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Bankruptcy: Foreclosure of Sweat Equity; Should a Hard Day's Work Be Worth an Honest Dollar - Norwest Bank - Worthington v. Ahlers

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CASENOTES

BANKRUPTCY: Foreclosure of Sweat Equity; Should a Hard Day's Work Be Worth an Honest Dollar? *Norwest Bank - Worthington v. Ahlers,* 108 S.Ct. 963 (1988).

James Ahlers (Ahlers) owned and operated an 840 acre farm in Noble County, Minnesota. Ahlers borrowed in excess of one million dollars from various financial institutions to help finance his operation.[1] Norwest Bank - Worthington (Norwest) loaned Ahlers nearly one-half of this amount.[2] Norwest had a second mortgage in 160 acres of Ahlers' farmland and a first security interest in his machinery and equipment, crops, livestock, and all farm proceeds.[3] In the fall of 1984 Ahlers defaulted on these loans. At default he owed Norwest approximately $450,000, which was secured by property valued at $210,000.[4]

Norwest commenced a replevin action seeking possession of the farm equipment. Two weeks later, Ahlers filed a petition for reorganization under Chapter 11 of the Bankruptcy Code,[5] which automatically stayed Norwest's replevin action.[6] Norwest then filed a motion for relief from stay to allow it to proceed with the replevin action.[7]

On remand from two previous appeals, the district court found that Ahlers' plan was "utterly unfeasible."[8] Ahlers appealed the decision to the court of appeals which found that Ahlers could file a feasible plan.[9] Norwest sought review of the court of appeals' decision.[10]

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1. As of November 30, 1987, the Ahlers owed:
Federal Land Bank - $525,854;
Norwest Bank - $450,468;
John Deere Credit Corp. - $35,791;
Commodity Credit Corp. - $3,337;
General Motors Corp. - $2,900.
In re Ahlers, 794 F.2d 388, 392 (8th Cir. 1986).

2. *Id.*

3. *Id.* at 392.

4. *Id.* at 412.

5. Norwest Bank-Worthington v. Ahlers, 108 S. Ct. 963 (1988). Congress had not enacted Chapter 12 at the time Ahlers filed under Chapter 11. *See* 11 U.S.C. §§ 1201-1231 (1982 & Supp. IV 1986)(Chapter 12 became effective 30 days after October 27, 1986). Chapter 12 is limited to "family farmer[s]." 11 U.S.C. §101(17) (Supp. IV 1986). The Court stated that Ahlers was apparently not eligible, or was disqualified from filing under Chapter 12 because he had already filed under Chapter 11. *Ahlers,* 108 S. Ct. at 970 n.9 (noting a split of authority as to disqualification by previously filing under Chapter 11, *compare, e.g., In re* Dry Angus Ranch, Inc., 69 B.R. 695, 699-701 (Mont. 1987), *with, e.g., In re* B.A.V., Inc., 68 B.R. 411, 412-13 (Colo. 1986)).

6. *Ahlers,* 108 S. Ct. at 963. A creditor's replevin action is automatically stayed by filing a petition for reorganization. 11 U.S.C. § 362 (1982 & Supp. IV 1986).

7. *Ahlers,* 108 S. Ct. at 963. 11 U.S.C. § 362(d) (1982 & Supp. IV 1986). The Bankruptcy Court granted Norwest's motion for relief from stay. On appeal, the district court affirmed the decision, but the court of appeals reversed and remanded the case to the district court with instructions to determine the feasibility of Ahlers' reorganization plan. *Ahlers,* 108 S. Ct. at 965.

8. *Ahlers,* 108 S. Ct. at 965.

9. *Id.* The court of appeals outlined a reorganization plan in the appendix of its opinion. *In re* Ahlers, 794 F.2d at 408-14. The court remanded the case to the bankruptcy court with instructions to confirm a plan following its suggested outline. *Id.* at 403.

10. *Ahlers,* 108 S. Ct. at 963.

At the time Ahlers filed his petition Norwest was an undersecured creditor,[11] and therefore it was allowed a secured claim[12] of $210,000 and an unsecured claim[13] of $240,000. Ahlers proposed to pay Norwest's secured claim in full, but not its unsecured claim.[14] Under the plan, Ahlers would have retained an equity interest in the farm and possession of the equipment.[15]

Before a plan can be confirmed it must satisfy the eleven requirements in section 1129(a) of the Code.[16] All of the requirements except section 1129(a)(8) are mandatory. Paragraph (a)(8) provides that each class of claims must accept the plan or not be impaired.[17] A class which is impaired and does not accept the plan is a dissenting class.

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11. *In re* Ahlers, 794 F.2d at 412. A creditor is undersecured when the value of his collateral is less than the loan which it secures. 11 U.S.C. § 506 (1982 & Supp. IV 1988).

