In Re Ahlers: The Farm Reorganization Exemption to the Absolute Priority Rule

by

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IN RE AHLERS: THE FARM REORGANIZATION EXCEPTION TO THE ABSOLUTE PRIORITY RULE

Prior to In re Ahlers, *the absolute priority rule was a formidable obstacle to insolvent farmers attempting to reorganize under Chapter 11 of the Bankruptcy Code over the objections of a class of unsecured creditors. In order for the debtor to meet the requirements of the absolute priority rule, he had to provide for the dissenting creditors in full before he could receive or retain any part of the reorganized farm. However, the Eighth Circuit Court of Appeals created a new exception to the absolute priority rule for farm reorganizations in* In re Ahlers. *The exception is based on the amount that a farmer's labor and management skills will contribute to the value of the reorganized entity. This note identifies the requirements of confirmation in a Chapter 11, explores the history of the absolute priority rule, reviews the exceptions to this rule created by prior litigation and examines the impact of the Ahlers decision on the confirmation of Chapter 11 farm reorganization plans over the objection of a class of unsecured creditors.*

I. INTRODUCTION

The Eighth Circuit Court of Appeals' recent decision in *In Re Ahlers*[1] will have a dramatic effect upon the confirmation of a farm debtor's Chapter 11 reorganization plan. In a Chapter 11, the acceptance of all the classes of creditors is the easiest way to obtain a confirmation of the plan.[2] However, if a class or classes of creditors will not accept the plan, this will not defeat confirmation of the plan as long as at least one impaired class of creditors accept the plan.[3] If this requirement is met, the debtor can use an alternative method of confirmation under section 1129(b) of the Bankruptcy Code. This alternative method is known as a cramdown. The term "cramdown" stems from the concept of cramming the plan down the throat of the dissenting creditors.[4] Allowing this alternative method of confirmation prevents a plan that is fair and feasible for the majority of the creditors and the debtor from being defeated by a small class of stubborn creditors.[5] Thus, if a class of unsecured creditors who are not being paid the full value of their claims against the debtor under the proposed reorganization plan reject the plan, the debtor can still force these creditors to accept the plan by invoking the cramdown power.

However, the cramdown power is not unlimited. Prior to *Ahlers*, the court could not confirm the plan over the objection of an entire class of im-

1. 794 F.2d 388 (8th Cir. 1986).

2. Bankruptcy Reform Act of 1978, 11 U.S.C. § 1129(a)(7)(A)(1986). Congress enacted the Bankruptcy Code into positive law by Pub. L. No. 95-598, November 6, 1978, 92 Stat. 2549. The new Title took effect October 1, 1979, and replaced the existing Title 11, Bankruptcy. Title 11 will appear in this paper as amended in 1984 by Pub. L. No. 98-353, 98 Stat. 333 (1984).

3. 11 U.S.C. § 1129(a)(10)(1984).

4. *Williams,* BANKRUPTCY PRACTICE LAW 11:54 (1986).

5. *Id.*

paired unsecured creditors in a cramdown situation unless the requirements of the absolute priority rule were met. The absolute priority rule states that a class of dissenting unsecured creditors must be provided for in full before any junior class may receive or retain any property under the plan.[6]

The court in *Ahlers*, however, created a new exception to the absolute priority rule. The court held that a junior class that contributes something reasonably compensatory and measurable to the reorganization enterprise may receive or retain property under the plan, notwithstanding the fact that a dissenting class of unsecured creditors is not provided for in full.[7] Thus, in a situation similar to the one in *Ahlers*, where the debtor retains an equitable ownership interest in the reorganized property without providing for the unsecured creditors in full, the plan may be confirmed.

The court then recognized that a farmer's labor, experience and expertise in farm management may constitute contributions towards the funding of a reorganization plan.[8] In addition, it was held that the value of such contributions may be calculated in money's worth.[9] Because the value of the Ahlers' farm operation and management skills would disappear if their farm was liquidated, the court reasoned fairness was not violated if their chapter 11 plan left that value in their hands.[10]

This holding is clearly an exception to the applicability of the absolute priority rule. It is now possible, in some instances, for a farm debtor to keep his property and use his contributions of labor and management to confirm a reorganization plan over the objections of his unsecured creditors, despite the fact that these creditors are not paid in full under the plan. The crucial issue raised by this holding will center around the problem of valuation, forcing courts to determine whether the value of the farmer's contributions of labor, experience and expertise in farm management can be translated into money's worth reasonably equivalent to the participation accorded the farm debtor.[11]

While the *Ahlers* court addressed both the issues of adequate protection and the absolute priority rule, this casenote is restricted to the court's modification of the absolute priority rule. The first part of this article will be devoted to a brief overview of the section 1129 confirmation requirements and a history of the cramdown power. This article will then discuss the *Ahlers* case, with emphasis placed on the valuation problems that arise in a cramdown situation involving unsecured creditors.

