Volume 32 | Issue 2 Article 3

1982

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Case Western Reserve Law Review

Volume 32 | 1982 | Number 2

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*The Bankruptcy Reform Act of 1978 was the first major revision of the bankruptcy law since 1938. This Article focuses on chapter 11 of the new act, which provides for the reorganization of almost any business entity of any size, and compares that chapter to its predecessors, chapters X and XI of the Bankruptcy Act. The Article places particular emphasis on section 1129(a) of chapter 11 which provides for a confirmation process in the situation where most, but not all, creditors are ready to approve a plan which the majority of each of the other classes also approves. It is through this section that creditors are encouraged to reach agreement extrajudicially through the consent of a majority of each impaired class. The Article also examines the consequences of the plan proponent's failure to obtain a confirmation through acceptance of a majority of each class and the problems of possibly forcing acceptance of a plan on nonaccepting classes.*



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A bankruptcy judge of standing has suggested that anyone who had any part in the writing or enactment of the Bankruptcy Code and who writes about the Bankruptcy Code should let the reader know of this connection. The writer has been a longstanding member of the National Bankruptcy Conference, *see infra* note 45, and the ABA Committee on Commercial Bankruptcy. As such, the writer has followed developments of what became the Bankruptcy Code. The writer, along with many others, testified at one congressional committee hearing and was consulted occasionally by the draftsmen on specific points during the extended drafting period. *See infra* note 62. The views expressed herein are those of the writer and cannot be ascribed to any committee or group of which he is or was a member.

The author wishes to acknowledge the aid of Scott Smith, University of Georgia Law School (1979); Randy Rogers, University of California, Hastings College of Law (1980); and Linda J. Philipps, University of California, Boalt Hall (1982).

## INTRODUCTION

Since October 1, 1979, chapter 11 of the Bankruptcy Code[1] has been the only chapter under which a business entity of any size can be reorganized.[2] This chapter replaces former section 77 (limited to railroad reorganizations)[3] and chapters X, XI, and XII of the Bankruptcy Act of 1898.[4] While chapter 11 borrowed heavily from the old acts, particularly from chapters X and XI, it adds new dimension to the corporate reorganization process.

This Article briefly summarizes the historical development of and need for corporate reorganization law.[5] Particular emphasis is given to the confirmation process in section 1129(a)[6]—a process which is accomplished only with the consent of what we will call a "statutory majority" of each impaired class—and its attendant problems.[7] Furthermore, the consequences of failing to obtain confirmation of a plan under section 1129(a) because of the absence of acceptance by the statutorily required majority are highlighted.[8] Attention is also directed to forcing a dissenting class to accept a plan under section 1129(b).[9]

## I. HISTORY

In any economy where goods or services are supplied on credit or where money is loaned to enable the buyer to purchase goods or services or pay debts, debtor-creditor law is necessary. For centuries that law has contained, and continues to contain, two inconsistent principles. The first principle is that, if a credit economy is to function, the debtor must be required to pay the debt as agreed even if payment requires great sacrifice by the debtor. The second

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1. 11 U.S.C. §§ 1101–1174 (Supp. III 1979).

2. *Cf. id.* §§ 1301-1330. Under chapter 13, an individual's small business might be reorganized.

3. Act of Aug. 27, 1935, ch. 774, § 77, 49 Stat. 911 (amending Bankruptcy Act of 1898, ch. 541, 30 Stat. 544).

4. Act of July 7, 1898, ch. 541, 30 Stat. 544, *amended by* Bankruptcy Act of 1938, ch. 575, 52 Stat. 840. Chapter X governed corporate reorganizations, chapter XI governed arrangements, and chapter XII governed real property arrangements of certain noncorporate persons.

5. *See infra* notes 10–34 and accompanying text.

6. 11 U.S.C. § 1129(a)(8) (Supp. III 1979). For a discussion of the § 1129(a)(8) process see *infra* text accompanying notes 127–45.

7. For a definition of the term "statutory majority" see *infra* text accompanying notes 146–48. *See also infra* notes 118–64 and accompanying text.

8. *See infra* notes 165–83 and accompanying text.

9. 11 U.S.C. § 1129(b) (Supp. III 1979). *See infra* notes 185–206 and accompanying text.

principle looks the other way: if this payment is adjudged by society to be too harsh, the law may soften the bargain by postponing the time of payment, reducing the amount to be paid, changing the form of compensation, or, in many cases, discharging the debt with little or even no payment.[10] Modern bankruptcy legislation, including modern corporate reorganization law, continues to balance these two principles.

Ancient law is replete with examples of debtor-creditor law resolving each of the contrary social policies behind these principles. In ancient Jewish law, for example, the creditor was allowed to take the debtor's garment in pledge by day but was required to return the garment for the cool of the night.[11] In a Jubilee year,[12] payment might be forgiven altogether.[13]

In Roman law, the debtor gave control of not only his goods, but also his body, to the creditor.[14] Some creditors even maintained private prisons for debtors who were in default.[15] Roman law, like Jewish law, however, had what was considered, at the time, to be a more humane side. In the fourth century B.C., the Romans abolished the law which allowed a creditor "to kill or sell the defaulting debtor."[16] By A.D. 161, the law, in some circumstances, authorized a composition by which a majority of creditors could agree to take less than the amount of their debt and thereby bind all creditors to do likewise.[17]

This principle of allowing the majority of a class to take away rights of a minority was incorporated into the Bankruptcy Act of 1938 by Section 12 in a limited way.[18] Chapter XI expanded the composition principle,[19] but chapter X, adopted the same day, al-

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10. *See generally* J. MacLachlan, Bankruptcy (1956).

11. *Exodus* 22:25, 26; *Deuteronomy* 24:13-22; *see* 1 R. De Vaux, Ancient Israel: Social Institutions 169 (2d ed. 1965); *see also* 2 *Kings* 4:1-7, *cited in* R. De Vaux, *supra*, at 172.

12. The Jubilee year occurred every fifty years. R. De Vaux, *supra* note 11, at 175.

13. *Id.* at 176.

14. Dalhuisen, *Roman Law of Creditors' Remedies*, in European Bankruptcy Laws 1, 3 (I. Ross ed. 1974).

15. *Id.* at 4.

16. *Id.*

17. *Id.* at 8.

18. Section 12 of the act is reproduced in W. Blum & S. Kaplan, Materials On Reorganization, Recapitalization, and Insolvency 212-13 (1969). Parts of section 12 lived on in chapter XI.

19. A chapter XI arrangement was essentially a composition between a debtor and his unsecured creditors.

most denied the principle.[20] Under the Bankruptcy Reform Act of 1978, the composition principle is almost controlling under section 1129(a). Section 1129(a) largely allows a two-thirds statutory majority of each class to decide the compensation its members must accept if a similar majority of each other class also consents. The composition principle does not apply as between classes: classes A, B, and C cannot bind class D by their acceptance. Section 1129(b) gives the court the power to decide whether the plan binds the nonassenting class.

While the number of credit transactions has increased in recent history, creditor rights and remedies are not new. Credit has been a prominent feature of American life since early colonial days. Many settlers obtained passage to America on credit as indentured servants.[21] As early as 1705, the seeds of modern bankruptcy legislation began to sprout in Massachusetts.[22] In colonial and post-colonial times, legislatures in various colonies granted petitions for relief from arrest for debt and petitions for discharge from debt. In 1764, for example, the Rhode Island legislature granted eleven petitions for relief from debt and denied an equal number.[23] In 1824, it was reported that an eighteen-year-old girl, with a child at her breast, was imprisoned for failing to pay a six to eight dollar debt.[24] As late as 1888, the New York City debtor's jail held 1,300 prisoners in custody for debts valued at less than twenty-five dollars, with more than half of the jail population owing less than ten dollars.[25]

At the corporate level, the 1851 decision in *Macon & Western Railroad Co. v. Parker*[26] possibly initiated the process by which a court could prevent individual creditor actions which would dismember a railroad and began an eighty-year period of railroad equity receiverships. The Georgia Supreme Court in *Parker* approved the lower court's action in preserving a railroad's assets by staying the hands of creditors who were pursuing their remedies in

20. Chapter X's requirement that no class could retain any interest unless every prior class was compensated fully was inconsistent with the composition principle.

21. P. COLEMAN, DEBTORS AND CREDITORS IN AMERICA: INSOLVENCY, IMPRISONMENT FOR DEBT, AND BANKRUPTCY 1607–1900, at 228 (1974). This text traces the history of American debtor- creditor law from colonial times.

22. *Id.* at 45.

23. *Id.* at 96.

24. *Id.* at 42.

25. *Id.* at 117.

26. 9 Ga. 377 (1851).

other courts.[27] The court in *Parker* recognized the need for a device which acknowledged both the rights of creditors to be compensated and the right of the debtor to remain economically viable. Until it was almost completely displaced in 1938 by the chapters added to the Bankruptcy Act, the equity receivership was the traditional corporate reorganization device for both railroad and nonrailroad corporations. In the late 1920's, the United States Supreme Court expressed doubts concerning the extensive use of this device.[28]

In 1933, Congress, perhaps influenced by the hint from the Court, enacted section 77 of the Bankrutcy Act, which was interpreted to have eliminated the equity receivorship in railroad reorganizations.[29] In the following year, Congress added section 77B which almost eliminated the equity receivership in nonrailroad reorganization.[30] Section 77 was amended in 1935,[31] and section 77B was replaced in 1938 by chapter X.[32] At the same time, chapter XI replaced and expanded the composition provisions of sections 12 and 74 of the Bankruptcy Act.[33] Finally, in 1978, Congress repealed the Bankruptcy Act of 1898 and replaced it with the Bankruptcy Code (except as to pending cases).[34]

27. *Id.* at 394. For the importance of holding off creditors temporarily if a reorganization is to be possible, see Coogan, Broude & Glatt, *Comments on Some Reorganization Provisions of the Pending Bankruptcy Bills*, 30 BUS. LAW. 1149 *passim* (1975).

28. *See* First Nat'l Bank v. Flersham, 290 U.S. 504 (1933); Harvin v. Brundage, 276 U.S. 36 (1927).

29. Act of Mar. 3, 1933, ch. 204, § 77, 47 Stat. 1467, 1474–82 (amending Bankruptcy Act of 1898, ch. 541, 30 Stat. 544). See New England Coal & Coke Co. v. Rutland R.R. Co., 143 F.2d 179 (2d Cir. 1944) (interpreting § 77).

30. Act of June 7, 1934, ch. 424, § 77B, 48 Stat. 912–22 (amending Bankruptcy Act of 1898, ch. 541, 30 Stat. 544).

31. Act of Aug. 27, 1935, ch. 774, § 77, 49 Stat. 911–26 (amending Bankruptcy Act of 1898, ch. 541, 30 Stat. 544).

32. Bankruptcy Act of 1938, ch. 575, § 1(101), 52 Stat. 840, 883 (amending Bankruptcy Act of 1898, ch. 541, 30 Stat. 544) *repealed by* Bankruptcy Reform Act of 1978, Title IV, § 401(a), 92 Stat. 2549, 2682. [Hereinafter Bankruptcy Act of 1938.]