12. *In re* Ahlers, 794 F.2d at 412. An allowed claim is a secured claim to the extent of the value of the creditor's interest in the bankruptcy estate's interest in such property. 11 U.S.C. § 506(a) (1982 & Supp. IV 1986).

13. *In re* Ahlers, 794 F.2d at 412. An allowed claim is an unsecured claim to the extent that the value of the creditor's interest exceeds its allowed claim. 11 U.S.C. § 506(a) (1982 & Supp. IV 1986).

14. *Ahlers,* 108 S. Ct. at 966.

15. *Id.*

16. To be confirmed a plan must meet the following requirements:
(1) The plan must comply with all applicable provisions of title 11; (2) The proponent of the plan must comply with all applicable provisions of title 11; (3) The plan must be proposed in good faith and not by any means forbidden by law; (4) Any payment made or promised for services rendered or for costs and expenses incurred in connection with the case or the plan must be approved by the court; (5) The identity and affiliation of the proposed directors, officers, or voting trustees must be disclosed as well as the identity of an affiliate of the debtor participating in a joint plan or a successor to the debtor under the plan. The proposed appointments of directors, officers, or voting trustees must be consistent with both the interest of creditors and equity security holders and with public policy. In addition, the proponent of the plan must disclose the identity of any "insider" of the debtor and the nature of compensation which will be paid to such persons; (6) If the debtor is subject to governmental regulation and the plan proposes to alter rates over which a regulatory commission has jurisdiction, such commission must have approved such rates or any proposed rate change must be conditioned on such approval; (7) With respect to each impaired class, the class must unanimously accept the plan or the class must receive under the plan at least what such class would receive in a liquidation under Chapter 7 of the Code. If, however, the class exercises the section 1111(b)(2) election, the class must receive property with a present value equal to the value of the class secured claims; (8) Each class must accept the plan or be unimpaired; (9) Unless the holder of a priority claim agrees to less favorable terms, administrative claims entitled to priority must be paid in cash on the effective date of the plan; employee claims, pension benefit claims, and consumer claims entitled to priority must be either paid in cash on the effective date of the plan or must be paid in full over time according to terms acceptable to the requisite majority of the particular class; tax and customs claims entitled to priority must be paid in full but payments in respect of such claims may be extended over a period not to exceed six years from the date of assessment of such claims as long as the present value of the payments as of the effective date of the plan equals or exceeds the amount of those claims; (10) If a class is impaired under the plan, at least one impaired class of claims must accept the plan; and (11) The plan must be feasible.
5 COLLIER ON BANKRUPTCY ¶ 1129.01[1] (15th ed. 1988); 11 U.S.C. § 1129(a)(1982 & Supp. IV 1986).

17. 11 U.S.C. § 1129(a)(8)(1982 & Supp. IV 1986).

If all the requirements of section 1129(a) have been satisfied except paragraph (8), then the plan can still be confirmed if it satisfies the cramdown provisions of section 1129(b).[18] Under that section, the plan must satisfy the absolute priority rule[19] which provides that a dissenting class of unsecured creditors must be provided for in full before any junior class can receive property under the plan.[20]

Norwest was an impaired creditor because its unsecured claim would not be paid in full. Norwest refused to accept Ahlers' plan and thus contended that the plan could not be confirmed over its objection because the plan violated the absolute priority rule.[21] Ahlers' plan did not satisfy the rule because Norwest's senior claim would not have been provided for in full, and he would have retained property under the plan.

Ahlers argued that the plan was confirmable under the "money or money's worth" exception to the absolute priority rule.[22] To satisfy the exception, Ahlers had to make a contribution in "money or money's worth," essential to the reorganization, which was reasonably equivalent to the interest he sought to retain.[23] Ahlers promised to provide future "labor, experience and expertise" to the farm.[24]

The court of appeals found Ahlers' efforts in operating and managing the farm were essential to the reorganization and measurable in money or money's worth.[25] In a unanimous decision, the United States Supreme Court reversed and refused to extend the "money or money's worth" exception to include non-capital contributions such as Ahlers' promise to provide future "labor, experience, and expertise."[26]

The Court's decision makes clear that a farmer's promise to contribute future labor to his insolvent farm is not "money or money's worth" and therefore he cannot retain property unless the absolute priority rule is satisfied. Congress enacted Chapter 12 to deal with the obstacles that the absolute priority rule provided for "family farmers" attempting to reorganize under Chapter 11,[27] and therefore eliminated the absolute priority rule from Chapter 12.[28] Although "family farmers" have been relieved

18. Under cramdown if all of the applicable requirements of subsection (a) of 1129, except paragraph (8), are met, the court, on the request of the proponent, may confirm the plan, notwithstanding the requirements of paragraph (8), if the plan does not discriminate unfairly, and is fair and equitable with respect to the dissenting class of claims. 11 U.S.C. § 1129(b) (1982 & Supp. IV 1986). A plan is fair and equitable with respect to a class of unsecured claims if it provides each holder of such a claim with property of value equal to its allowed claim; or does not provide for any junior claim to receive property under the plan. 11 U.S.C. § 1129(b)(2)(B)(1982 & Supp. IV 1986).