II. SECTION 1129

A. *Requirements*

Section 1129 of the Bankruptcy Code states the requirements for confirm-

6. *See infra* note 36 and accompanying text.
7. *Ahlers*, 794 F.2d at 403.
8. *Id.* at 403-04.
9. *Id.* at 403.
10. *Id.* at 404.
11. *Id.*

ing a chapter 11 reorganization plan. Before beginning a discussion concerning the debtor's cramdown power and the absolute priority rule, it is important to understand that the great majority of chapter 11 plans are confirmed without ever reaching the stage of a cramdown confrontation. In most cases, the debtor and his creditors will have negotiated a settlement agreement whereby all classes of the creditors have voluntarily accepted the debtor's proposed plan.[12] If all classes of claims and interests accept the plan, the plan needs only to meet the general standards of confirmation under section 1129(a).[13]

There are eleven subdivisions of section 1129(a) which must be met to obtain confirmation of a reorganization plan without a cramdown.[14] First,

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12. Broude, *Cramdown and Chapter 11 of the Bankruptcy Code: Settlement Imperative*, 39 BUS. LAW. 441 (1984); Klee, *All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code*, 53 AM. BANKR. L.J. 133, 1363 (1979).

13. Klee, *supra* note 12, at 136.

14. 11 U.S.C. § 1129(a) states as follows:

(a) the court shall confirm a plan only if all of the following requirements are met:

(1) The plan complies with the applicable provisions of this title.

(2) The proponent of the plan complies with the applicable provisions of this title.

(3) The plan has been proposed in good faith and not by any means forbidden by law.

(4) Any payment made or to be made by the proponent, by the debtor, or by a person issuing securities or acquiring property under the plan, for services or for costs and expenses in or in connection with the case, or in connection with the plan and incident to the case, has been approved by, or is subject to the approval of, the court as reasonable.

(5)(A)(i) The proponent of the plan has disclosed the identity and affiliations of any individual proposed to serve, after confirmation of the plan, as a director, officer, or voting trustee of the debtor, an affiliate of the debtor participating in a joint plan with the debtor, or a successor to the debtor under the plan; and

(ii) the appointment to, or continuance in, such office of such individual, is consistent with the interests of creditors and equity security holders and with public policy; and

(B) the proponent of the plan has disclosed the identity of any insider that will be employed or retained by the reorganized debtor, and the nature of any compensation for such insider.

(6) Any governmental regulatory commission with jurisdiction, after confirmation of the plan, over the rates of the debtor has approved any rate change provided for in the plan, or such rate change is expressly conditioned on such approval.

(7) With respect to each impaired class of claims or interests—

(A) each holder of a claim or interest of such class—

(i) has accepted the plan; or

(ii) will receive or retain under the plan on account of such claim or interest property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under Chapter 7 of this title on such date; or

(B) if section 1111(b)(2) of this title applies to the claims of such class, each holder of a claim of such class will receive or retain under the plan on account of such claim property of a value, as of the effective date of the plan, that is not less than the value of such holder's interest in the estate's interest in the property that secures such claims.

(8) With respect to each class of claims or interests—

(A) such class has accepted the plan; or

(B) such class is not impaired under the plan.

(9) Except to the extent that the holder of a particular claim has agreed to a different treatment of such claim, the plan provides that—

(A) with respect to a claim of a kind specified in section 507(a)(1) or 507(a)(2) of this title, on the effective date of the plan, the holder of such claim will receive on account of such claim cash equal to the allowed amount of such claim.

both the proposed plan[15] and the debtor[16] are required to comply with the applicable provisions of chapter 11. The plan must be proposed in good faith, and it must not be illegal in any manner.[17] Certain payments which are to be made under the plan must be disclosed to the court and approved as reasonable.[18] The debtor must disclose the identity of any individual whom he proposes to have serve as a director, officer or voting trustee in the plan, or who is an affiliate of the debtor participating in a joint plan with the debtor.[19] The debtor must also disclose any successor to the debtor under the plan.[20] The identity and compensation of any insider whom the debtor proposes to employ under the plan must also be disclosed.[21] Additionally, if the plan provides for a proposed interest rate change, such change must be approved or conditioned on approval by any regulatory commission with jurisdiction over the rates.[22]