33. Sections 12 and 74 of the Bankruptcy Act authorized compromises with creditors. *See* Securities and Exchange Comm'n v. U.S. Realty & Improvement Co., 310 U.S. 434, 448 (1940). For a discussion of the historical aspects of these provisions in relation to § 77B, chapter X, and chapter XI see *id.* at 448–58. *See generally* E. DODD & D. BILLYOU, CASES & MATERIALS ON CORPORATE REORGANIZATION (1950).

34. The term "Bankruptcy Act" or "the act" is used to refer to the 1898 Act, while "the code" is used to refer to the legislation which generally became effective October 1, 1979. The act designated numbers of chapters in Roman numerals, e.g., chapter X. The code uses arabic numbers, e.g., chapter 11, and skips even numbers in chapter and section numbers.

## II. FACTORS LEADING TO CORPORATE REORGANIZATION

The causes of financial loss which lead to reorganization are almost infinite in character. Great variations of bad luck and bad judgment are the most common causes of inability to pay business debts as they fall due. One wheat grower suffers crop losses from excess rain which causes the seed to rot. In the same year, wheat growers in another part of the country suffer similar harm from the lack of rain. The loss of a year's crop makes it impossible to repay loans made for seed and cultivation. Financial difficulties also result from increases in the cost of money, oil, or an essential raw material or service. Competition does not allow the debtor to recover the increased costs. An established manufacturer becomes complacent about his substantial market share; because he has been successful with the established product, he has given little attention to research and development. A competitor introduces a new, improved product and takes the lead. Unsuccessful attempts to force the public to purchase the old products deplete the lower amount of revenues until cash becomes perilously low. An air controllers' strike causes an airline to reduce its number of flights and thus its revenues. Bad judgment, including unwise expansion into new areas, as well as bad luck beyond the debtor's control, can cause the financial loss that leads to reorganization.[35] Fraud and breach of trust, though much less common than bad luck or bad judgment, also may cause financial problems.

Whatever the cause of the loss, when the debtor discovers (or some of his creditors conclude for him) that it is impossible for him to meet his contractual obligations, rearrangement of the debtor-creditor relationship is required. Sometimes the debtor or some of his creditors will see no hope except through complete liquidation and discharge of indebtedness for whatever portion of the debt it brings. The debtor or the creditors may initiate a chapter 7 liquidation. To the typical debtor, this is economic death. Any arrangement that continues economic life is preferable not only to the debtor but also to many creditors.

In the absence of resort to relief under the Bankruptcy Code by the debtor or some other creditors, each individual creditor retains the traditional remedies. A creditor may be concerned about his debtor's affairs even though no debt is due him at the moment. The creditor may or may not have a right to accelerate maturity of

35. *See, e.g.*, *In re* Yale Express Sys. Inc., 250 F. Supp. 249 (S.D.N.Y.), *rev'd*, 370 F.2d 433 (2d Cir. 1966).

future payments. In the typical installment loan or purchase agreement, when a debtor is unable to pay one installment of interest or principal on a long-term debt, the creditor has the right to accelerate the maturity of the entire debt. The debtor may be able to repay the debt by selling some of his assets or borrowing from others. Accelerating the maturity of the debt, however, often gives the creditor no comfort since it is unlikely that a debtor who is unable to pay one interest installment will be able to repay the entire debt.

If the obligation is due and is secured by collateral, the secured creditor can seize the collateral and with great good luck, sell it for enough to repay the debt. More often, at a distress sale, the collateral will sell for less than the amount of the debt and much less than its value to the debtor in a continuing operation.

When the debtor defaults in payment of an unsecured debt, the unsecured creditor can obtain judgment, levy an execution on particular assets of the debtor, sell the property, and, with good fortune, receive payment out of the proceeds. This process will not produce the desired results, however, if another creditor already has obtained a security interest in or attached the assets. Needless to say, acceleration of a debt's maturity and the execution process are highly objectionable to the debtor and its employees and may be more than objectionable to the other creditors.

Some other creditors may file a bankruptcy petition to prevent a sale. If bankruptcy should follow, the trustee may recover the asset or payment as a preference. Individual action may be unsatisfactory even to the levying creditor. Thus, either the debtor or the creditors may decide that he or they would prefer a reorganization of some sort—informal, if possible; formal, if necessary.

The success of conventional creditor remedies, including mortgage remedies, may be impaired further by the size or type of the assets. In 1851, in *Macon & Western Railroad Co. v. Parker*,[36] for example, the Georgia Supreme Court recognized that "disastrous consequences would have resulted, if each judgment creditor had been allowed to seize and sell separate portions of the [rail]road, at different sales, in the six different Counties through which it passed, and to different purchasers!"[37] By the end of the nineteenth century, the Supreme Court recognized the inadequacy of conventional debtor-creditor laws in complex situations and, in

36. 9 Ga. 377 (1851).
37. *Id.* at 394.

the absence of any better procedure, blessed the equity receivership.[38] Today, however, even where size is not a complicating factor, the nature of the collateral may make application of conventional liquidation remedies disappointing not only to the debtor, but also to the creditor who brought these remedies into action. Work in process in a textile manufacturing concern, for example, may scarcely be worth the cost of removing it from the machines. The creditor may have a right to liquidate the entity, but often liquidation is not the answer; if, however, the entity can continue to operate, the proceeds from the same collateral, in finished form, may pay off the loan.

A partial rearrangement of the parties' rights and duties often may appear to either debtor, creditors, or both to be a more practical solution to this problem. The forms of rearrangement available are as varied as their causes. A bank or supplier, for example, may simply extend the maturity date of a debt due it, leaving other creditors undisturbed. Another alternative to a formal reorganization is an out-of-court agreement, with all or most of the creditors, to extend the time of payment and possibly reduce the amount of debt. If obtaining consent of every creditor is recognized by the creditors as a near impossibility, the body of creditors may agree to extend the time of payment if a certain high percentage of debt holders—85 percent, for example—will consent. The workout agreement may permit the debtor to pay the remaining 15 percent of its creditors now in cash, or in a shorter time period than it pays the assenters, on time. Since obtaining the agreement of each creditor is often crucial, the success of this out-of-court alternative is often directly related to the number of creditors involved. With a modest number of creditors, obtaining voluntary consent of each creditor may be practical. If, however, there are many parties involved, the debtor, creditors, or both frequently prefer a proceeding under the federal bankruptcy law because they can use the statutory forcing power which, with what generally are mild limitations, permits the statutory majority of a creditor or equity class to bind the nonassenting minority.[39]

In some situations, an otherwise financially healthy debtor may need only temporary relief from creditor harassment. Some

38. *See* Louisville, New Albany & Chicago Ry. v. Louisville Trust Co., 174 U.S. 552 (1899).

39. *See* 11 U.S.C. § 1126(c) (Supp. III 1979); Coogan, Broude & Glatt, *supra* note 27, at 1154. For our use of the term "statutory majority" *see infra* text accompanying notes 146–48.

reorganization specialists consider that the relief from creditor harassment created by the stay is one of the more important aspects of a bankruptcy filing. The casting of an umbrella over the debtor and his assets gives time for voluntary rearrangements. Such relief is created automatically by filing a petition, and it is obtained through a section 362 stay.[40] When possible to obtain it, voluntary restraint on the creditors' part is ideal.[41] The temporary stay or restraint may lead to extending the time of payment.

At the other end of the spectrum, reorganization might involve a merger with a financially stronger entity[42] which may entail a major shift in control of the entity. If the financial difficulty involves only unpaid dividend arrearages, recapitalization or rearrangement of the stock structure may cure the problem. A plan under section 1123 of the Bankruptcy Code might involve one or more of these elements and much more.[43] Thus, a reorganization may be analogous to an individual's recovery from a bad case of flu, a minor operation, or a near fatal illness. The cost of the disaster may be taken in stride by creditors and the debtor alike or it may almost kill the patient-debtor economically, and the best arrangement that can be worked out may be costly to creditors. If economic damage already has occurred, a reorganization may stop further damage, but it seldom can do better than to divide the existing loss between the different classes of holders of claims and interests and to keep the debtor alive with hope for a better day.

## III. Chapters X and XI of the Bankruptcy Act—The Predecessors of New Chapter 11

To understand the new chapter 11 of the Bankruptcy Code, it would be helpful to understand the strengths and weaknesses of its grandparent, the equity receivership, under which most reorganizations were affected during the last half of the nineteenth and first third of the twentieth century.

It is helpful, and perhaps necessary, to understand the elements of the two principal direct predecessors of chapter 11—chapters X and XI of the Bankruptcy Act. These two chapters, which differed drastically between themselves in philosophy and method, became part of the Bankruptcy Act in 1938 when the

40. 11 U.S.C. § 362(a) (Supp. III 1979).

41. Out-of-court compositions or stand-still agreements are not uncommon, particularly in some industries.

42. 11 U.S.C. § 1123(a)(5)(C) (Supp. III 1979).

43. *See generally id.* §1129(b).

Chandler Act became law.[44] Chapter X throughout shows the influence of the staff of the Securities and Exchange Commission (SEC); chapter XI does not. In a way, however, the two chapters were sponsored unofficially by the then fairly recently constituted National Bankruptcy Conference.[45] Each chapter, however, had its own draftsmen and advocates who approached the problem in the light of their different practices.[46]

Partisans of former chapter XI are wont to say that new chapter 11 discards too much of old chapter XI. Some authorities, particularly academic experts, may think that chapter X has been weakened too much. A case can be made for either position. In any event, it is necessary to have some understanding of what these two chapters were like. While a confirmation under section 1129(a) in many ways resembles the confirmation of a plan of arrangement under old chapter XI, parts of old chapter X show themselves even in this section 1129(a) confirmation by consent of each impaired class. Chapter X is more fully revived, though again with modifications, in a confirmation where one class does not consent and the debtor, with or without cooperation of a majority of the other classes, forces it to accept something which the judge finds is the fair equivalent of what they now hold in rights.

### A. *Former Chapter X*

The principal objective of chapter X, when it was drafted in the later 1930's, was to correct the ostensible deficiencies in section 77B[47]—a section which in the earlier 1930's had been created to remedy the real or alleged deficiencies of the federal equity receiv-

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44. *See supra* note 4. For a lucid description of the history of chapters X and XI, see Rostow & Cutler, *Competing Systems of Corporate Reorganization: Chapters X and XI of the Bankruptcy Act*, 48 YALE L.J. 1334 (1939).

45. The National Bankruptcy Conference is an unofficial body composed of practitioners and scholars of debtor-creditor law. The members of the conference occasionally are consulted by appropriate congressional committees. While the members may help in drafting, the committee has the last say.

For example, spokesmen for the National Bankruptcy Conference presented a memorandum recommending that Congress make the bankruptcy courts full-fledged Article III courts after the Supreme Court's decision in Northern Pipeline Constr. Co. v. Marathon Pipe Line Co., 102 S. Ct. 2858 (1982). While the Supreme Court held that Congress had gone too far in giving the bankruptcy courts certain powers reserved to the Article III courts by the Constitution, the Court delayed the effective date of its opinion to allow Congress a chance to remedy the unconstitutional aspects of the Bankruptcy Reform Act of 1978.