19. 11 U.S.C. § 1129(b)(2)(B)(ii)(1982 & Supp. IV 1986).

20. 11 U.S.C. § 1129(b)(2)(B)(ii)(1982 & Supp. IV 1986).

21. *Ahlers*, 108 S. Ct. at 966.

22. *Id.*

23. Case v. Los Angeles Lumber Co., 308 U.S. 106, 122 (1939).

24. *Ahlers*, 108 S. Ct. at 967.

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

26. *Ahlers*, 108 S. Ct. at 967-68.

27. 132 CONG. REC. S15075 (daily ed. October 3, 1986). Ahlers filed for bankruptcy in 1984, prior to the enactment of Chapter 12. *See supra* note 5.

28. 132 CONG. REC. S15075 (daily ed. October 3, 1986). For confirmation requirements under Chapter 12, *see, e.g.*, 11 U.S.C. § 1225 (1982 & Supp. IV 1986).

of the rule, the problems faced by Ahlers, as a sole proprietor, continue to exist for the owners of small businesses attempting to reorganize under Chapter 11.

This casenote will consider the development of the absolute priority rule and its application to sole proprietors, under Chapter 11; and analyze whether the Court should have distinguished Ahlers, an individual as opposed to a corporate debtor, and expanded the "money or money's worth" exception to include a sole proprietor's promise to provide future "labor, experience and expertise."

BACKGROUND

The founding fathers recognized a vital national interest in a workable bankruptcy system when it gave Congress the power to pass uniform bankruptcy legislation.[29] This legislation was intended to give a debtor a fresh start and to provide a fair means for distributing his assets to all the creditors. A bankrupt debtor generally has the choice between liquidation[30] or reorganization.[31]

The fundamental premise of business reorganization is that assets used for production are more valuable than those sold as scrap.[32] It is designed to allow the debtor to restructure his debts so that the business can continue to operate, provide employment, pay creditors and produce a return for the shareholders. The primary struggle in reorganization law revolves around how to divide the difference between the "going concern value"[33] and the "liquidation value,"[34] especially where the going concern value is insufficient to pay all the creditors in full.[35] The absolute priority rule developed as a standard for distributing the going concern value of the reorganization among the parties.[36] In distributing this value courts must attempt to balance the "competing rights of debtors, unsecured creditors, secured creditors, and public holders of corporate securities."[37]

Courts developed the absolute priority rule under Chapter X of the Bankruptcy Act. The Bankruptcy Act contained three chapters designed primarily for business reorganization, Chapters X, XI, and XII.[38] Chapter 10 was intended as a reorganization tool for corporations with public security holders.[39] Chapter XI was designed to permit an individual, part-

29. U.S. CONST. art.I, § 8, cl.4.
30. *See, e.g.*, 11 U.S.C. §§ 701-766 (1982 & Supp. IV 1986).
31. *See, e.g.*, 11 U.S.C. §§ 1101-1174 (1982 & Supp. IV 1986).
32. Klien, *The Bankruptcy Reform Act of 1978.* 53 AM. BANKR. L.J. 1, 7 (1979).
33. Going concern value is "the value of the assets of a business as a going, active concern rather than merely as items of property..." BLACK'S LAW DICTIONARY 622 (5th ed. 1979).
34. Liquidation value is the value the assets of a business would bring under liquidation. BLACK'S LAW DICTIONARY 622 (5th ed. 1979).
35. Brudney, *The Bankruptcy Commission's Proposed 'Modification' of the Absolute Priority Rule.* 48 AM. BANKR. L.J. 305, 307 (1974).
36. *Id.*
37. King, *Chapter 11 of the 1978 Code.* 53 AM.BANKR. L.J. 107 (1979).
38. 5 COLLIER ON BANKRUPTCY, ¶ 1100.01 [1] (15th ed. 1988).
39. *Id.*

nership or corporate debtor to reorganize unsecured debts.[40] Chapter XII provided individual or partnership debtors, with debts secured by real estate, an opportunity to reorganize.[41]

Under the Bankruptcy Act, a plan had to be "fair and equitable."[42] The Court developed the absolute priority rule to define this undefined requirement.[43] The rule was based on the equitable principle that a creditor's claim should retain priority over a debtor's claim in the property of an insolvent operation.[44]

In 1952, Congress eliminated the absolute priority rule under Chapter XI, because it restricted closely held corporations' and individuals' ability to reorganize.[45] Strict application of the rule would impair an individual's efforts to scale down debts, and would make reorganization impractical.[46]