In addition to these technical requirements, certain priority claims, such as administrative expenses,[23] fringe benefits,[24] wage claims,[25] and claims of consumer creditors[26] must receive special treatment unless the claimholder agrees otherwise.[27] These priority claims must generally be paid in cash on the effective date of the plan.[28] Priority tax claims[29] must receive deferred payments over a period of not more than six years from the tax assessment.[30]

Furthermore, in order for the court to confirm a debtor's plan, each class

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(B) with respect to a class of claims of a kind specified in section 507(a)(3), 507(a)(4), or 507(a)(5) of this title, each holder of a claim of such class will receive—

(i) if such class has accepted the plan, deferred cash payments of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or

(ii) if such class has not accepted the plan, cash on the effective date of the plan equal to the allowed amount of such claim; and

(C) with respect to a claim of a kind specified in section 507(a)(6) of this title, the holder of such claim will receive on account of such claim deferred cash payments, over a period not exceeding six years after the date of the assessment of such claim, of a value, as of the effective date of the plan, equal to the allowed amount of such claim.

(10) If a class of claims is impaired under the plan, at least one class of claims that is impaired under the plan has accepted the plan, determined without including any acceptance of the plan by any insider.

(11) Confirmation 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, unless such liquidation or reorganization is proposed in the plan.

15. 11 U.S.C. § 1129(a)(1).
16. 11 U.S.C. § 1129(a)(2).
17. 11 U.S.C. § 1129(a)(3).
18. 11 U.S.C. § 1129(a)(4).
19. 11 U.S.C. § 1129(a)(5)(A)(i).
20. If the court appoints any of these disclosed parties to serve under the reorganization, their appointment must be consistent with public policy. 11 U.S.C. s 1129(a)(5)(A)(ii).
21. 11 U.S.C. § 1129(a)(5)(B).
22. 11 U.S.C. § 1129(a)(6).
23. 11 U.S.C. § 507(a)(1).
24. 11 U.S.C. § 507(a)(4).
25. 11 U.S.C. § 507(a)(3).
26. 11 U.S.C. § 507(a)(5).
27. 11 U.S.C. § 1129(a)(9)(B)(ii).
28. *Id.*
29. 11 U.S.C. § 507(a)(7).
30. 11 U.S.C. § 1129(a)(9)(C).

of claims must either accept the plan or be unimpaired by the plan.[31] When the majority of the creditors in a class voluntarily agree to the plan, but there is still a creditor who objects, then the plan may be confirmed over the creditor's objections as long as he receives at least as much under the plan as he would receive in a Chapter 7 liquidation of the debtor.[32] At the very least, one class of creditors must either consent to the plan, or be unimpaired by the plan in order for the plan to be confirmed.[33] Finally, the plan must be feasible.[34]

Many times, the creditors will voluntarily agree to the plan submitted by the debtor. In these instances, as long as all the requirements set forth in section 1129(a) are met the plan will be confirmed. It is only when an entire class of creditors refuses to accept the plan that the alternate method of confirmation by invoking the cramdown power may be used.

Section 1129(b) of the Bankruptcy Code states the requirements for confirming a Chapter 11 plan by invoking the cramdown power. This section provides that if the debtor who proposed the plan asks the court to confirm the plan over the objection of a class of impaired interests, the court must do so if the plan does not discriminate unfairly[35] and is fair and equitable with respect to that class.[36] This requirement is also known as the absolute priority rule.[37]

A farm debtor will be more likely than other businessmen to use the cramdown power in order to obtain a confirmation of their reorganization plan.[38] This is because a farmer normally keeps his trade debt current, and does not have many unsecured creditors. Thus, the farmer's largest unsecured creditor is often also his largest secured creditor, usually either a bank, PCA, or, as in the Ahlers' case, the Federal Land Bank. Therefore, the only way the

31. 11 U.S.C. § 1129(a)(8).
32. 11 U.S.C. § 1129(a)(7)(A).
33. 11 U.S.C. § 1129(a)(10).
34. 11 U.S.C. § 1129(a)(11).
35. Nothing in the Code aids the determination of whether a plan "does not discriminate unfairly" with respect to a dissenting class. The legislative history states that the requirement "is included for clarity" and applies in the context of subordinated debentures. Klee, *supra* note 12, at 141.
36. 11 U.S.C. § 1129(b)(2)(B)(ii). This section sets out the requirements of fairness and equity where unsecured creditors are concerned in the absolute priority rule:

> (b)(1) Notwithstanding section 510(a) of this title, 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 the 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.
>
> (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:
>
> (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.

