be placed into two classes of claims.<sup>77</sup> They held secured allowed claims<sup>78</sup> measured by the value of the collateral at the effective date of the plan and unsecured claims for the difference between value of the collateral and amount of the debt.<sup>79</sup> Therefore, the Ahlers' plan had to meet two standards of "fair and equitable" to be crammed down.<sup>80</sup>

Considering the class of secured claims, the court found that the

this subparagraph; *or*

(iii) for the realization by such holders of the indubitable equivalent of such claims.

(B) With respect to a *class of unsecured claims*—

(i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; *or*

(ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property.

(C) With respect to a *class of interests*—

(i) the plan provides that each holder of an interest of such class receive or retain on account of such interest property of a value, as of the effective date of the plan, equal to the greatest of the allowed amount of any fixed liquidation preference to which such holder is entitled, any fixed redemption price to which such holder is entitled, or the value of such interest; *or*

(ii) the holder of any interest that is junior to the interests of such class will not receive or retain under the plan on account of such junior interest any property. (Emphasis added.)

75. In re Ahlers, 794 F.2d at 400-01.

76. See *supra* notes 73 and 74.

77. See *supra* note 5.

78. 11 U.S.C. § 506(a) (1982) provides in part:

(a) An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title, is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, . . . and is an unsecured claim to the extent that the value of such creditor's interest . . . is less than the amount of such allowed claim.

79. In re Ahlers, 794 F.2d at 399.

80. *Id.* at 400-01.

plan could be crammed down if 1) the plan proposed that the secured creditors retain a lien in the collateral securing their allowed secured claims, and 2) that they receive deferred cash payments having a present value equal to the value of the collateral securing their claims.<sup>81</sup>

With regard to the class of unsecured claims, the court found that the plan could be crammed down if it satisfied one of two alternate tests set out in the statute.<sup>82</sup> The first test required that the plan provide for the class of unsecured claims to receive property of a value equal to the amount of their claim.<sup>83</sup> The court agreed with the creditors' contention that the Ahlers could not propose any realistic reorganization plan that would satisfy such a test.<sup>84</sup> The court did not agree with the creditors' argument that such inability also prevented the Ahlers from meeting the second test.<sup>85</sup> The alternate test allowed "cram down" of a plan that provided for any treatment of the class of unsecured claims so long as no junior class retained an interest in the debtor's property<sup>86</sup> "on account of such junior claim or interest . . . ."<sup>87</sup> The creditors argued that the Ahlers' plan did not satisfy the second test because they would retain their ownership interest, which was junior to the unsecured claims, without providing for the unsecured creditors in full.<sup>88</sup> The court did not agree with this argument, finding that the statutory test applied a modified version of the absolute priority rule, which incorporated the *Case* exception<sup>89</sup> rather than the traditional formulation advanced by the creditors.

The court reviewed the United States Supreme Court holdings in *Case v. Los Angeles Lumber Products Co.*<sup>90</sup> and *Kansas City Terminal Railway Co. v. Central Union Trust Co.*<sup>91</sup> and interpreted them as establishing an exception to the absolute priority rule. The exception allowed a junior ownership interest to participate in the reorganization plan when it makes a fresh contribution equal to the value of its retained interest.<sup>92</sup> This contribution exception would allow the participation even though dissenting senior creditors might receive less than

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81. *Id.* at 400.

82. *Id.* at 400-01.

83. *Id.*

84. *Id.* at 401.

85. *Id.*

86. *Id.*

87. 11 U.S.C. § 1129(b)(2)(B)(ii)(1982).

88. *In re Ahlers*, 794 F.2d at 401.

89. *Id.* at 401-02.

90. 308 U.S. 106 (1939).

91. 271 U.S. 445 (1926).

92. *In re Ahlers*, 794 F.2d at 401-02.

their allowed claims.<sup>93</sup> Concluding that a contribution satisfies the absolute priority rule as codified when it is "something that is *reasonably compensatory* and is measurable,"<sup>94</sup> the Eighth Circuit found persuasive a statement in *Case*<sup>95</sup> that when funds are "essential to the success of the undertaking," and "the old stockholders make a fresh contribution and receive in return a participation *reasonably equivalent* to their contribution, no objection can be made."<sup>96</sup> The court also considered the Supreme Court's purpose behind its statement in *Case* that "the stockholder's participation must be based on a contribution in money or in money's worth, *reasonably equivalent*, in view of all the circumstances to the participation of the stockholder."<sup>97</sup>

Having framed the above rule, the court next considered whether the Ahlers' proposed contribution of labor, skill, and expertise in continuing to operate the farm was "reasonably compensatory and . . . measurable."<sup>98</sup> In deciding that the labor contribution was measurable in "money or in money's worth," the court reasoned that since the farm operation and management skills were of value, but would not be recovered by the creditors if the farm were liquidated, allowing the Ahlers to claim them as contribution was not unfair to the creditors.<sup>99</sup>

The court found that the question of whether the proposed labor contribution was reasonably compensatory required further analysis.<sup>100</sup> Since the issue was whether the new contribution was reasonably equivalent to the retained ownership interest, the problem was one of valuation. The court did not formulate a mathematical test to be applied; rather, it adopted the rule of *In re Landau Boat Co.*<sup>101</sup> that the value of the retained interest should be based on the expectation of income or future earning capacity of the reorganized debtor, discounted by a business risk factor.<sup>102</sup>

The court applied this rule to the facts in *Ahlers* and concluded that "the Ahlers would not realize any real profit or benefit from their retained equitable ownership interest until the reorganization plan was

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93. *Id.* at 401.

94. *Id.* at 402 (emphasis added).

95. 308 U.S. 106 (1939).