Congress codified the absolute priority rule in Chapter 11 of the new Bankruptcy Code.[47] Chapter 11 represents a consolidation of Chapters X, XI, and XII of the Bankruptcy Act.[48] Congress found that large corporations were filing under Chapter XI to avoid application of the absolute priority rule and consolidated the chapters to stop corporations from using Chapter XI to a creditor's disadvantage.[49]

It is not clear whether Congress, in enacting the Code, intended the rule to be applied to small, closely held corporations or sole proprietorships which had previously qualified under Chapter XI.[50] Commentators have suggested, based on the application under Chapter XI and the lack of legislative history concerning codification of the rule, that it should not be strictly applied to individual debtors.[51]

In *In re Star City Rebuilders, Inc.*,[52] the court recognized that strict application of the absolute priority rule would restrict an individual's ability to effectively reorganize under Chapter XI; and that such a result was contrary to bankruptcy policies. The court drew a distinction between closely held corporations and large corporations.[53] However, other courts have found that drawing a distinction between sole proprietorships and

40. *Id.*
41. *Id.*
42. Northern Pacific Railway v. Boyd, 228 U.S. 482 (1913).
43. *Id.* at 505.
44. *Id.*
45. *In re* Star City Rebuilders, Inc., 62 B.R. 983, 987-88 (Bankr. W.D. 1986).
46. *Id.*
47. 11 U.S.C. § 1129(b)(2)(B)(ii)(1982 & Supp. IV 1988).
48. *In re Star City*, 62 B.R. at 988.
49. *See*, H.R. REP. No. 595, 95th Cong., 2d Sess. 3, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS, 6209-13.
50. *In re Star City*, 62 B.R. at 988.
51. Fischer, *Sweat Equity: In re Ahlers*. 23 TULSA L.J. 37, 73 (1987).
52. 62 B.R. at 988 (allowing debtor to retain property which had "no value").
53. *Id.*

corporations under Chapter XI would violate the statutory language of section 1129(b)(2)(B)(ii).[54]

In *Case v. Los Angeles Lumber Co.,* the Supreme Court recognized an exception to the absolute priority rule[55] in dicta. The case involved a Chapter X reorganization, where the stockholders of the corporation attempted to retain twenty-three percent of the new stock in the reorganized corporation, without making a new capital contribution.[56] The *Los Angeles Lumber* court found that the existing shareholders' pledge of their "financial standing and influence in the community" and their "continuity of management" could not be translated into money's worth reasonably equivalent to the shareholder's interest in new stock.[57] The Court noted that the contributions reflected "vague hopes or possibilities" which had "no place in the asset column of the balance sheet of the new company."[58] But the Supreme Court said that where a debtor made a contribution of new capital in the form of money or money's worth he could retain an equity interest even though a senior creditor was not paid in full.[59]

Since *Los Angeles Lumber,* courts have invoked the "money or money's worth" exception in various situations. They have found that where a stockholder pledged security for the corporate debtor's loan;[60] committed to loan operating funds to the corporation;[61] or renewed a personal guarantee on corporate debt[62] the contribution was "money or money's worth."

Previous attempts to qualify noncapital contributions under the exception have been rejected.[63] In *In re Sawmill Hydraulics, Inc.,* the court held that a shareholder's promise to provide future services for below normal wages was not a capital contribution.[64] However, in *Horowitz v. Kaplan,* the court found that the absolute priority rule did not prevent two share-

54. *In re* Stegall, 85 B.R. 510, 516 (C.D. Ill. 1987)(citing *In re* Pecht, 57 B.R. 137, 141 (Bankr. E.D. Va. 1986). In *In re Pecht,* the court refused to draw such a distinction. *In re* Pecht, 57 B.R. at 141 (refusing to allow an individual to retain an interest based on business income, which was not attributable to debtor's personal services).

55. Case v. Los Angeles Lumber Products Co., 308 U.S. 106, 121-23.

56. *Id.* at 112.

57. *Id.* at 122.

58. *Id.* at 122-23.

59. *Id.* at 121-22.

60. *In re* Brown's Industrial Uniforms, Inc., 58 B.R. 139, 141 (Bankr. N.D. Ill. 1985)(A shareholder was allowed to receive new stock in the reorganization when he pledged his personal assets as security to procure a working capital loan for the corporation).

61. *In re* Landau Boat Co., 13 B.R. 788, 792 (Bankr. W.D. Mo. 1981)(shareholder entered an irrevocable commitment to loan funds to the corporate debtor).

62. *In re* Potter Material Services, Inc., 781 F.2d 99 (7th Cir. 1986)(shareholder committed to pay debtor corporation's attorney fees and renewed his personal guarantee of corporate debts).