37. *Id.*
38. *The Question of the Remedies Available to Debtors and Creditors Under Bankruptcy, How They Relate to the Great Plight of the American Farm and the Farm Family: Hearings Before the Senate Committee on the Judiciary*, 99th Cong., 1st Sess. 511 (1986)(Testimony of R. Fred Dumbaugh, bankruptcy attorney from Cedar Rapids, Iowa).

farm debtor can get a confirmation over a creditor's objection is through the use of the cramdown power.[39]

B. *The Absolute Priority Rule*

Prior to *Ahlers*, the absolute priority rule simply stated that a dissenting class of unsecured creditors must be provided for in full before any junior class can receive or retain any property under the plan.[40] The meaning of this section has been held to be absolute on its face in that the equity security holder can not receive or retain any property on account of its interest under the plan of reorganization if the impaired class of unsecured creditors does not accept the plan.[41]

The courts have enforced the traditional interpretation of the absolute priority rule by holding that in order for the court to confirm a plan over the dissent of the impaired, unsecured creditors, the unsecured creditors must be paid in full. If these creditors are paid less than in full, then no class junior may receive anything under the plan.[42]

However, when the background of the absolute priority rule is examined in detail, it becomes clear that the absolute priority rule was applicable only to corporate reorganizations under Chapter X of the Old Bankruptcy Act.[43] The absolute priority rule was not to be applied to Chapter XI, XII or XIII arrangements which could be proposed by either individuals, partnerships or closely held corporations.[44]

1. *Legislative History*

In 1952, Congress specifically amended section 366 of the Bankruptcy Act to eliminate the absolute priority rule under a Chapter XI reorganization plan which could be filed by individuals, small family-owned businesses or closely held corporations seeking to reorganize.[45] In expressing the legislative intent behind eliminating the absolute priority rule as a confirmation standard, the sponsors in the House of Representatives stated that the absolute priority rule cannot be realistically applied to the individual debtor in situations where ownership is substantially identical with management.[46] Where it would be so

39. *Id.*

40. 11 U.S.C. § 1129(b)(2)(B)(ii).

41. *In re* Genessee Cement, Inc., 31 Bankr. 442, 443 (Bankr. E.D. Mich. 1983).

42. *See In re* Landau Boat Co., 8 Bankr. 436 (W.D. Mo. 1981); *In re* Tomlin, 22 Bankr. 876, 877 (Bankr. M.D. Ala. 1982); *In re* Knutson, 40 Bankr. 142 (Bankr. W.D. Wis. 1984); *In re* Pecht, 53 Bankr. 768 (Bankr. E.D. Vir. 1985); *In re* Huckabee Auto Company, 33 Bankr. 132 (Bankr. M.D. La. 1985); *In re* East, 57 Bankr. 14 (Bankr. M.D. La. 1985).

43. Coogan, *Confirmation of a Plan Under the Bankruptcy Code*, 32 CASE W. RES. L. REV. 301, 310-15, 320, 352-57 (1982). *See also* Broude, *supra* note 12, at 441-42; *In re* Marston Enterprises, Inc., 13 Bankr. 514, 517-518 (Bankr. E.D.N.Y. 1981); Brief for the States of Arkansas, Iowa, Minnesota, Missouri, Nebraska, North Dakota and South Dakota In Opposition to the Petition For Rehearing En Banc at 21, *In re* Ahlers, 794 F.2d 388 (8th Cir. 1986).

44. For a very detailed history of the predecessors of Chapter 11 *see* Coogan, *supra* note 40, at 309-20.

45. *See* Pub. L. No. 82-456, 66 Stat. 579 (1952).