46. Rostow & Cutler, *supra* note 44, at 1341.

47. *Id.* at 1338.

ership system.[48] The staff of the Securities and Exchange Commission played a significant role in establishing the philosophy of chapter X.[49] William O. Douglas was an influential participant. The SEC staff was critical of the part which the old management played in equity receiverships. Management usually represented stock interests. The SEC staff was also critical of the part played by the corporation's investment bankers. The staff thought that stockholders had too much influence, while creditors, especially senior creditors, had too little influence in formulating a reorganization plan. It apparently was assumed that bonds were likely to be held largely by holders who were both scattered and unsophisticated, while stocks tended to be held by insiders. Furthermore, the SEC staff thought that the equity receiver, often a former officer of the debtor, would be reluctant to investigate responsibility for the corporation's financial problems since he was once associated with its management. A plan devised by the receiver would likely favor the class the receiver was thought to have represented. Equity receivership law was entirely case law and necessarily left many problems unresolved.

To remedy these and other defects, chapter X was devised as a complete reorganization vehicle. A plan under chapter X could modify all kinds of claims—secured and unsecured, fixed and contingent. Changes in rights of stockholders as well as creditors could be affected to meet the real or imagined management control problem and the necessary shifts of equity ownership. Chapter X relieved management not only of major responsibilities for formulation of the plan, but also for the current operations of the debtor,[50] except that the independent trustee might engage services of some officers. Not only the debtor's management, but also its counsel were replaced by the judge's appointees. The chapter X reorganization process became the responsibility of the federal district judge who would designate a "disinterested" trustee[51] who, in turn, would receive advice from "disinterested" counsel.[52] In keeping with the philosophy of the times, therefore, crucial decisions were shifted away from the then unpopular business managers and entrepreneurs. In short, the trustee had the

48. *Id.*

49. *Id.* at 1335.

50. Chapter X required the appointment of a disinterested trustee when indebtedness was greater than $250,000. FED. R. BANKR. P. 10- 202.

51. Bankruptcy Act of 1938, ch. 575, § 1(156), 52 Stat. 840, 888. For the definition of a disinterested person, see *id.* § 1(158).

52. *Id.* § 1(157).

responsibility of discovering any management wrongdoing, supervising the operations of business, and eventually formulating a plan. The trustee might listen to some creditors, but subject to control by the judge, supervision was his responsibility.[53]

The disinterested trustee, by definition, initially was ignorant of the corporation's affairs and was required, therefore, to learn on the job. Creditors were fearful that too much of this stranger's time would be spent looking for the devil who caused the financial crisis rather than thinking about changes in the firm's production or marketing decisions, its financial structure, or remedies designed to alleviate its financial difficulties. After their investigation of past management's sins, however, much time of the trustee and his counsel was devoted to an involved process of determining the future earnings and, therefore, the present value of the firm. From this determination, these individuals hoped a plan of reorganization would emerge. Only after the judge's tentative approval of the plan could it be submitted to creditors and stockholders for their acceptance or rejection.[54]

Even if holders of two-thirds in amount and number of each class affected by the plan accepted it, under old chapter X, a judge could not confirm a plan until he made an independent determination that the plan was "fair and equitable, and feasible."[55] Finding that the plan was "feasible" required the creation of a capital structure which would not crumble from the weight of its own fixed charges in a future financial storm.[56] Finding a plan fair and equitable usually meant that every holder of a claim or equity interest would have received full compensation in the order of his contract priorities before any member of the class below his class was allowed any participation in the reorganized corporation. Approval of the statutory two-thirds of the class did not excuse the judge from making a fair and equitable finding. The

53. See the monumental Securities and Exchange Commission Report of the Study and Investigation of Protective and Reorganization Committees (1936–1939). Chapter X reflected the New Deal attitude decrying the malefactors of great wealth whose financial machinations brought about the debtor's troubles. Practitioners in the reorganization field generally agree that bad luck, bad judgment—even stupidity—were and are found to be causes of financial disaster much more frequently than a breach of trust. Experienced credit men are likely to think of a moral breakdown of a person who ordinarily is honest as a result, not a cause, of financial trouble.

54. Bankruptcy Act of 1938, ch. 575, § 1(174), 52 Stat. 840, 891. The classic exposition is that of Case v. Los Angeles Lumber Products Co., 308 U.S. 106 (1939). *See infra* notes 57, 118–21 and accompanying text.

55. Bankruptcy Act of 1938, ch. 575, § 1(221)(2), 52 Stat. 840, 897.

56. 5 W. COLLIER, COLLIER ON BANKRUPTCY ¶ 11.07 (15th ed. 1979).

words "fair and equitable" were so interpreted by Justice Douglas, writing for the Court in *Case v. Los Angeles Lumber Products Co.*[57] Two years later, in *Consolidated Rock Products Co. v. DuBois*,[58] the Supreme Court required a valuation of the reorganized corporation based primarily on its probable estimated future earnings in a typical year to make the fair and equitable determination. That earnings estimate was then multiplied by a suitable times earnings multiple to produce an entity valuation.[59]

Until the Supreme Court's ruling in *Ecker v. Western Pacific Railroad Corp.*,[60] it was thought that the two-step entity valuation process of *Consolidated Rock Products* was the only permissible method to fix reorganization value, as distinguished from liquidation value. A present valuation based on estimated future earnings necessarily involves crystal ball gazing into the future, with limited help from past earnings performance and modifications of those earnings hopefully influenced by the debtor's cure from its financial ills, predictable changes in the industry, and changes in the reorganized entity's operations. The desired result was, according to Justice Douglas in *Consolidated Rocks Products*, an educated guess.[61] The valuation was not necessarily a statement of the entity's present earnings or present market value, but rather, what its earnings and values would be should it recover from the trauma of reorganization, perhaps two or three years hence.

Although abstractly this two-step method may have been and still is the best method available, it does have make-believe characteristics.[62] Estimating earnings of a healthy company for several

57. 308 U.S. 106 (1939). It is not easy to trace the history of the "fair and equitable" phrase. The Court cites railroad receivership cases as authority for the meaning of the phrase. Although none of the cited cases used that exact phrase, the Court concluded that "the phrase became a term of art used to indicate that a plan of reorganization fulfilled the necessary standards of fairness." *Id.* at 118.

58. 312 U.S. 510 (1941).

59. *Id.* at 526.

60. 318 U.S. 448 (1942).

61. 312 U.S. at 526.

62. Gardner, *The SEC and Valuation Under Chapter X*, 91 U. PA. L. REV. 440, 451 (1943). Gardner's article can be regarded as the classic exposition of the doctrine at the time it was written.

*See* H.R. REP. No. 595, 95th Cong., 2d Sess. 222, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS at 6181: "As Peter Coogan has aptly noted, such a valuation is usually 'a guess compounded by an estimate.'" The report later notes, "The process, however, is inherently uncertain. Professor Peter Coogan frequently has referred to [the earnings estimate valuation] as 'an estimate compounded by a guess.'" *Id.* at 225, 1978 U.S. CODE CONG. & AD. NEWS at 6184. I frequently have been asked which statement is mine. My reply is that I could have said either, or both, or neither.

years in the future is difficult enough; adding the cost of recovery by a business almost sure to have had losses for perhaps several years back complicates the practice. Under this method, for example, various creditor and equity classes would argue for a result that favored the interests of their class. Senior classes who thought that all or most of the corporate assets belonged to them would argue for low future earnings, a low earnings multiple and, consequently, a low capitalized earnings value. If each senior class were compensated fully by the issuance of securities under the plan, the total entity value produced by the low earnings estimate would thereby be exhausted. The process would result in a capital structure which would allow for little or no participation by junior interests.

In contrast, spokesmen for the junior interests, who hoped to retain some or all of their interest in the reorganized corporation, would present witnesses to support higher earnings estimates or a higher earnings multiple, or both, to justify retention of some or all of the junior interest. Ultimately, the decision as to which earnings estimates and which multiple to use would be made by the judge and not by the interested parties. (The creditors, however, had the last chance since they could accept or reject the plan.) The valuation, and the determination of which classes could participate in the reorganized entity, would follow. An estimate of $1,765,500, for example, gives an illusion of certainty where none could exist. A valuation based on applying a 10% capitalization rate to $17,650,500, for instance, creates the same illusion. The valuation remains, at best, an educated guess, and perhaps an uneducated guess.

The judge's valuation set a ceiling on the amount of securities which the reorganized corporation could issue. The absolute priority rule of chapter X required that each class be compensated fully before any junior class could participate. If the senior class prevailed in establishing its future earnings estimate and/or a low earnings multiple, the absolute priority rule would reduce or eliminate junior interests, beginning with stockholders and continuing in inverse order according to the priority of the different classes of investors. (If one could be certain as to valuation, it would be hard to argue that contract rights of the classes should not be respected.)

The requirement that the judge find the plan to be feasible would prevent an all secured debt structure or, for that matter, an all senior capital structure. To avoid too much debt, senior classes might be given some or all of their compensation in junior securities. It often was necessary, therefore, to downgrade the quality of the securities issued to old prior classes to prevent the capital structure from becoming an economic monstrosity. Since a thousand-dollar par value of common stock is not the equivalent of a thousand-dollar bond, the decrease in the quality demanded an increase in the quantity of a lower grade security to be given to the higher priority class.

This adjustment further reduced what was left for junior classes. Often the reorganization values would have been exhausted before the junior class was reached. The new capital structure must be kept within the feasibility aspect of the "fair, equitable and feasible" requirement.[63] If, for example, earnings prospects did not justify participation by holders of common stock but did justify participation by the holders of preferred stock, the latter class probably would get most of the new common stock. The valuation process could continue so long that a sick entity could not survive. Practitioners in the reorganization area had serious doubts that a valuation reached by this process necessarily produced a more satisfactory result than that which would have been reached if the interested classes had negotiated a settlement as businessmen normally determine values when they buy or sell a business.

For good reasons or bad, neither creditors nor debtors made great use of chapter X. The Commission on the Bankruptcy Laws of the United States observed in its 1973 Report "that Chapter XI has evolved into the dominant reorganization vehicle."[64] The draftsmen of chapter 11 were influenced, no doubt, by the preference of the market for the simpler, if theoretically less accurate, procedures of chapter XI.

### B. *Former Chapter XI*

While chapter X was being drafted by one group of members of the National Bankruptcy Conference (largely reflecting the practice under the old equity receivership and section 77B as well

63. *See, e.g.*, Group of Institutional Investors v. Chicago, Milwaukee, St. Paul & Pac. R.R., 318 U.S. 523 (1943). The phrase used in § 1(221) of the act was "fair and equitable and feasible." In the code, the two concepts are separated: "fair and equitable" appears in § 1129(b)(1) and is applicable only when a plan is forced on a rejecting class. The "feasibility" test, under § 1129(a)(11) applies to every confirmation.

64. H.R. Doc. No. 137, 93d Cong., 1st Sess. pt. 1, at 246 (1973). *See infra* note 71 for statistics proving the preference for chapter XI filing.

as the influence of Justice Douglas and the SEC staff),[65] another group of members, whose experience and outlook were quite different, drafted a dissimilar piece of legislation—chapter XI. This latter group of draftsmen typically represented trade creditors or their small and medium sized debtors. These lawyers were familiar, therefore, with common law compositions and Sections 12 and 74 of the Bankruptcy Act.[66] The draftsmen of Chaper XI did not purport to cover the entire corporate reorganization area. Not every kind of debt was affected—some kinds of debt were not dischargeable. Chapter XI made no provision for altering secured claims or equity interests. Who would decide whether the debtor's plan was satisfactory better than the parties concerned? Since each secured party was likely to be in a class by himself, approval by a majority in amount and number often was not meaningful.