96. *In re Ahlers*, 794 F.2d 388, 401 (quoting *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106, 121 (1939)) (emphasis added).

97. 794 F.2d at 401 (quoting *Case*, 308 U.S. at 122) (emphasis added).

98. 794 F.2d at 402.

99. *Id.*

100. *Id.*

101. 13 Bankr. 788 (Bankr. W.D. Mo. 1981).

102. *In re Ahlers*, 794 F.2d at 402-03.

completed and the secured creditors had been paid the full amount of their allowed secured claims."<sup>103</sup> The court held that the Ahlers' contribution of labor, skill, and expertise would satisfy the exception to the rule of absolute priority, if the value of this contribution equaled or exceeded the value of the retained ownership interest.<sup>104</sup> The court remanded the case to the bankruptcy court for a determination of whether the proposed labor contribution was reasonably compensatory.<sup>105</sup>

Judge Gibson, dissenting,<sup>106</sup> argued that the exception was more narrowly drawn than the majority represented; that is, it was limited to the contribution of fresh capital essential to the success of the plan.<sup>107</sup> He reasoned that the majority's reliance on the dictum "money or in money's worth" was unsound because the analogy between contributions of labor and capital was illogical. Gibson noted that labor is not a liquid asset and that the value of labor is not fixed, but subject to speculation that injects uncertainty into the valuation process. The dissenting judge also argued that a contribution of capital is made before plan approval, and that a contribution of labor would be unenforceable and therefore not of sufficient certainty to be found feasible. Finally, Judge Gibson concluded that the majority had gone beyond its proper role as a court of review by making a policy decision and formulating law to implement it.<sup>108</sup>

The dissent in *Ahlers* charges and the majority concedes that its decision is one based on policy.<sup>109</sup> The majority realizes that to hold labor contribution ineffective as an offset to the absolute priority rule would deny the individual farmer an opportunity to reorganize.<sup>110</sup> However, in making this policy decision the court has not necessarily moved beyond its duty to interpret the law.

The *Ahlers* decision is clearly one of policy. The Eighth Circuit has taken the lead in deciding an issue on which the applicable statute and its legislative history are silent. By its holding in *Ahlers*, the Eighth Circuit has incorporated the *Case* rule of contribution into the statutory "cram down" provision. It has also defined contribution as including a commitment to operate and labor upon a farm. Since the

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103. *Id.* at 403.

104. *Id.*

105. *Id.*

106. *Id.* at 404 (Gibson, J., dissenting).

107. *Id.* at 406.

108. *Id.* at 408.

109. *Id.*

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

determination that a debtor's contribution of labor renders a plan "fair and equitable" may turn on the specific facts of a case, it is appropriate that the definition of contribution be judicially determined rather than legislatively codified.<sup>111</sup>

The points raised by the dissent merit consideration by the court in its duty to apply the law, but there is no precedent that would render them dispositive. The valuation process is not one of rigorous mathematical precision.<sup>112</sup> Further, a going concern has many intangible, nonliquid assets that bear directly upon the success or failure of the concern, including good will and the skill and expertise of its personnel.

The dissent's point that a commitment of labor could not be enforced is a statement that goes to the issue of servitude and policy concerning enforcement of labor contracts. Because of these issues the point deserves full judicial consideration. However, the court has within its power the means to compel a person to do what he says he will do.

The dissent's concern that a contribution of labor is made after plan approval is similar to the concern of the court in *In re Pecht*.<sup>113</sup> The court in *Pecht* based its conclusion on the "spirit" of the "cram down" provision.<sup>114</sup> However, the Bankruptcy Act has embraced the concept of "present value" as the basis for adjusting the terms and conditions of debt payment.<sup>115</sup> Debt payment over time cannot be in-

111. Secured creditors with undersecured claims are the parties most prejudiced by the *Ahlers* holding. The adverse impact can be reduced in some circumstances by making an election under 1111(b) and maintaining a claim for the full amount of their secured debt. In a "cram down" situation the dissenting creditor who so elects will receive a lien on the collateral to the full amount of the secured debt, whereas the nonelecting creditor will receive a lien only to the amount of the allowed claim, which has been reduced to the value of the underlying collateral. The election is particularly attractive when the value of the underlying collateral is depressed but expected to recover. 11 U.S.C. § 1111(b) (1982) provides:

(b)(1)(A) A claim secured by a lien on property of the estate shall be allowed or disallowed under section 502 of this title the same as if the holder of such claim had recourse against the debtor on account of such claim . . . unless —

(i) the class of which such claim is a part elects . . . application of paragraph (2) of this subsection . . . .

(2) If such an election is made, then . . . such claim is a secured claim to the extent that such claim is allowed.

See Historical and Revision Notes following 11 U.S.C. § 1129 (1982) at 145-46 for a discussion of the operation of 1111(b).

112. See Note, *supra* note 19, at 904.

113. 57 Bankr. 137 (Bankr. E.D. Va. 1986).

114. *Id.* at 140.

115. 11 U.S.C. § 1129(a)(9)(B)(i)(1982) provides in relevant part: "deferred cash payments of a value, as of the effective date of the plan, equal to the allowed amount of such claim . . . ." 11 U.S.C. § 1129(a)(9)(C)(Supp. III 1985) provides in relevant part: "deferred cash payments . . . of a value, as of the effective date of the plan, equal to the allowed amount of such claim." (Emphasis added.) See J. TROST, G. TREISTER, L. FORMAN, K. KLEE & R. LEVIN, RESOURCE

consistent with this concept, which is used throughout the statute.

The holding of *Ahlers* may be applicable to all noncorporate business reorganizations. However, a court may, if it chooses, limit the holding to the case of an individually owned and operated farm. Such limitation may be justified because of the strong policy considerations that influenced the decision.

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