46. H.R. REP. NO. 2320, 82d Cong., 2d Sess. 2, *reprinted in* 1952 U.S. CONG. & AD. NEWS 1981-82.

applied, the only way such a debtor could effectuate a reorganization plan would be to pay in full the claims of all creditors.[47] The amendment to eliminate the absolute priority rule's fair and equitable requirement was clearly designed to avoid this unjust result.[48]

The Bankruptcy Reform Act of 1978 created Chapter 11. Chapter 11 was derived in part from Chapter XI and in part from Chapter X.[49] Chapter X was strictly for large public corporate reorganizations, while individuals and small businesses could apply for reorganization under Chapter XI.[50]

Under Chapter XI a cramdown power was unnecessary since the plan was not required to be approved by the creditors.[51] In the individual debtor's situation a liquidation analysis was simply applied: if the creditors received as much under the plan as they would have received under the debtor's liquidation, the plan could be confirmed.[52]

In contrast to Chapter XI, it was a requirement that the plan be approved by the creditors before it could be confirmed under a Chapter X corporate reorganization.[53] Where unsecured creditors objected to the plan, the "fair and equitable" requirement prevented any junior interests from retaining any interest in the reorganized corporation unless their senior creditors were paid in full.[54] Thus, a valuation hearing had to be held to determine if the debtors could retain any interests in the reorganized corporation based on their contributions to the going concern value of the business.[55] Valuation hearings were often complex, time-consuming and expensive, and their final result was often little more than an estimate.[56] Yet it was this final value that was determinative of whether the values contributed by junior shareholder interests enabled them to participate in the reorganized corporation.[57] Large corporations avoided the valuation risks involved in dealing with the absolute priority rule by filing under Chapter XI as a closely-held corporation.[58] This abusive avoidance of the absolute priority rule was the motivating factor behind the consolidation of reorganizations into one single chapter.[59]

Under the current Chapter 11, the absolute priority rule applies to a debtor seeking to reorganize over the objections of a class of unsecured creditors. The Bankruptcy Code insures fairness and equitability by requiring that "the holder of any claim or interest that is junior to the claims of such class

47. *Id.*
48. *Id.*
49. Coogan, *supra* note 43, at 302, 309.
50. *Id.* at 316-17.
51. King, *Chapter 11 of the 1978 Bankruptcy Code*, 53 AM. BANKR. L. J. 107, 108 (1979) (best interests test).
52. Coogan, *supra* note 43, at 316-17.
53. King, *supra* note 51, at 108.
54. Coogan, *supra* note 43, at 312.
55. *Id.* at 313.
56. King, *supra* note 51, at 109.
57. *Id.*
58. Coogan, *supra* note 43, at 318-19.
59. *Id.* at 319. *See generally* Booth, *Cramdown on Secured Creditors: An Impetus Toward Settlement*, 60 AM. BANKR. L.J. 69, 77-80 (1986).

will not receive or retain under the plan on account of such junior claims any property.[60] Thus, when a farmer attempts to obtain a confirmation over the objection of the class of unsecured creditors, a strict interpretation of the absolute priority rule will clearly defeat confirmation by requiring that the farmer pay off the dissenting unsecured creditors in full before being allowed to retain any property interest in the reorganized farm.

2. *Case Law*

The Supreme Court's first recognition of the principles which led to the arrival of the absolute priority rule was in *Northern Pacific Railway Co. v. Boyd*.[61] However, the "fixed principle"[62] in *Boyd* was foreshadowed in two earlier Supreme Court cases, *Chicago, Rock Island & Pacific Co. v. Howard*,[63] and *Louisville Trust Co. v. Louisville, New Albany & Chicago Ry Co.*[64] In these three cases, the Court essentially held that, in the absence of an agreement between the classes of creditors, all secured creditors had to be paid in full before junior secured creditors could be paid, junior secured creditors before unsecured creditors and unsecured creditors before shareholders.[65]

Before *Ahlers*, the courts developed exceptions to the absolute priority rule where the debtor contributes a substantial amount of fresh capital that is essential to the success of the reorganization.[66] The Supreme Court, in *Case v. Los Angeles Lumber Products Co.*,[67] upheld the absolute priority rule, but recognized that there are circumstances under which stockholders may participate in a plan of reorganization of an insolvent debtor. Where new money is essential to the reorganization, and the old stockholders make a fresh contribution of money or money's worth, the stockholders may then receive in return a participation reasonably equivalent to their contribution.[68]

In light of this fresh contribution exception, other cases have allowed a debtor to participate in the reorganized entity despite the absolute priority rule's strong prohibition against any junior class retaining any property. Thus, in *In Re Landau Boat Company*, a debtor's plan was confirmed when the debtor volunteered to make substantial investment contributions towards the continued operation of the business.[69] Similarly, in *In Re Marston* the debtor's new contributions were regarded as new consideration.[70] The original equity that the debtor once had in the property was cancelled.[71] The