Draftsmen with a background of nonstatutory or statutory workouts could not be expected to be enthusiastic about at least two features which became part of chapter X. The first feature was the appointment of a disinterested trustee to operate the business. This arrangement, for example, made no sense for a small to medium sized retail entity—a "mom and pop" store, more common in the late 1930's than now. Creditors depended on the relationships between management and its customers for continuing operations, and without continued operations, the debtor could not pay. Replacement of management often would end the business. Who other than an owner, hoping to revive the business, would "keep store" nights and Sundays? There was also probably no money to pay for an independent trustee, even if the old customers would accept one.

Another feature which must have been objectionable to the draftsmen of chapter XI was the stipulation that the stockholders could retain their equity interest only if the creditors first were compensated fully. In many rearrangements, some class of creditors, and sometimes every class, will be less than fully compensated. If a class with payment due now is to be paid in the future, some rights are taken away from the class, and under chapter X, this loss would require compensation at the expense of the stockholder. This requirment of chapter X—that each creditor be compensated fully before shareholders could participate in the reorganized entity—often would have entailed the transfer of part,

65. *See supra* notes 44–50 and accompanying text.

66. *See supra* note 33.

and sometimes all, of the stockholders' equity interest to the creditors. Was it realistic for creditors to expect the debtor to pull the entity out of its financial hole for the prime benefit of his creditors and retain little or no equity for himself? Trade creditors were generally philosophical about giving up something to the debtor. Without owner-management, there was no equity for the creditors to take over. And if, as was not too infrequent, the situation was such that the creditors were entitled to a share of the equity in return for the sacrifices which they were asked to make, who could decide better than the parties themselves what the division would be? Creditors could refuse to vote for a plan which did not compensate them for their sacrifice.

The chapter XI draftsmen began, therefore, with quite different premises than did the chapter X draftsmen. Under the draftsmen's "plan of arrangement,"[67] the debtor remained in control of the enterprise, management was not ousted, and a trustee was not appointed. The debtor began with the assumption that he could retain all or much of his equity; he entered into a composition, which if approved by a majority of unsecured creditors, would either reduce the amount of unsecured debt or postpone the time of payment, or both. The share of equity ownership to be transferred to the creditors was a bargaining point between the debtor and his creditors. If a majority in amount and number of unsecured creditors approved an arrangement, regardless of whether the creditors were compensated fully, the judge would have been required to confirm the arrangement if satisfied as to two major conditions: the arrangement had to be both feasible and "in the best interest of creditors." Basically, the test largely meant that the creditors had to receive at least as much as they would have received if the enterprise had been liquidated.[68]

After the enactment of chapters X and XI, the commentators rated chapter X as the fair-haired child and chapter XI as the poor stepsister.[69] If, however, the value of an idea is determined by its acceptance or rejection in the marketplace,[70] then these early commentators were wrong. After all, the statistics prove that chapter

67. Bankruptcy Act of 1938, ch. 575, § 1(306), 52 Stat. 840, 906.

68. *Id.* § 1(366), 52 Stat. at 911. This specific language read, "it [the arrangement] is for the best interests of the creditors. . . ." *Id.* That language has been interpreted, when compared with the former § 12(d), to mean that a plan which paid creditors less than they might expect to receive in liquidation, was a plan not in the best interests of the creditors. 9 W. COLLIER, *supra* note 56, ¶ 9.17.

69. *See* Rostow & Cutler, *supra* note 45, at 1334.

70. Abrams v. United States, 250 U.S. 616, 630 (1919) (Holmes, J., dissenting).

XI has been the predominant vehicle for corporate reorganization for several decades.[71] Chapter XI's relative simplicity and creditor-debtor direct bargaining may explain its popularity with both creditors and debtors.[72] The time-consuming adversary process was considerably shortened and often eliminated under chapter XI. In contrast, the complex procedures of chapter X, almost necessitating the adversary process, deterred both debtors and creditors because its mechanics consumed too much of the time that was critical to the life of the corporation.[73] Even a good plan may fail if its help is delayed too long.

The necessity for the appointment of a trustee in almost all chapter X cases and its absence in chapter XI[74] further increased the desirability of chapter XI. It is too much to expect that corporate executives and directors would rush to file under chapter X where filing almost certainly would result in their replacement by a trustee not of their choosing. Except in rare cases, the corporate

71. The number of bankruptcy filings under chapter XI and X are as follows:

| YEAR | CHAPTER XI FILINGS | CHAPTER X FILINGS |
|---|---|---|
| 1940 | 990 | 320 |
| 1950 | 583 | 134 |
| 1960 | 622 | 90 |
| 1970 | 1,262 | 115 |
| 1973 | 1,458 | 101 |
| 1974 | 2,171 | 163 |
| 1975 | 3,506 | 189 |
| 1976 | 3,235 | 141 |
| 1977 | 3,046 | 96 |
| 1978 | 3,266 | 75 |
| 1979 | 3,042 | 63 |

*See*, U.S. DEP'T OF COMMERCE, BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES 539 (102d ed. 1981).

*See also* ADMINISTRATIVE OFFICE OF THE UNITED STATES COURTS, TABLES OF BANKRUPTCY STATISTICS, published annually.

72. Unsecured creditors under chapter XI could choose to demand stock participation as compensation for decreases in amount or deferral of the time of payment. If creditors demanded participation and the debtor refused, the creditors could reject the plan. This type of leverage frequently gave creditors some stock interest in return for accepting a plan which altered their rights. As for secured creditors and stockholders, there was no provision for the alteration of their rights. Changes in capital stock structure were made under state corporation law. Changes in secured claims and stock interests, therefore, frequently were made by contract between the debtor and each secured creditor. *See, e.g.*, S. REP. No. 989, 95th Cong., 2d Sess. 1, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5787.

73. "The primary problem posed by Chapter X is delay. . . . Over and over again, it is demonstrated that corporations which must avail themselves of the provisions of the Bankruptcy Act suffer appreciable deterioration if they are caught in a Chapter X proceeding for any substantial period of time." 124 CONG. REC. S 17,418 (daily ed. Oct. 6, 1978) (remarks of Sen. DeConcini).

74. *See* Bankruptcy Act of 1938, ch. 575, § 1(156), 52 Stat. 840, 888. *See also id.* ch. 575, § 1(44), 52 Stat. at 860; H.R. 8046, 75th Cong., 3d Sess. (1938).

officials would rather retain control of the debtor's business and the reorganization plan, as provided in chapter XI, than be replaced by a disinterested trustee whose identity, to say nothing of his qualifications, could not be known until it was too late for the executives and directors to change their choice of remedy. Similarly, creditors seemingly preferred to negotiate with interested parties directly instead of entrusting their fate to an unknown trustee. Creditors also might have preferred to negotiate directly with equity owners for an interest in the new entity, rather than leaving it to the judge to determine, under a fair and equitable analysis of the plan, that junior classes should or should not be allowed to continue to participate in the enterprise.[75]

Chapter XI, however, had serious shortcomings, particularly when used for cases for which it was not designed—the debtor with substantial assets and many security holders. Chapter XI had no provisions by which a minority of any class other than unsecured creditors could be bound by a majority and no provisions to bind a class which had not accepted the plan; furthermore, certain debts were not dischargeable. The terms of secured debt could be changed only by contract with each holder. Chapter XI gave no power to alter rights of shareholders.

These defects prompted the National Bankruptcy Conference to appoint a committee in the early 1960's to determine whether changes should be made in chapters X and XI. I was a member and acted as secretary of that committee. The committee discussed the need for a more structured reorganization scheme for what were called "middle size" entities than the one available in chapter XI but a less structured scheme than that of chapter X. Soon dubbed the "Chapter X 1/2 Committee," the members considered whether these changes should be made by tightening chapter XI's provisions, loosening chapter X's provisions, or creating a new chapter. Before the issue was resolved, however, the matter was removed in effect from the jurisdiction of the committee with the appointment of a congressional commission to study the bankruptcy laws.[76] In 1972, that commission recommended a change in reorganization law and prepared a draft which served

75. Bankruptcy Act of 1938, ch. 575, § 1(174), 52 Stat. 840, 891. "[T]he judge shall enter an order approving the plan or plans which in his opinion . . . are fair and equitable, and feasible, and shall fix a time within which the creditors and stockholders affected may accept the same." *Id.*

76. Act of July 24, 1970, Pub. L. No. 91-354, 84 Stat. 468 established the Commission on the Bankruptcy Laws of the United States.

as a starting point for what became part of the Bankruptcy Code about six years later.[77]

## IV. CHAPTER 11: PRINCIPLE CHANGES IN REORGANIZATION

Today, reorganization of almost any business, regardless of size, can be conducted under chapter 11 if the entity is not entirely excluded from any form of relief under the Bankruptcy Code. Since financial institutions, such as banks, savings and loan associations, and insurance companies cannot be debtors under chapter 7, they also are excluded under chapter 11.[78] State law generally provides for liquidation of these financial institutions. Although interstate railroads are excluded from chapter 7 liquidations, these corporations can be dealt with under a separate subchapter of chapter 11 (to which only this passing reference is made in this Article).[79] Contrariwise, the liquidation of stock and commodity brokers is provided for in subchapters III and IV of chapter 7, but they are excluded from a chapter 11 reorganization or liquidation. Apparently, Congress was convinced that financial failure of a broker destroyed that which reorganization is intended to save—going concern value.[80]

A review of some of the principal changes in the law will illustrate how chapter 11 follows parts of chapters X, where it follows chapter XI, and where it breaks new ground. Unlike old chapters X and XI, the relief available under new chapter 11 generally is not influenced by the character of the debtor unless it is in a class entirely excluded from the Bankruptcy Code. While only a corporation could be a debtor under chapter X,[81] a chapter 11 petition may be filed by or against an individual, partnership, corporation, or almost any other entity.[82] Almost any person who qualifies for a chapter 7 liquidation can become a debtor under chapter 11.[83]

Another principal change resulting from chapter 11's enact-

77. For information regarding the commission's recommendations and rationales, see H.R. DOC. No. 137, 93rd Cong., 1st Sess. pt. 1, *supra* note 64. *See also* W. COLLIER, *supra* note 56, ¶ 1100.01[1], [2]; S. REP. No. 989, 95th Cong., 2d Sess. 1, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5787.

78. 11 U.S.C. § 109(b), (d) (Supp. III 1979).

79. *Id.* §§ 1161–1174.

80. *See id.* §§ 741–752.

81. Bankruptcy Act of 1938, ch. 575, § 1(106)(5), 52 Stat. 840, 883.

82. 11 U.S.C. § 109(b), (d) (Supp. III 1979).