63. *Ahlers,* 108 S.Ct. at 967 n.4 (citing *In re* Baugh, 73 B.R. 414, 418 (Bankr. E.D. Ark. 1987)(following *In re* Ahlers, but finding insufficient evidence to establish value); *In re* Pecht, 57 B.R. 137, 139-41 (Bankr. E.D. Va. 1986); *In re* Sawmill Hydraulics, Inc., 72 B.R. 454, 456 (Bankr. C.D. Ill. 1987)).

64. *In re* Sawmill Hydraulics, Inc., 72 B.R. 454, 456-57 (Bankr. C.D. Ill. 1987)(following *In re* Stegall, 85 B.R. at 510, which held that future labor did not constitute a new capital contribution).

holders, whose continued management was an important assurance of a successful reorganization and where they were bound by contract to remain in the management positions for the pendency of the reorganization, from retaining an interest in stock.[65]

Before the Code was enacted, the Bankruptcy Commission made a proposal to modify the absolute priority rule.[66] The modification would have allowed shareholders to participate in the plan, if their future contributions, or continued management, were essential to the business.[67] Congress did not enact such a liberalization as part of the codified absolute priority rule.[68]

The court of appeals, in *In re Ahlers*, was the first and only court to hold that a debtor's promise to provide future labor was an adequate substitute for "money or money's worth."[69] However, that court was divided on the issue.[70]

PRINCIPAL CASE

In a unanimous decision, the United States Supreme Court reversed the court of appeals' decision.[71] The Court held that the absolute priority rule prohibited a Chapter XI debtor from retaining property over the objections of a senior unsecured creditor.[72]

Ahlers attempted to avoid application of the absolute priority rule by asserting a number of arguments. He claimed that the interest he retained had no value and therefore was not property under section 1129 of the Code;[73] and that the rule should not apply where the court found that the reorganization plan was in the best interest of all the creditors and debtors.[74] The heart of Ahlers' argument was that even if the plan violated the absolute priority rule, his promise to contribute future labor satisfied the "money or money's worth" exception to the rule, and therefore he could retain property.[75] Finally, Ahlers contended that even if his contribution did not satisfy the exception, it did satisfy some broader exception to the rule.[76]

The Supreme Court held that any interest which Ahlers retained was property,[77] and that whatever equitable powers bankruptcy courts pos-

65. Horowitz v. Kaplan, 193 F.2d 64, 74-75 (1st. Cir. 1951) *cert. denied*, 342 U.S. 946 (1952).

66. H.R. Doc. No. 137, 93rd Cong., 1st Sess., pt. 1, at 258-59 (1973).

67. *Id.*

68. *Ahlers*, 108 S.Ct. at 968.

69. *In re* Stegall, 85 B.R. at 515.

70. *In re* Ahlers, 794 F.2d at 404 (Gibson, J., dissenting).

71. *Ahlers*, 108 S.Ct. at 963.

72. *Id.*

73. Ahlers' argument was based on the "no value" theory. *Id.* at 969 (*see, e.g., In re* Star City Rebuilders, 62 B.R. at 988-89).

74. *Id.* at 968.

75. *Id.* at 966.

76. *Id.* at 968.

77. The Court rejected the "no value" theory relying on the overwhelming consensus of authority. *Id.* at 969-70 (*See In re* Modern Glass Specialists, Inc., 42 B.R. 139, 140-41

sess "must and can only be exercised within the confines of the Bankruptcy Code."[78] The Court found that any expansion of any exception to the rule, beyond those recognized when the Code was enacted, would be contrary to the language and legislative history of section 1129(b).[79] Therefore Ahlers could only retain property in accordance with the absolute priority rule and the "money or money's worth" exception.[80]

The Court held that Ahlers' promise to provide future "labor, experience, and expertise" was a noncapital contribution which did not constitute "money or money's worth."[81] Therefore, the absolute priority rule prohibited Ahlers from retaining property over Norwest's objection.

The Court relied on *Los Angeles Lumber* in deciding that a debtor's promise to provide future "labor, experience, and expertise" was not "money or money's worth."[82] The Court noted that there was no way to distinguish Ahlers' promise from those offered by the shareholders in *Los Angeles Lumber.*[83]

The Court characterized Ahlers' promise of future services as a noncapital contribution which was not readily marketable and insufficient to escape the absolute priority rule.[84] It noted that previous attempts to qualify noncapital contributions had been unanimously rejected.[85]

The Court found Ahlers' proposed solutions contrary to the Bankruptcy Code and a long line of caselaw,[86] and his application of the absolute priority rule and the exception to be "unprecedented, illogical and unfair."[87]

ANALYSIS

The "money or money's worth" exception which originated in *Los Angeles Lumber,* was based on the Court's recognition of the need, under certain circumstances, to seek a fresh contribution of "money or money's worth" which was "essential to the success of the undertaking."[88] Courts

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(Bankr. Ct. E.D. Wis. 1984); *In re* Huckabee Auto Co., 33 B.R. 132, 141 (Bankr. M.D. Ga. 1981); *In re* Landau Boat Co., 8 B.R. 436, 438-39 (Bankr. W.D. Mo. 1981)). The Court found that even in a sole proprietorship, where the going concern value is minimal, "there may still be value in the control of the enterprise [and] in potential future profits . . ." *Ahlers,* 108 S. Ct. at 969-70. The Court held that any interest Ahlers retained was property. *Id.* at 970.