60. *See supra* note 36 and accompanying text.
61. 228 U.S. 482 (1913).
62. *See* Booth, *supra* note 59 at 71-72.
63. 74 U.S. 392 (1869).
64. 174 U.S. 674 (1899).
65. Booth, *supra* note 59, at 72-73.
66. *See* Case v. Los Angeles Lumber Products Co., 308 U.S. 106 (1939); *In re* Landau Boat Company, 13 Bankr. 788 (Bankr. W.D. Mo. 1981); *In re* Marston, 13 Bankr. 514 (Bankr. E.D.N.Y. 1981).
67. 308 U.S. 106 (1939).
68. *Id.* at 121.
69. 13 Bankr. 788, 791 (Bankr. W.D. Mo. 1981).
70. 13 Bankr. 514, 517 (Bankr. E.D.N.Y. 1981).
71. *Id.*

debtor's equitable ownership participation in the reorganized entity would thus depend upon the value that his contributions add to the reorganized business.[72]

This fresh contribution is not required to be a cash payment.[73] Participation in the reorganization plan of any debtor would thus depend upon the new equity contributed.[74] In order to justify the retention of an equitable interest, it must appear that the debtor has furnished some compensatory additional consideration or have an equity in the bankruptcy estate after the rights of creditors are fully paid.[75]

Case law prior to *Ahlers* relaxed the traditional absolute priority rule, and allowed corporate shareholder debtors to retain an interest in the reorganized corporation where the shareholders made a fresh contribution of money or money's worth which was necessary to keep the corporate business in operation.

III. THE *Ahlers* CASE

In order to obtain financing for their farming operation, the Ahlers entered into several financing agreements with the Federal Land Bank of Saint Paul and with the Norwest Bank of Worthington, Minnesota ("Norwest").[76] The Federal Land Bank secured a first mortgage on the Ahlers' land to insure the repayment of the loan.[77] Norwest took a second mortgage on the Ahlers' land and a first mortgage on their machinery, equipment, crops, livestock and other farm proceeds to secure Norwest's loans.[78] Unfortunately, the depreciation of farm land and used farm machinery values, combined with low commodity prices caused a decrease in the values of this collateral.[79] Consequently, Norwest and the Federal Land Bank became substantially undersecured.[80]

When the Ahlers defaulted on their loan payments, Norwest sued the Ahlers in state court to obtain possession of the Ahlers' farm machinery and equipment.[81] Fourteen days after Norwest instigated this suit, the Ahlers filed for bankruptcy under Chapter 11 of the Bankruptcy Code.[82]

Norwest and the Federal Land Bank petitioned the Minnesota Bankruptcy Court for relief from this automatic stay so that they could proceed with their statutory foreclosure remedies.[83] The bankruptcy court determined

72. *Id.*
73. For example, contribution may be through the use of income bonds, preferred stock, or, as the court in *Ahlers* has held, in labor and management that create a going concern value greater than the liquidation value of the business. *See generally Los Angeles Lumber*, 308 U.S. 106.
74. Sophian v. Congress Realty Co., 98 F.2d 499, 501-02 (8th Cir. 1938).
75. *Ahlers*, 794 F.2d at 404.
76. *Id.* at 392-93.
77. *Id.* at 392.
78. *Id.* at 393.
79. *Id.*
80. *Id.*
81. *Id.*
82. *Id.*
83. *Id.*

that the creditors were entitled to relief from the automatic stay because the Ahlers could not provide Norwest and the Federal Land with adequate protection.[84]

The Ahlers appealed the bankruptcy court's decision to the district court.[85] The district court affirmed the granting of relief from the automatic stay, and additionally found that the Ahlers' proposed reorganization plan had no realistic prospect of success.[86]

The Ahlers appealed to the Eighth Circuit Court of Appeals.[87] The Eighth Circuit concluded that relief from the automatic stay should not have been granted because the lower courts erred in defining the elements of adequate protection.[88]

The Eighth Circuit Court of Appeals then proceeded to hold that, if an effective reorganization of the Ahlers' farming operation was feasible, then the absolute priority rule would not prevent the confirmation of that plan, despite the fact that it allowed the Ahlers to retain control of their farming operation.[89] The court's justification for this holding was that the Ahlers' yearly contributions of labor, experience and expertise over the life of the plan would constitute the going concern value of the reorganized farm which would have no value to the creditors upon liquidation.[90] Thus, an equitable ownership interest would be created to the extent that the value of the Ahlers' labor and experience exceeded the liquidation value of the farm. This equitable ownership interest would naturally increase each year and would not mature until the reorganization plan was completed and the secured creditors had been paid the full amount of their claims.[91] Applying this reasoning, the Eighth Circuit concluded that if the bankruptcy court determined on remand that the value of the Ahlers' yearly contributions of labor and farm management would equal or exceed the value of the retained ownership interest in the farm at maturity, the dissenting unsecured creditors could not complain that they had not been accorded their full right of priority against the debtor's assets.[92]