83. *Id.* § 109(a) provides: "Notwithstanding any other provision of this section, only a person that resides in the United States, or has a domicile, a place of business, or property in the United States, or a municipality, may be a debtor under this title." *Id.* § 109(d), relating to chapter 11, provides: "Only a person that may be a debtor under chapter 7 of

ment concerns the nature of the debt, including limits on its dischargeability. In this area, chapter 11 is patterned after chapter X rather than chapter XI. While chapter XI could affect only unsecured debt and contained limits on dischargeability,[84] chapter X could affect any type of debt or equity interest.[85] For this reason, a debtor sometimes chose chapter X primarily to receive the benefits of greater dischargeability.[86]

Under chapter 11, however, debt and equity interests may be altered and all debts may be discharged except those listed in section 1141[87] or in the actual plan. Failure to file a claim, therefore, does not prevent discharge.[88]

New chapter 11 also follows in the footsteps of chapter X regarding who may file a petition for relief. Chapter 11, somewhat like chapter X, allows either the debtor or the debtor's creditors (ordinarily three or more) to file a petition for relief.[89] Only the debtor, however, has a period of exclusivity.[90] In contrast, chapter XI permitted voluntary filings by the debtor and permitted no filings by the creditors.[91] Thus, there were situations under the act where the creditors, who would have preferred another plan under chapter XI, had to choose among the available alternatives: they could convince the debtor that he should change the plan; they could file for an involuntary liquidation under the act; they could make (as to a corporation only) an involuntary filing under chapter X; they could convince enough unsecured creditors to reject the plan; or they could simply let the debtor drift. Often, none of these alternatives were satisfactory.

Chapter 11 also varies from its predecessors with respect to the

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this title, except a stockholder or a commodity broker, and a railroad may be a debtor under chapter 11 of this title."

84. *See* 5 W. COLLIER, *supra* note 56, ¶ 1100.01[1].

85. *Id.*

86. *Id.* ¶ 1141.01[1].

87. 11 U.S.C. § 1141(a)(2), (3) (Supp. III 1979). Section 1141(a)(2) provides that the confirmation of a plan does not discharge an individual debtor from any debt excepted from discharge under § 523. Section 1141(a)(3) states:

> The confirmation of a plan does not discharge a debtor if—(A) the plan provides for the liquidation of all or substantially all the property of the estate; (B) the debtor does not engage in business after the consummation of the plan; and (C) the debtor would be denied a discharge under section 727(a) of this title if the case were a case under chapter 7 of this title.

88. 5 W. COLLIER, *supra* note 56, ¶ 1141.01[4].

89. 11 U.S.C. §§ 301, 303(a), (b), 1121 (Supp. III 1979).

90. *Id.* § 1121(b). Only the debtor may file a plan until 120 days after the date of the order for relief.

91. *See supra* note 84.

appointment of a trustee.[92] Under chapter X of the Bankruptcy Act, the appointment of a disinterested trustee was mandatory for any case of significant size.[93] This trustee operated the business and was responsible for the formulation of a plan. Under chapter XI, however, the debtor was the only person who could file a plan and ordinarily he was left in possession; occasionally, a receiver was appointed.[94] Under new chapter 11, as was true under old chapter XI, the debtor is ordinarily left in possession.[95] A trustee's appointment occurs only at the request of a "party in interest," and only where there has been fraud, incompetence, or like cause; or, where such appointment is "in the interest of creditors or equity holders."[96] Under section 1106, an examiner may be appointed to perform the investigatory function similar to that of a chapter X trustee.

It is fair to assume that the parties in interest usually will not request a trustee under chapter 11. Their preference for a debtor in possession is indicated by their preference for chapter 11. Thus, in this regard, chapter 11 more closely parallels chapter XI. And, in the case where a trustee is appointed at the request of a party, the appointment may be terminated, restoring the debtor to possession.[97]

The administrative role of the judge in what is expected to be the normal chapter 11 case—one in which confirmation of a plan is based on approval of the statutory majority of each impaired class—may be limited indeed. The judge appoints a creditor's committee at an early stage; he need only satisfy himself on a limited number of points before confirmation. In any case where the parties fail to agree, a party in interest may ask the judge to decide any number of issues. Where acceptance by a majority of each class cannot be obtained, the role of the judge is increased, but even then his responsibility with respect to the accepting classes is limited.

The SEC's role also has been reduced under the new chapter 11. The judge in a chapter X proceeding could request the SEC to

92. *See* 11 U.S.C. § 1104 (Supp. III 1979).

93. FED. R. BANKR. P. 10-202. This rule raised the statutory amount in regard to trustee appointment to $250,000; few chapter X cases involved less than this amount.

94. Rothchild, *Liability Incurred by a Receiver or Trustee in Bankruptcy Conducting a Business*, 15 HASTINGS L.J. 520, 521 (1964).

95. *See* 11 U.S.C. §§ 1104-1108 (Supp. III 1979).

96. *Id.* § 1104(a).

97. *Id.* § 1105.

report on any plan submitted by the court.[98] These reports, which were frequently exhaustive, served as guidance for the trustee and judge. A comprehensive report by persons theretofore unfamiliar with the case, however, took precious time. Further, the report was one more act which removed the solution from the direct responsibility of the parties concerned. Under chapter 11, the SEC is not responsible for making such reports to the judge. The SEC may be heard on any issue, however, but it is denied the right to appeal.[99]

The new chapter 11 accords the debtor or creditors the right to convert a chapter 11 reorganization into a chapter 7 liquidation.[100] The debtor's power is subject to limitations; he can convert only if he is a debtor in possession.[101] If an involuntary petition is filed by creditors under chapter 11, or they convert their chapter 7 proceeding to a chapter 11 proceeding, the debtor has no power to convert to chapter 7.[102] Either the debtor or the creditors, however, may move to transfer from a chapter 7 proceeding to a proceeding under chapter 11.[103]

In situations where the debtor is not in possession and initially could have been subjected to an involuntary chapter 7 liquidation, creditors may request the court either to convert a chapter 11 reorganization into a chapter 7 liquidation or dismiss the case.[104] Section 1112(b) enumerates the reasons for dismissal which include the unlikelihood of any reorganization being accomplished, continued loss to the estate, and undue delay in effectuating a plan.[105]

Under chapter X, the trustee initially had the duty of formulating a plan, though others could make suggestions.[106] Eventually, a creditor could file his own plan.[107] Under chapter XI, however, only the debtor could file a plan. Creditors could influence the debtor's plan by making it plain to the debtor that a plan with certain features would not obtain the necessary majority vote for

98. FED. R. BANKR. P. 10–303(b).

99. 11 U.S.C. § 1109(a) (Supp. III 1979).

100. *Id.* § 1112(a).

101. *Id.* § 1112(a)(1).

102. *Id.* § 1112(a)(2), (3).

103. *See id.* §§ 1112(a)-(b), 706. Under § 1112(a), the debtor may convert unless the debtor does not have possession, the case is an involuntary case originally commenced under chapter 11, or the case was converted previously to a chapter 11 case by someone other than a debtor. *Id.*

104. *Id.*

105. *Id.* § 1112(b).

106. FED. R. BANKR. P. 10–301.

107. *Id.*

confirmation, but the debtor had the sole right to present a plan of arrangement.

There are other ways in which chapter 11 follows and modifies parts of chapter XI, and sometimes, chapter X. Under section 1121,[108] the debtor has an exclusive right to file a plan, but unlike his perpetual exclusivity under chapter XI, this right exists only for a limited period of time. If a trustee has not been appointed, the debtor has the exclusive right to file a plan within 120 days of the relief order.[109] If the debtor files a plan within the 120-day period, another 60 days remain to obtain acceptances.[110]

The judge may extend or shorten the 120-day or 180-day periods at the request of a party in interest after notice and hearing.[111] In a situation where the debtor does not meet the 120- day or 180-day limit or where a trustee has been appointed, a party in interest (including creditors, the trustee, the debtor, and the security holders' committee) may file a plan.

Under chapter XI, only the debtor could file a plan of arrangement. Since a plan under chapter XI could "affect" only unsecured claims, secured creditors had no vote; any secured creditor could agree or not agree as to a change in his rights but not the rights of his class (if there were other members). Under the code, a statutory majority may control any class, secured or unsecured creditors, or equity owners, if each other class is somehow to be bound, subject to compliance with certain general provisions of chapter 11. Assuming, for simplicity, one class of unsecured claims, the chapter XI plan could be approved under former section 362(1) by holders of a majority in number and amount of unsecured claims.

Under chapter 11, secured creditors and equity holders also can be impaired, and if so, they also would vote. Instead of a majority in number and amount, chapter 11, in section 1129(a)(8), requires a "statutory majority" (as herein defined) of each class for approval. Sections 1126(c) and (d) require holders of two-thirds in amount and more than half in number[112] (except that for equity interests the numbers test does not apply). At least one class of claims must accept under section 1129(a)(10).[113] The plan

108. 11 U.S.C. § 1121 (Supp. III 1979).

109. *Id.*

110. *Id.*

111. *Id.* § 1121(d).

112. *See infra* notes 146-47 and accompanying text.

113. *See infra* note 174 and accompanying text.

proponent under new chapter 11 has a higher hurdle to jump to obtain confirmation through class acceptance, and contrariwise, an opposing group can more readily prevent approval. A nonassenter may defeat the plan if he can prevent the proponent from obtaining the required two-thirds in amount or more than one half in number vote. Unlike a creditor under chapter XI, any holder of a claim or interest under chapter 11 can file his own plan (after a period of exclusivity for the debtor) and can have the plan approved over the debtor's opposition if he can muster the needed statutory majority.[114] The debtor or other plan proponent who has failed to obtain the requisite majority may be able, under the fairly stringent provisions of section 1129(b), to obtain confirmation if the judge can make certain findings.

Whether on balance, chapter 11 favors the debtor or creditors is not readily answered. The change made by section 1121, which allows a creditor to file a plan in addition to the creditors' right to file a section 303(b) petition,[115] supports those who claim that new chapter 11 removes some of the debtor's previous advantages under old chapter XI.[116] On the other hand, these changes mollified creditors who charged that old chapter XI unduly favored the debtor since it gives the debtor the sole right to file a petition and a plan.[117]

Chapter 11's most significant aspect is the provision contained within section 1129(a) which reduces the role of the judge in the proceeding where the statutory majority of each impaired class approves under section 1129(a)(8). This provision is not in keeping with the standards of chapter X. It is more like chapter XI which did not require a judge to determine whether the plan is fair and equitable as to a member of any class when the statutory majority of each unsecured class had consented to the plan.

Chapter 11 almost reversed *Case v. Los Angeles Lumber Products Co.*,[118] a landmark decision which held that chapter X's predecessor, section 77B, imposed a two-fold requirement on the

114. 11 U.S.C. §§ 1126(c), 1121(c) (Supp. III 1979).

115. *Id.* § 303(b).

116. *See generally* Moller & Foltz, *Chapter 11 of the 1978 Bankruptcy Code*, 58 N.C.L. Rev. 881 (1980). As to an earlier bill, see Weintraub & Crames, *Critique of Chapter VII and Related Sections of the Proposed Bankruptcy Act of 1973*, 48 Am. Bankr. L.J. 1 (1974).

117. *See* Brudney, *The Bankruptcy Commission's Proposed "Modifications" of the Absolute Priority Rule*, 48 Am. Bankr. L.J. 305 (1974). Many changes were made in the sections discussed after Professor Brudney's article was written. *See* 11 U.S.C. § 1129(b) (Supp. III 1979).

118. 308 U.S. 106 (1939).

confirmation of a plan: First, the plan must be approved by the requisite majority; and second, the judge must find independently that the plan was "fair and equitable, and feasible."[119] *Case*, however, was not reversed completely; the fair and equitable requirement survives in section 1129(b), but that situation applies only where consent of at least one impaired class has not been obtained. The feasible requirement survives as to every plan in section 1129(a)(11).