78. *Id.* at 968-69.

79. *Id.* at 968. The Court relied on the fact that Congress did not include a proposed modification that would have allowed shareholders to participate in a plan based on future contributions of continued management essential to the business.

80. *Id.* at 970.

81. *Id.* at 966-67.

82. *Id.* at 967-68.

83. *Id.*

84. *Id.* at 967.

85. *Id.* at 967 n.4 (relying on *In re* Baugh, 73 B.R. 414, 418 (Bankr. E.D. Ark. 1987); *In re* Pecht, 57 B.R. 137, 139-41 (Bankr. E.D. Va. 1986)).

86. *Id.* at 971.

87. *Id.* at 966 (quoting Judge Gibson's dissent in *In re* Ahlers, 794 F.2d 388, 406 (1986)).

88. *Los Angeles Lumber Co.,* 308 U.S. at 121.

since then have used the exception as a flexible tool to avoid the rigid application of the absolute priority rule,[89] while they have continued to be guided by the *Los Angeles Lumber* Court's holding that the exception cannot be applied where an inadequate contribution by the debtor would dilute a creditor's rights.[90]

In *Ahlers,* the Court decided that an individual's promise to provide future services was inadequate consideration to satisfy the "money or money's worth" exception. The Court did not distinguish between corporate and noncorporate debtors, failing to recognize that a sole proprietor's promise to provide future labor is different from shareholders' pledge of "continuity of management." Further, that application of its holding was contrary to the underlying policies of bankruptcy law.

Instead, the Court relied on caselaw developed before the absolute priority rule applied to sole proprietors[91] and held that extending the "money or money's worth" exception to include noncapital contributions was contrary to the explicit language of the Code.[92]

Chapter XI of the Code does not distinguish between corporate and noncorporate debtors.[93] The language of the absolute priority rule is clear. Courts have recognized that drawing a distinction between sole proprietorships and corporations under Chapter XI would violate the statutory language of section 1129(b)(2)(B)(ii).[94] Congress was aware of the problems the absolute priority rule created for small businessmen, including family farmers. However, it was only willing to extend relief to family farmers under Chapter XII.[95]

The Code provides that it is up to the creditor to accept or reject a plan.[96] From a creditor's point of view, the exception should apply only to capital contributions. Capital is the means of exchange in our society.[97] If no monetary value is added, the creditor is forced to absorb the risk of a successful reorganization. Such a reorganization simply becomes a mandated scale down of creditor's rights.[98]

If the debtor is allowed to contribute an unenforceable promise to work, the creditor is forced to give up rights in exchange for the debtor's promise to operate more successfully in the future. A creditor is saddled with the risk that the reorganization will fail and its security interest will be further diminished.

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89. *Id.*
90. *Id.*
91. *See, e.g., Los Angeles Lumber Co.,* 308 U.S. 106.
92. *Ahlers,* 108 S.Ct. at 971.
93. 11 U.S.C. § 109(d)(1982 & Supp. IV 1986).
94. *In re* Stegall, 85 B.R. at 516 (citing *In re* Pecht, 57 B.R. 137, 141 (Bankr. E.D. Va. 1986).
95. Congress recognized a distinction between corporate and individual debtors. It limited application of Chapter 12 to individuals or family farm corporations or partnerships. 11 U.S.C. § 101(17)(1982 & Supp. IV 1986).
96. 11 U.S.C. § 1126 (1982 & Supp. IV 1986).
97. *In re Stegall,* 64 B.R. 296, 300 (Bankr. C.D. Ill. 1986).
98. Brief for the United States as Amicus Curiae Supporting Petitioners at 28, Norwest Bank Worthington v. Ahlers, 108 S.Ct. 963 (1988)(No. 86-958).

If the reorganization becomes unfeasible in the future, a capital contribution could be liquidated.[99] The promise to provide future labor, in all likelihood, could not be liquidated to protect the creditor.[100]

Finally, if a debtor is allowed to retain an interest over the creditor's objection, the creditor is denied the benefit of his bargain.[101] This is not a reasonably foreseeable result,[102] and would create unpredictability in the allocation of risk between debtor and creditor.[103]

Thus, the language of the Code makes it clear that the absolute priority rule does apply to sole proprietors and that it is the creditor's right to accept or reject the plan. Therefore, from a creditor's viewpoint the exception should not apply to noncapital contributions. However the "money or money's worth" exception is still valid,[104] and provides the courts with a tool to allow a debtor to remain in business and pay creditors what is fair under the circumstances. The essence of the exception is to allow a debtor to retain an interest where his contribution is essential to the success of the reorganization.