IV. ANALYSIS

The Eighth Circuit's holding in *Ahlers* now requires that, when determining whether or not to confirm a plan of reorganization under which the farmer will retain an equitable ownership of the farm assets, the Bankruptcy Court must value 1) the farmer's labor and management skills, and 2) the reorganized enterprise. It is in determining these values that labor and management

84. *Id.*
85. *Id.* at 393-94.
86. *Id.* at 394.
87. *Id.*
88. *Id.* at 394-398.
89. *Id.* at 400-02.
90. *Id.* at 404.
91. *Id.*
92. *Id.* at 404-05.

skills are significant factors which must be considered in distinguishing the liquidation value of a farm from its going concern value.

The commercial value of a business is the greater of either its liquidation value or its value as a going concern.[93] The fact that a debtor is seeking to reorganize implies that the going concern value is greater.[94] The absolute priority rule has specifically been criticized because it fails to give weight to this essential difference between the liquidation value and the reorganization value of a business.[95]

Prior to *Ahlers*, only monetary contributions were added into the calculation of the valuation of a business enterprise. The debtor's contributions of continued management, which may have contributed to the value of the reorganized business, was excluded. This, in effect, prevented the going concern value of the business from being taken into consideration. However, the continuity of management enhances the going concern value of a farm. The fact that a farmer's contribution of management is intangible seems to do little to support an argument that the contribution is of no value to the reorganized farm.[96] Its value is implicit in the earning power of the business.[97]

In an enterprise valuation, the earning power of the business is the very basis which is commonly used in the valuation of the business for purposes of reorganization.[98] In *Consolidated Rock Products Company v. Dubois*,[99] the Supreme Court recognized the value of a going concern is dependent upon the earning power the business can develop. The enterprise must be valued by a capitalization of prospective earnings.[100] At best, however, this is only an educated guess.[101] However, since "the commercial value of property consists in the expectation of income from it," the valuation of a business can be made with reasonable exactitude.[102]

Thus, the earning power of a farm is recognized as an important element in determining its value. To ignore the possible contribution of a farmer's labor and management to his reorganized business is to ignore the very core of the matter as stated in *DuBois*, that any estimate of value "must be based on an informed judgment which embraces all facts relevant to future earning capacity and hence to present worth."[103] To the extent that the farmer's labor and management is essential to the creation of the estimated earnings that cause the value of the reorganized farm to exceed its liquidation value, the

93. Guthmann, *Absolute Priority in Reorganization: Some Defects in a Supreme Court Doctrine*, 45 COLUM. L. REV. 739, 740 (1945).
94. *Id.*
95. *Id.*
96. *Id.* at 742.
97. *Id.* at 743.
98. *Id.*
99. 312 U.S. 510 (1941).
100. *Id.* at 525.
101. *Id.* at 526.
102. *Id.* at 525-26.
103. *Id.* at 526.

farmer is contributing an important element of value and should be allowed to participate in the reorganization plan to that extent.

The Ahlers' labor and management will constitute a fresh contribution of value each year that the reorganization plan is in effect. This value will not mature until the plan is successfully completed, but at that time, the Ahlers will receive the value of their contributions of labor and management made over the years. This contribution, calculable in money's worth, is necessary to any successful reorganization of the farm. This reasoning is based on the same underlying principle in *Marston*[104] and *Landau Boat Company*[105] which allowed debtors to retain interest in reorganization where they made fresh contributions that were necessary for the continuation of the business.

Two sources offer guidance for assessing the value of a farmer's labor and management skills. Farm management services may be obtained in the marketplace from farm management firms who provide these services at a prescribed fee. As such, these firms may be useful for determining the value of the farmer's management contributions.

Farm appraisers may also be utilized to obtain an estimate of the value of a reorganized farming enterprise. Factors important to appraisers include the labor contributions of the farm operator as an essential factor in the farm operation's value as it relates to earning capacity. The value of a reorganized farm could then be the value by which the farm's going concern value exceeds the liquidation value.