The *Case* doctrine survives only as to the dissenting class. Section 1129(a) of chapter 11, however, requires compliance only with the first test of *Case*—acceptance by the statutory majority of each class whose rights have been impaired.[120] In addition to finding that this requirement has been met, the judge must find that the plan is feasible—another test of that case. Under section 1129(a)(11), the judge must find that the plan is "feasible," as therein defined. This last requirement is aimed at insuring that the contemplated reorganization cures the debtor's problems—that the debtor will not be back for further relief in the foreseeable future.[121]

If, however, the plan proponent cannot meet the test of 1129(a)(8) and a party asks the judge to confirm under section 1129(b)(2), other aspects of *Case* return to life, but in a limited manner— only as to reach rejecting class. As to that class, the judge must be satisfied that the plan is fair and equitable under the revised standards of 1129(b).

Next, we discuss confirmation under section 1129(a)(8)—through consent of the majority of each impaired class. Keep in mind the possibility that under section 1129(b), a plan proponent may be able to have a plan confirmed even if it does not receive the approval of a majority of each class. Under that section, a rejecting class can, subject to stringent provisions to

119. *Id.* at 114. This case involved a nonassenting minority member of a senior class of bondholders which had accepted the plan by an overwhelming majority. This plan gave the senior class stock with a par value equal to approximately one-fourth of the bonded debt and also allowed the stockholders to receive twenty-three percent of the new equity. The Court stated that the district court was in error in having approved a plan which allowed equity interests to retain an interest based on "appraisals and audits," while a senior claimant had not been compensated in full. *Id.* That plan failed the fair and equitable test of § 77B and, inferentially, it would have failed the test under its successor, chapter X. *Id. See supra* notes 55–63 and accompanying text.

120. We here limit our discussion of confirmation requirements to those associated with *Case*.

121. *See infra* text accompanying note 176 for the exact language of section 1129(a)(11).

protect the nonaccepting class, be forced to accept a plan.[122] This latter alternative may prove to be more onerous to the plan proponent than to the dissenting class.

There is also a possibility, under one interpretation of sections 1124 and 1126(f), that a plan might be confirmed without the consent of each class because a class is unimpaired, or is treated under section 1124 as though it were unimpaired, and, under section 1126(f), is "deemed to have accepted" (in effect rendered incapable of rejecting).[123] That interpretation is rejected by several cases.[124] There are also the further questions whether the requirement of section 1129(a)(10) for acceptance of a plan by at least one class would be satisfied by a class which is "deemed to have accepted" under section 1126(f),[125] and whether a "deemed" acceptance by a class excuses a vote by that class under section 1129(a)(8)(B).[126]

## V. Section 1129(a)—Confirmation of a Plan Obtained Through the Consent of Each Class

Chapter 11, like its predecessors, recognizes that one class may

122. This type of forced acceptance, in which the plan is confirmed under § 1129(b) over the objections of one or more classes, is often called a cramdown. Confirmation under subsection (b) may be difficult. *But see infra* note 132. Section 1129(b) requires that a plan comply with "certain standards of fairness to dissenting creditors or equity security owners." H.R. Rep. No. 595, 95th Cong., 2d Sess. 413, *reprinted in* 1978 U.S. Code Cong. & Ad. News 5963, 6369.

123. Section 1124 indicates that the contractual rights of a creditor or interest holder are unimpaired in certain circumstances therein set forth when they are not materially affected. A class, however, may feel that its rights were impaired even if § 1124 deems it not to be impaired. For some difficulties in interpreting § 1124, see *infra* notes 152–62 and accompanying text. Can a recalcitrant creditor be in effect crammed down because he is deemed unimpaired in a confirmation under § 1129(a) rather than under § 1129(b)? *See infra* 336 *passim*.

124. *See, e.g.*, *In re* Barrington Oaks Gen. Partnership, 15 Bankr. 952 (D. Utah 1981); *In re* Marston Enterprises, Inc., 13 Bankr. 1403 (E.D.N.Y. 1981) (section 1129(a)(10) requires that one class of impaired claims must actively accept the plan). *But cf. In re* Bel Air Assocs., Ltd., 4 Bankr. 168 (W.D. Okla. 1980) (an unimpaired class counts under § 1129(a)(10); the unimpaired creditor has not affirmatively rejected the plan); *see also In re* Landau Boat Co., 13 Bankr. 788 (W.D. Mo. 1981) (followed *Bel Air*). The abbreviation Bankr. refers to the West Bankruptcy Reporter 1979 to date, sometimes cited B.R.

Cramdown cases under chapter X have been rare. Much of the law has developed within the last decade under § 416(11) of chapter XII. *Compare* Comment, *Bankruptcy Reform Act of 1978: Chapter 13 Cramdown of the Secured Creditor*, 1981 Wis. L. Rev. 333. While a chapter 13 cramdown is not the same as under chapter 11, and in fact, a cramdown under old chapter XII was not the same as one under chapter X, the chapter 13 discussion is relevant.

125. *See infra* note 174 and accompanying text.

126. *See infra* notes 136 & 150 and accompanying text.

be entitled to more benefits under the plan than another class. One class may be secured by collateral which insures full or partial payment and can thereby retain its secured position. Another class may be accorded priority under section 507[127] and thus receive special treatment under section 1129(a)(9) on confirmation of a plan. Under section 506(a),[128] a secured creditor has a secured claim, but only to the extent of the collateral's value; any debt in excess of that value is an unsecured claim.[129] By contrast, one class of secured or unsecured creditors may have subordinated its right by contract to certain others in favor of another class.[130] Equity interests also may be in different classes—preferred is prior to common, and one preferred or common class could be ahead of another.

### A. *Section 1122—Classifying Claims*

An analysis of the confirmation of a plan properly begins with section 1122 of the code which concerns classifying claims. This provision states:

> Except as provided in subsection (b) . . . a plan may place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class.
>
> (b) A plan may designate a separate class of claims consisting only of every unsecured claim that is less than or reduced to an amount that the court approves as reasonable and necessary for administrative convenience.[131]

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127. 11 U.S.C. § 507 (Supp. III 1979) addresses the priority given to classes of unsecured creditors to receive their share of the "property of the estate." The available amount is subject to several qualifications. *See infra* note 130.

128. 11 U.S.C. § 506(a) (Supp. III 1979).

129. Section 506(a) may involve either a creditor's lien on the debtor's property or the creditor's right to offset a "mutual debt" owing by the creditor to the debtor. The section states in pertinent part:

> 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, or to the extent of the amount subject to setoff. . . and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to setoff is less than the amount of such allowed claim.

*Id.*

130. *Id.* § 510. "A subordinate agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law." *Id.*

131. *Id.* § 1122. The phrase "substantially similar" means "similar in legal character or effect as a claim against the debtor's assets or as an interest in the debtor." 5 W. COLLIER, *supra* note 56, ¶ 1122.03. It should be noted that § 506(a) of the code sharpens the distinction between secured and unsecured claims. Classification under this section is by the nature of the claim rather than the character of the creditors. A secured class, for example,

Under section 1122(a), determining when a claim or interest is "substantially similar" to others under subsection (a) is a major and strategically important task.[132] The extent of the plan proponent's ability to separate or combine certain claims to increase the chance of obtaining class acceptances is not clear from the statute. The Preliminary Draft of Proposed New Bankruptcy Rule 3013 makes it clear there must be a hearing before the court's determination of the classes.[133] A class could be a single holder whose claim or interest differs from others. It is often easy to determine when a claim is "substantially similar" to other claims. When, for example, one thousand persons hold bonds of the same series, which are issued under the same indenture and which have the same covenants and maturities, then each of these secured claims is clearly like the others in the class.[134] Each member of this class is substantially similar to another but dissimilar to two thousand persons who hold debentures which are unsecured or which are governed by and secured under a different indenture.

Under section 1122(b), the plan proponent under the act possesses some flexibility in classification. That section permits the proponent to dispose of numerous small claims which otherwise might be separate classes or fit into different classes. There may be thousands of small claims against a debtor which, in the aggregate, are insignificant compared to the total claims. A plan proponent may offer a higher percentage of the total claim to the aggregate class of small claimants than he would offer to the large claimants, merely to reduce administrative handling. Mr. X, for example, has a claim of $1,321. As a general unsecured creditor, the plan will offer him ten percent of this debt in cash and certain deferred payments, or stock. Under section 1122(b), however, the

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may hold a secured claim up to the value of its collateral and an unsecured claim for any amount by which its total debt is in excess of its secured debt—its deficiency claim.

132. *See* J.P. Morgan & Co. v. Missouri Pac. R.R., 85 F.2d 351, 352 (8th Cir. 1936); Pachulski, *The Cram Down and Valuation Under Chapter 11 of the Bankruptcy Code*, 58 N.C.L. Rev. 925, 930 (1980). The classification of creditors should not depend on the claimant's nature or his particular bias or experience; rather, it should depend on the nature of the claim. *In re* Los Angeles Land & Invs., Ltd., 282 F. Supp. 448 (D. Hawaii 1968). A conflicting interest of a member of a class might result in exclusion of his vote under the good faith test of § 1126(e).

133. Pre-Bankruptcy Code cases on classification are not necessarily controlling—section 1122 has its own language. The new Bankruptcy Rules, in preliminary form distributed for comments in March, 1982, do not add much to the statute.

134. *See, e.g.,* Schirk v. Newton (*In re* Rocky Mountain Fuel Co.), 152 F.2d 747 (10th Cir. 1945) (all creditors of equal rank with claims against the same property should be placed in the same class).

plan might offer Mr. X the opportunity to reduce his claim to $1,000 and be paid seventy percent of that amount on confirmation. Mr. X accepts and receives $700 in cash. A plan proponent, therefore, may decrease the number of potential holders who will reject the plan by paying to creditors with relatively small claims more cash or paying them within a shorter time. To obtain confirmation under section 1129(a), classifications of the plan must comply with the applicable provisions of section 1122.

### B. *Section 1129—The Importance of the "Class" in a Plan Confirmation*

The concept of a class of holders of claims or interests is important primarily in the confirmation of a plan under section 1129. Under section 1129(a)(8), the judge must confirm a plan if it is accepted by the statutory majority of each class,[135] and he is satisfied that the plan and action of the parties in interest generally conforms to some fairly mild provisions of the Bankruptcy Code.[136] This process is more nearly comparable to, but not the same as, the corresponding practice under old chapter XI and is a significant departure from that under old chapter X, under which consent of the classes was meaningless unless, in addition, the judge found the plan to be "fair and equitable, and feasible."

### C. *Soliciting Acceptance of the Plan—The Disclosure Statement and Pre-Petition Acceptances*

A primary concern of the judge will be the disclosure provisions of sections 1125 and 1126. Pursuant to section 1125, the judge determines, prior to post-petition solicitation, whether the holders of claims and interests will have received adequate information before they accept or reject. Under section 1126(b), the judge must determine whether pre-petition acceptances can be counted. Since acceptance of the plan by the class is largely determinative, the vote must be made on meaningful data.

For a post-petition solicitation, each member of the class must receive "adequate information" before the vote which conforms to section 1125(a)(l) which reads:

> "[A]dequate information" means information of a kind, and in sufficient detail, as far as is reasonably practicable in light of

135. 11 U.S.C. § 1129(a) (Supp. III 1979). For a description of the term "statutory majority," see *infra* text accompanying notes 146–48.