Prior to codification it was not necessary to allow a sole proprietor to make a noncapital contribution because the absolute priority rule only applied to corporations. The cases, under the Code, which have refused to allow a sole proprietor to retain an interest can be distinguished from Ahlers' situation.[105]

For example, in *In re Baugh,* the court stated that a debtor's future labor and management were "money or money's worth" but that the record contained no evidence from which the court could value the debtor's contributions.[106] In *In re Pecht,* the court refused to allow the debtor to retain an interest based on a contribution of business income, but did not foreclose the possibility, if the contributions were attributable to his personal services.[107]

The fact that prior to codification the rule did not apply to sole proprietors, that a sole proprietor has nothing else to contribute to the reorganization except his future labor, and the economic realities of bankruptcy support modification. Therefore, where a sole proprietor contributes future services, which can be valued and are essential to the suc-

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99. *In re* Ahlers, 794 F.2d at 407 (Gibson, J. dissenting).

100. *Id.* (questioning the court's power to order specific performance of labor obligations, *see* Karrick v. Hannaman, 168 U.S. 328, 335-36 (1897)).

101. Fischer, *supra* note 51, at 75.

102. *Id.*

103. *Id.* at 75-76.

104. In *Ahlers,* the Supreme Court did not decide whether the exception was valid. *Ahlers,* 108 S.Ct. at 967 n.3. The Court noted a split of authority on the issue. *Id. Compare, e.g., In re* Sawmill Hydraulics, Inc., 72 B.R. 454, 456, and n.1 (Bankr. C.D. Ill. 1987) *with, e.g., In re* Pine Lake Village Apartment Co., 19 B.R. 819, 833 (Bankr. S.D.N.Y. 1982).

105. In *Ahlers,* the Court relies on *In re Baugh* and *In re Pecht* to find that noncapital contributions had previously been unanimously rejected. *Ahlers,* 108 S.Ct. at 967 n.4.

106. *In re Baugh,* 73 B.R. at 419.

107. *In re Pecht,* 57 B.R. at 141.

cess of the reorganization, the contribution should satisfy the "money or money's worth" exception.

Ahlers was a sole proprietor filing under Chapter XI. A sole proprietor's relationship with the business differs from that of shareholders' with the corporation. In *Los Angeles Lumber,* stockholder participation was not limited to stockholders who were actually a part of management.[108]

Corporate shareholders may be diverse and distinct from management.[109] Being owners of shares in a corporation does not require expertise, knowledge or a contribution of labor. Mere shareholders' contributions are not essential to the reorganization,[110] they add nothing to the continuity of management, and their financial standing and influence are intangible.[111]

A corporation is a legal entity, separate and distinct from its shareholders. The shareholder is not bankrupt. He is protected by limited liability and may possess individual assets to contribute or his personal guarantee to provide to the reorganization.

A sole proprietor is not distinct from management. His continued support and services are essential to the ongoing business. This is particularly true of businesses, like farming, which are labor intensive. A proprietor is not protected by limited liability. There is a unity of interest and ownership. Therefore a bankrupt proprietor has little or no outside assets to contribute. In such a case, he can only offer his unsalaried future labor.

Prior to codification, Congress recognized that application of the rule to individual debtors would impair or entirely curtail their efforts to scale down debts.[112] Although Congress consolidated corporate, partnership, and small business reorganization into Chapter XI and codified the absolute priority rule, it did not intend to foreclose a sole proprietor's opportunities to reorganize.[113] If the rule is strictly applied, an individual debtor would be unable to reorganize.[114] This result would frustrate the policy goals of reorganization.

Ahlers' promise to provide future labor was distinguishable from corporate shareholders' pledge of their "financial standing and influence in the community" and their "continuity of management." In business reorganization, management of the new enterprise is essential to a successful

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108. *Los Angeles Lumber,* 308 U.S. at 122.
109. *Id.* at 123 n.17.
110. *Id.*
111. *Id.* at 122.
112. *In re Star City,* 62 B.R. at 988 (citing 9 COLLIER ON BANKRUPTCY, at ¶ 9.18 (14th ed. 1978)).
113. Congress consolidated these chapters to stop corporations from using bankruptcy to a creditor's disadvantage. Corporations were filing under Chapter XI to avoid the absolute priority rule. H.R. REP. No. 595, 95th Cong., 2d Sess. 3, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 5965.
114. 132 CONG. REC. S15075 (daily ed. October 3, 1986).

reorganization. This management will have to be paid.[115] If the debtor provides the management he is entitled to be paid.