Because farmers are distinguishable from corporate shareholders, the absolute priority rule should not be applied to the individual farm debtor seeking to reorganize. As mentioned earlier, one exception to the absolute priority rule was established in *Case v. Los Angeles Lumber Products Co.*, which involved a corporate reorganization under Chapter X of the old Bankruptcy Act.[106] *Los Angeles Lumber* is distinguishable from the individual farm debtors situation. First, the stockholder participation in the reorganized corporation in *Los Angeles Lumber* was not limited to those stockholders who were actually part of the management.[107] In contrast, any participation in the plan afforded the Ahlers would be in direct relation to the value of the management skills provided by the Debtors to run the farm. The Ahlers would only benefit to the extent that their management increased the value of the reorganized farm. This result is a fair one. The Ahlers would not be retaining anything that would be of value to the creditors in a liquidation proceeding.

The second distinguishing factor between the corporation in *Los Angeles Lumber* and the individual farm debtor is that the corporation's reorganization plan could not assure the continuance of the old management group.[108] In *Los Angeles Lumber*, there was no contractual agreement by the former

104. *Marston*, 13 Bankr. 514.
105. *Landau Boat*, 13 Bankr. 708.
106. *Los Angeles Lumber*, 308 U.S. 106.
107. Horowitz v. Caplan, 193 F.2d 64, 74 (1951).
108. *Id.* at 74-5.

managers to continue their managerial responsibilities.[109] In *Ahlers*, by contrast, there is no question that the debtors will remain on their farm and continue to provide the continued management necessary for the successful implementation of the reorganization plan. The farmer's situation is quite unlike that of a corporate shareholder who, normally a passive investor, performs none of the managerial duties of the corporation. When a farmer loses his farm, he loses more than just a mere investment. He or she may lose a way of life.

The Eight Circuit's decision in *Ahlers* diverges significantly from the statutory absolute priority rule enacted in the Bankruptcy Code and from the Supreme Court's interpretation of the absolute priority rule in *Los Angeles Lumber*. It is interesting to note, however, that Congress has recently enacted similar legislation regarding the farm bankruptcy issue. A new "Family Farm Reorganization Act" has been signed into law by the President.[110] This act creates a new Chapter 12 which will allow the individual farm debtor to reorganize their debts and keep their property.[111] More specifically, the new Chapter 12 is modeled after a Chapter 13 plan and does not require creditor approval before the plan may be confirmed.[112] Since the new Chapter 12 does not require creditor approval, it effectively eliminates the absolute priority rule in the individual farm debtor's situation. This legislation is clearly evidence of modern congressional intent to abolish the absolute priority rule in regard to the individual debtor. This modern intent is in accord with the historical congressional intent of the Old Bankruptcy Act.

Under any reorganization plan, the debtors are always going to retain some title to the property. That is the underlying principle of a reorganization. If the absolute priority rule required that the farmer must pay off every senior creditor in full before he is allowed to retain an equitable ownership interest in the control of the farm property, then there would essentially be no purpose in seeking a reorganization. The intent of Congress was that the debtors could not retain any interests with a value to the unsecured creditors while at the same time asking those unsecured creditors to reduce their claim. What the farm debtor is retaining is the going concern value of the reorganized farm. Because this value would not exist upon liquidation, it does not violate the fair and equitable standard.

The dissent in *Ahlers* acknowledges this underlying principle by stating:

> This corollary recognizes that a reorganized going concern generally is worth more than its liquidated assets. If reorganization requires the debtor participation, and if the impaired creditors suffer no net loss by virtue of the debtor's concomitant contribution, otherwise lost value is captured without violating the fair and equitable requirement.[113]

109. *Id.*
110. The Des Moines Register, Oct. 28, 1986, at 4A, col. 3.
111. *Id.*
112. *Id.*
113. *Ahlers*, 794 F.2d at 408.

The debtor's retention of the going concern value does not cause the unsecured creditors to suffer any net loss. Thus, lost value is captured without violating the fair and equitable requirement.

CONCLUSION

The absolute priority rule should not prevent a farmer's reorganization plan from being confirmed where the farmer contributes labor and management skills of a substantial value that equal or exceed the value of the farmer's retained interest in the reorganized farm. The reorganization plan should be valued by looking at whether the going concern value exceeds the liquidation value. The going concern value of a farm now includes consideration of the value of continuity of management, a relevant factor in considering the reorganized farm's future earning capacity and its present worth.

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