136. 11 U.S.C. § 1129(a)(8)(B) (Supp. III 1979).

> the nature and history of the debtor and the condition of the debtor's books and records, that would enable a hypothetical reasonable investor typical of holders of claims or interest of the relevant class to make an informed judgment about the plan.

The material, however, need not include any information about any other proposed plans.

In section 1125(a)(l), chapter 11 recognizes the facts of life in a distress situation. The debtor's books may be almost unintelligible during a period of turmoil preceding a filing. The services of an outside accountant may have been discontinued for lack of money to pay him, or for less creditable reasons. A debtor in trouble may take liberties with accounting rules and prefer to avoid the "interference" of outside accountants.[137] Often neither time nor money is available for a full audit of the financial records; the plan proponent must manage with the available information.[138]

When acceptances or rejections are solicited prior to commencement of the case, under section 1126(b), the judge must be satisfied that some applicable nonbankruptcy law on disclosure was followed[139] or, if no such law is applicable, that there was adequate disclosure under the standards of section 1125(a)(1). One weakness of chapter XI was that it did not have a provision analogous to the disclosure requirements of chapter 11. When chapter XI was enacted in 1938, the full effect of the Securities Act of 1933 and its progeny had not yet been felt. The philosophy of these acts focuses on the adequacy of the information given to the investors, buyers, sellers, or other decisionmakers, thereby enabling the prospective investor, buyer, seller, or other person being solicited to decide for himself whether to buy, sell, accept, or reject the proposal at issue. Chapter 11, almost a half century later, adopts that philosophy.

### D. *Sections 1125 and 1126—Determining Acceptances and Rejections*

For purposes of section 1129(a), holders of claims vote by

137. An entrepreneur who for years has bought control of business entities in financial distress once remarked to me that he had never found the financial records not to overstate assets and understate liabilities. Often a switch from one permitted accounting practice to another may produce a misleading financial picture.

138. *See generally* S. Rep. No. 989, 95th Cong., 2d Sess. 1, *reprinted in* 1978 U.S. Code Cong. & Ad. News 5787.

139. *See, e.g.*, 15 U.S.C. § 78b (1976).

classes.[140] Section 1126 defines when a class has accepted or rejected the plan.[141] Section 1126(b) governs pre-petition acceptances and rejections. Such votes may be counted when: (1) the solicitation material is made in accordance with applicable nonbankruptcy law, such as the proxy rules of the Securities Exchange Act of 1934;[142] or (2) in the absence of such law, the judge finds that information given before the vote is adequate under section 1125(a)(1).[143] While nothing in section 1126 relates to solicitations during the proceedings, section 1125(b) forbids post-petition solicitation except after receipt by the voters of materials which give "adequate information."[144] Section 1125(b) is one of the comparatively few provisions which direct the judge to exercise preconfirmation supervision over certain aspects of every chapter 11 case. The plan proponent's failure to comply with sections 1125 and 1126 may prevent a confirmation under section 1129(a)(8).[145]

*The Terms Statutory Majority and Statutory Minority*

These terms are not used in the Bankruptcy Code, but by using them, we may avoid bothersome repetition of provisions of section 1126 and, to a lesser extent, section 1124. The following is a description rather than a definition.

Start with section 1126(c). In the rough, the "majority" consists of holders of two-thirds in amount and more than half in number of a class of claims. Subsection (c) goes on to make three important qualifications: (1) the calculation is made as to those

140. 11 U.S.C. § 1124(3) (Supp. III 1979) treats the claim as unimpaired if the amount of the creditor's claim which is allowed is paid in cash and the creditor is thereby "cashed out." An unimpaired class of creditors need not be solicited, but § 1126 is ambiguous as to whether that class can vote against a plan filed in chapter 11; § 1126(f) provides that it is "deemed to have accepted the plan." Section 1126(a) leans the other way. The preliminary draft of the new Bankruptcy Rules number 3018 seems to say that any creditor with an allowed claim can vote. See *In re* Barrington Oaks Gen. Partnership, 15 Bankr. 952 (D. Utah 1981), for a statement of the cases.

141. 11 U.S.C. § 1126(a)-(g) (Supp. III 1979). Subsection (a) states that each "holder of a claim or interest allowed under section 502 . . . may accept or reject the plan." *See supra* note 140.

142. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78jj (1976).

143. *See, e.g.*, 15 U.S.C. § 78b (1976).

144. 11 U.S.C. § 1125(b) (Supp. III 1979). Failure to comply with §§ 1125 and 1126 could interfere with meeting the requirements of § 1129(a)(1)-(3) and thereby prevent confirmation.

145. *See id.* § 1129(a)(1), (2). Furthermore, all of the provisions of § 1129(a), including those of (a)(10) and (11), must be met for confirmation under § 1129(a) or (b), except that resort to (b) excuses compliance with (a)(8) only.

who accept or reject; (2) under subsection (e), on request of a party in interest, the judge may exclude an entity which he finds has not acted or was not solicited in good faith; and (3) on one reading of section 1126(f) and 1129(2)(8)(B), a class may be excluded from voting. The class is "deemed to have accepted" by subsection (f) of section 1126 because section 1124 states that it is unimpaired. But suppose a class which the statute says is unimpaired thinks that it is in fact impaired and affirmatively rejects the plan? Some well-reasoned cases interpret "deemed" to mean "presumed" to have accepted, and that presumption is overridden by an actual rejection. Section 1126(f) does not require solicitation of an unimpaired class, but it does not *prohibit* solicitation. If members of the class receive no ballot, Form 30 in the proposed new Bankruptcy Rules provides one. Again, the problem and the cases and commentaries are well discussed by Bankruptcy Judge Mabey in *In re Barrington Oaks General Partnership*.[146]

In contrast to the "deemed acceptance" of section 1126(f), a class that gets nothing is conclusively deemed to have rejected the plan under subsection (g)'s provisions. It seems unlikely that a class which gets nothing will object to being counted as having rejected, but a class of stockholders might prefer to accept because, for example, the plan gives members of the class something desirable on their subordinated debentures.[147]

Subsection (d) is to classes of interests what subsection (c) is to creditors, except that there is no "half in number" requirement. A majority of a class determined under these qualifications is what we will call the statutory majority.

Conversely, a statutory minority is any combination of holders of claims or interests which will prevent the plan proponent from obtaining a statutory majority of the class. A statutory minority can be the holders of just over one-third in amount of the class' claims or interests; or one-half of the holders of a class of claims, plus one.

A class can be comprised of a single holder of a claim or interest, if his claim or interest is distinguishable from others. This one holder might prevent a plan from being confirmed under section 1129(a)(8) (unless disqualified on good faith grounds or disen-

146. 15 Bankr. 952 (D. Utah 1981). *See also In re* Marston Enterprises, 13 Bankr. 514 (E.D.N.Y. 1981) for a good discussion.

147. Some holders of claims may be excluded under this formulation. 11 U.S.C. § 1126(e)-(g) (Supp. III 1979). *See* text accompanying *infra* notes 148–49.

franchised under section 1124, if that is possible); the minority of one class can prevent the proponent from obtaining the required statutory majority of each class. To repeat, both the statutory majority and the statutory minority are determined from those entitled to, and who in fact did, vote. We have raised questions concerning two exceptions: a class that gets nothing is deemed to have rejected the plan—section 1126(g); and a class that is unimpaired is deemed under subsection (f) to have accepted.

The concept of what constitutes acceptance or rejection by a class of interests is important primarily with respect to a confirmation under section 1129(a)(8) or 1129(b). A class acceptance means little unless each other class somehow is also bound—by the statutory majority under section 1129(a), by exclusion from voting under section 1124 or 1126, or by certain judicial findings under section 1129(b). If a plan proponent fails to obtain confirmation under section 1129(a)(8) because he fails to obtain consent of a class, before he considers a cramdown of that class under section 1129(b), he may look for help under section 1124.[148] Depending on which line of cases predominates, the combination of sections 1126(f) and 1124 may or may not be important in obtaining confirmation of a plan by removing the power of a nonconsenting class to reject.[149] Under section 1124, a class may be held to have been unimpaired; under section 1126(f) an unimpaired class is "deemed to have accepted a plan," and the class need not be solicited. Section 1129(a)(8)(B) does not require the class' acceptance. A small number of cases, but the weight of what authority there is at this early date, rejects this reasoning if the class actually has rejected.

Before we turn to section 1124, we may contrast sections 1126(f) and (g). Under subsection (f), an unimpaired class is deemed to have accepted, and it need not be solicited. Contrariwise, under section 1126(g), classes which receive no compensation under the plan are deemed to have rejected the plan. Unlike subsection (f), subsection (g) contains no indication that these classes need not be solicited. The automatic rejection by a class which gets no compensation under the plan, even though it has no equity, may prevent confirmation under section 1129(a)(8); under section 1129(a)(8)(B), acceptances need not include a class which is unimpaired as to the "deemed to have rejected" class since there

148. *See supra* notes 123 & 140 and accompanying text.

149. *See infra* note 152 and *supra* notes 123 & 140 and accompanying text.

is no counterpart of section 1129(a)(8)(B). If the class has no equity, however, giving it nothing is giving it what it is worth, and confirmation under section 1129(b) may be possible.[150].

Under old chapter X and section 77, a plan proponent was not required to solicit a class of holders of claims or interests whose members would not participate in the new corporate entity. There is no similar provision in chapter 11. Subsection (g), unlike subsection (f), does not excuse solicitation of the no-equity class with which subsection (g) deals. Section 1126(g) seems to recognize the right of such a class to be eliminated only after the plan proponent goes through the exercise prescribed under section 1129(b).[151] If, however, a prior class had been more than compensated by the stream of earnings, the rejected class might be able to prove that there was something left for it. A hearing on an earnings valuation could be tedious and expensive in a contested case. Proving that the class should get nothing would involve earnings estimates, determination of a suitable times-earnings multiple and all that goes with a fair and equitable valuation under section 1129(b).

To summarize, since confirmation under section 1129(a)(8) requires acceptance by every impaired class, automatic rejection of a class under section 1126(g), even one impaired to the point that it has no equity, can prevent confirmation under subsection (a) of section 1129. Confirmation under subsection (b) may be possible; after proof under section 1129(b)(2)(B) or (C) that its claim is worth zero, the class gets zero. Any class junior to that class would likewise be excluded.

Classes which retain a participation in the plan may find it more profitable to give some interest to the classes with no apparent present equity interest, thereby obtaining consent of the class. With that consent, confirmation under section 1129(a)(8) can be

150. *See infra* notes 186–206 and accompanying text.

151. If, for example, stockholders are also holders of a class of prior claims, they might be influenced to vote for a plan which gives them nothing on their stock, but something acceptable on the prior claims. The language in § 1126(g) seems to give no weight to the consent of persons in this position. This section provides:

> Notwithstanding any other provision of this section, a class is deemed not to have accepted a plan if such plan provides that the claims or interests of such class do not entitle the holders of such claims or interests to any payment or compensation under the plan on account of such claims or interests.

11 U.S.C. § 1126(g) (Supp. III 1979). Does "deemed to have accepted" mean more than presumed to have accepted in the absence of contrary action? See S.REP. No. 989, 95th Cong., 2d Sess. 122, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5787, 5709-10, stating that rejection under § 1126(g) is conclusive. No similar remarks are made as to § 1126(f).

obtained, thus avoiding the problems associated with a section 1129(b) cramdown.