Earnings from services performed after the commencement of the reorganization are property of the individual.[116] When the proprietor provides the services, the reorganization has been relieved of a cost. Therefore participation should be allowed where the value of future services can be appropriately appraised.

A proprietor's services can be valued by comparing the compensation received by other similarly situated persons in the marketplace.[117] The present value of these services can be determined by discounting at the appropriate rate.[118] In *Ahlers,* the Supreme Court found that Ahlers' promise had "value" and was of some benefit to any reorganized enterprise,[119] but in all likelihood was unenforceable.[120]

In *Horowitz,* the court held that participation should be allowed if the debtor's continued management is an important assurance of the business's future success and he is bound by contract.[121] A debtor's contract for employment would provide a means of enforcement. While a court cannot demand specific performance,[122] a creditor could recover for breach of contract.

Finally, if a debtor is not allowed to retain an interest based on his promise to provide future labor, in all probability, he will be forced into liquidation. The only chance a bankrupt business has is to lower debts to a level which its cashflow will sustain. If low profitability has dried up capital resources, the debtor is unable to make a capital contribution and cannot overcome the absolute priority rule. If he cannot overcome the rule, the plan cannot be confirmed and his only option is to liquidate. Such a result is contrary to the rehabilitative purpose of Chapter XI.[123]

Part of the lending business is the risk of loss. This risk is reflected in the interest rate charged by lenders. A debtor should not be forced to absorb all the risk of a deflation in asset values. Under liquidation, a forced sale may result in a loss in property value and therefore both the creditor's secured and unsecured claim would probably not be paid in full. However, under reorganization the secured claim would be paid in full,

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115. Brudney, *supra* note 35, at 336.

116. 11 U.S.C. § 541(a)(6)(1982 & Supp. IV 1986).

117. Courts should consider the degree of debtor's knowledge and experience, and the amount of time he intends to work. *In re* Baugh, 73 B.R. at 419.

118. Courts calculate the value of an equity interest based on future cashflows. If the interest retained can be calculated on future earnings then a contribution based on future salary can be calculated in a similar manner. *See* Schorer, *The Right of the Undersecured Creditor to Postpetition Interest in Bankruptcy on the Value of Its Collateral: Implication of Recent Cases.* 21 U.C.C. L.J. 61, 74 (1988).

119. *Ahlers,* 108 S.Ct. at 967.

120. *Id.*

121. Horowitz v. Kaplan, 193 F.2d at 75.

122. *In re* Ahlers, 794 F.2d at 407 (Gibson, J. dissenting) (citing Karrick v. Hannaman, 168 U.S. 328, 335-36 (1897)).

123. *In re Star City,* 62 B.R. at 988.

and the unsecured claim would have the opportunity to receive a pro rata share of any future profits.[124]

The creditor is assured of an interest in any future distributions under reorganization. Without the sole proprietor's contribution, the reorganization has no going concern value and there is no potential for future distributions. Under liquidation, the creditor will not receive any of the future distributions.

The economic reality of bankruptcy is that there are losses in value. Courts should attempt to minimize these losses. Allowing a sole proprietor to remain in business, provide jobs and pay creditors what is reasonable under the circumstances minimizes the losses to all parties, and thus fulfills the rehabilative intent of bankruptcy.

Although Chapter XI of the Code makes no distinction between corporations and other debtors, in applying the absolute priority rule, and provides that it is the creditor's decision of whether to accept or reject a plan, the Court should have afforded Ahlers relief by expanding the "money or money's worth" exception. The fact that Congress did not state whether the absolute priority rule should continue to apply to debtors who previously qualified under Chapter XI, supports drawing a distinction between corporations and sole proprietors. Although a creditor may be accepting greater risk, he will receive as much or more under reorganization as he would under liquidation. Allowing the debtor to remain in business satisfies the goals of reorganization and minimizes the overall costs to society.

CONCLUSION

The case clearly establishes that a promise to provide future labor is not "money or money's worth." Beyond that, it illustrates the harsh effects of the absolute priority rule and raises questions concerning its application to sole proprietors under Chapter XI. Legislative history suggests, in an attempt to remedy past abuses under Chapter XI by large corporations, that the little guy was lost in the shuffle.

Despite the language of the Code, a host of equitable arguments support expanding the exception to allow a sole proprietor to retain an interest based on his contribution of future labor, which has value and is essential to the reorganization's success. Based on the distinctions between sole proprietorships and corporations, the value and necessity of a sole proprietor's management to a successful reorganization, and the economic realities of bankruptcy, the Court should have expanded the exception to allow a sole proprietor to reorganize based on his contribution of future labor.

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124. The court of appeals, in *In re Ahlers,* awarded the unsecured creditors a pro rata share of any future profits. *In re Ahlers,* 794 F.2d at 403.