### E. *Section 1124—Depriving a Class of a Right to Reject*

#### 1. *Can a Plan Proponent Effectively Prevent a Class from Rejecting a Plan by Fitting that Class Into One of the Subsections of Section 1124?*

We must develop more fully several concepts introduced earlier. Assume that the debtor is having difficulty in persuading one class to accept the plan and that this failure is preventing him from having a confirmation under the relatively easy standards of section 1129(a)(8). While subsection (A) requires that a majority of each class accept the plan, subsection (B) excepts a class that is unimpaired. Subsections (1), (2), and (3) of section 1124 state that certain classes are unimpaired. Under subsection (f) of section 1126, an unimpaired class is deemed to have accepted. To ask the question more accurately: Can a plan proponent prevent a class from rejecting by fitting that class into subsection (1), (2), or (3) of section 1124? The answer to this question is not simple. We start with section 1126(f). That section begins:

> notwithstanding any other provision of this section, a class that is not impaired under a plan is deemed to have accepted the plan, and solicitation of acceptances with respect to such class from the holders of claims or interest[s] of such class is not required.

There has been no other default under the indenture but the filing of the petition was a default. The market price of a class of bonds which section 1124(1) treats as unimpaired has dropped precipitiously on announcement of the reorganization. The class unanimously rejects the plan, arguing that it is entitled to better treatment under the plan or, at worst, that as a rejecting class, it is entitled to the economic protection afforded by section 1129(b)(2)(A).

A class of two banks indicates that the class will also reject the plan. One installment of interest has been unpaid—beyond the grace period—a clear default under the loan agreement. Suggestions by the class as to an acceptable plan are rejected. The debtor scrapes up enough cash to pay the overdue interest installment, with interest on interest, six months after the grace period has expired. Under section 1124(2), the class is now unimpaired. The bank class also believes that it should be better treated under the plan and would be treated better under sections 1129(b)(2)(A)(i)(I) and (II) as a rejecting class.

The class members announce their intention to send in ballots marked "reject." Counsel for each class points to the first sentence in section 1126(a):

> (a) The holder of a claim or interest allowed under section 502 of this title may accept or reject a plan.

Counsel argues that the "deemed to have accepted" provision is overridden by an actual rejection. Counsel also cites the preliminary draft of Rule 3018 of the Bankruptcy Rules, published for discussion in March 1982, which seems to be more influenced by that first sentence of section 1126(a) than by the special language of subsection (f). Subsection 1129(a)(8) reads:

> With respect to each class
> (A) Such class has accepted the plan; or
> (B) Such class is not impaired under the plan.

The pertinent language of section 1124 reads:

> . . . a class of claims or interests is impaired under a plan unless, with respect to each claim or interest of such class, the plan—
> (1) leaves unaltered the legal, equitable, and contractual rights to which such claim or interest entitles the holder of such claim or interest . . . .

The debtor contends that the bondholders fit within this provision.

The banks come within subsection (2):

> notwithstanding any contractual provisions or applicable law that entitles the holder of such claim or interest to demand or receive accelerated payment of such claim or interest after the occurrence of a default—
> (A) cures any such default other than a default of a kind specified in section 365(b)(2) of this title, that occurred before or after the commencement of the case under this title; [Section (A) would excuse the petition filing.]
> (B) reinstates the maturity of such claim or interest as such maturity existed before such default; [Section (B) would permit cure of the interest default.]
> (C) compensates the holder of such claim or interest for any damages incurred as a result of any reasonable reliance by such holder of such contractual provisions of such applicable law; and [The debtor contends that interest on interest satisifes (C).]
> (D) does not otherwise alter the legal, equitable, or contractual rights to which such claim or interest entitles the holder of such claim or interest . . . .

The banks argue that they are impaired economically and legally in not being able to call in a low interest debt and currently reinvest at twice the old rate. The bondholders maintain that a default giving them the same right to accelerate is only a matter of time and that the legal injury occurred six months earlier. Each class argues that it is in fact impaired economically; in fact, each has rejected the plan, thus contradicting the "deemed to have accepted" language of section 1126(f).

This analysis might well be followed by an examination of subsection (3) of 1124, but since that section has no appeal to the debtor on the facts here, we will discuss first the concepts of impairment and acceptance mentioned above. Very roughly, a claim is "impaired" under the code in the manner in which it would be "materially and adversely affected" under the act, but the tests are not exactly the same. Nevertheless, subsection (l) carries forward a traditional principle: If the class in fact is not materially affected (impaired under the code) tradition has it that the class need not be consulted as to a reorganization plan. Between them sections 1124(2)(A) and 365(a)(2) excuse the petiton filing as a default. Thus, a class of first lien bonds, as to which no default has occurred, are to be left "undisturbed" under the plan. The class under a combination of sections 1124(1) and 1126(f) need not be solicited and is deemed to have accepted. The drop in market price of the bonds proves that the mere filing caused an economic impairment. Though neither class is solicited, members of each write up ballots in the form the Bankruptcy Rules prescribe and reject the plan.

Subsection (2) assumes the occurrence of a default which can either be disregarded or cured, depending on the type of default. Congress apparently is saying two things:[152] if the default is one which might be considered "technical" in nature, the proponent can act as though no such default has occurred. These defaults include a failure to maintain some financial ratio or the act of having filed the petition under this proceeding. This kind of a default is basically noncurable, and thus, section 1124 follows section 365(b)(2) in excusing a cure. Congress also is saying, in subsection (A), that the cure of a default may be made presumably without regard to the time limits imposed by the contract between the debtor and the creditors if subsections (2)(B), (C), and (D) are satisfied. That cure would have to be accompanied by the

152. *See, e.g.*, H.R. REP. No. 595, 95th Cong., 2d Sess. 401–32, *reprinted in* 1978 U.S. CODE CONG. *& Ad. News* 5963, 6357–87.

payment of any actual damages suffered by the creditor. Section 1124(2) differs from section 365 in that 365 requires assurance of future ability to perform as a condition to pretending that no default has occurred.[153] Can the banks successfully argue that they are damaged to the extent of the difference between continuing ten percent on the old debt and twenty percent currently obtainable? The statute's idea that no impairment has taken place may not be shared by the class whose contract was not fulfilled. The default on the bank loans which will be cured on confirmation was the result of the failure to pay the last installment on the bank loan; that payment has now been made with interest on interest as "damages."

Assuming that no legal injury has taken place, section 1124(2) says that the class rights will no longer be impaired. The bank takes quite a different attitude. The failure of the debtor to have made a payment, the maturity date of which had been agreed to long ago, indicates to the credit analyst that the credit has deteriorated seriously. Nevertheless, the plan reinstates the original maturity, and the debtor is treated as though no such default had occurred. The bank argues strenuously that the ten percent fixed interest rate on this term loan which has been outstanding for some years is seriously out of line with the twenty percent rate which it could obtain in the 1982 market. Mere reinstatement of the old maturity and payment of back interest does not satisfy section 1124(C); creditors relied on the ability to call the loan on filing of a petition. The bank also argues that even if the interest rate is adjusted upwards to meet 1982 standards, it is impaired legally by being forced to continue a credit which does not meet the standards agreed to in the original loan agreement. Notwithstanding the language of sections 1124(2) and 1126(f), the bank rejected the plan.

Can the debtor take the position that a judge must disregard the actual rejection by the bank and count the bank class as having accepted the plan because section 1126(f) deems that acceptance to have taken place? The early commentators on this section seem to have assumed that these two sections mean what they may appear to say. When actual cases came before the courts, the answer was not that easy. In *In re Marston Enterprises, Inc.*,[154] the court looked to the fact of rejection and not to the "deemed ac-

153. *See* 11 U.S.C. § 365(b)(A), (B), and (C) (Supp. III 1979).

154. 13 Bankr. 514 (E.D.N.Y. 1981).

ceptance" of section 1126(f). The court read "deemed" to mean basically the same as "presumed." A presumption can be rebutted by the actual facts. The cases and the literature are reviewed in *In re Barrington Oaks General Partnership*.[155] *Barrington* follows *Marston*.

What difference does it make how the question is resolved? Assume that the creditors are the bondholders, the banks, and unsecured creditors with insignificant claims. If the plan can be deemed to have been accepted by the bondholders and the banks, all other classes (i.e., one unsecured creditor class with insignficant aggregate claims in comparison with those of the holder of bonds and bank debt) having accepted through a statutory majority, the plan can be confirmed under section 1129(a)(8). If the vote of the bondholders or the banks is considered as a rejection, the rejecting class can be forced to take what the plan provides only if that plan satisfies the legal and economic standards of section 1129(b)(2)(A)(i) or (ii) or (iii). The banks and the bondholders are satisfied that their rights will be protected better if the debtor resorts to a cramdown under subsection (b)(2). The situation might be a bit ironic in light of one interpretation of sections 1126(f) and 1129(a)(10). Suppose there is no actual class to accept (insiders are not counted under section 1129(a)(10)). If the deemed acceptance controls over an actual rejection, a plan might be confirmed because the rejecting class is deemed to have accepted.

An answer to a question above—whether the debtor can use sections 1124 and 1126(f) to take away from a creditor class the right to reject— would arise again with respect to action which might or might not satisfy section 1129(a)(10). That section requires that no plan can be confirmed by the judge unless it has been accepted by at least one class. There is some ambiguity: must that one class be an impaired class which has given an actual acceptance, or can it be a class which section 1124 says is not impaired? Again, the later cases require an actual acceptance.[156]

### 2. *A Cash-Out Under Section 1124(3), Without and With Section 1111(b) Complications*

We have not discussed the third subsection of section 1124. It is possible that the debtor who desires to put through a plan against the wishes of a particular class might be able to "cash out"

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155. 15 Bankr. 952 (D. Utah 1981).

156. *See, e.g.* Marston Enterprises; Barrington Oaks.

the class by a cash payment at confirmation of the full amount of the claim or interest. A payment in cash is what the bondholders and the banks would have liked, but the debtor would find it most unattractive in the case described above.

This subsection (3), and the related section 1111, may be difficult to understand without regard to what secured creditors considered an undesirable result under the famous case of *In re Pine Gate Associates, Ltd.*[157] A bankruptcy court held that under the prior section 461(11) of chapter XII, a nonassenting creditor could be "cashed out," not at the amount of the debt, but at its value. In this case, since the claim was one in which the individual partner debtors were not liable personally, the court held that the value of the debt was no more than the value of the collateral. Unfortunately, the value of the apartment complex had deteriorated greatly since the time that the mortgage loan was made. Putting aside the questions as to how that value was determined, we can say that under the cramdown power of the court under section 461(11) of chapter XII, the partnership debtor was able to refinance the mortgage debt in a smaller amount from a different lender and to discharge the old mortgage debt by the payment of something considerably less than the amount of the old debt. The partners, with a nominal investment, now owned the property subject to a smaller mortgage; they awaited a normal real estate market while the partially paid lender licked his wounds. This case aroused the interest and ire of secured creditors who argued that the secured creditor should have been allowed either to take over the property and take his chances that at some point the property would again be worth something close to the amount of the loan, or he should be paid now the amount of the loan rather than its "value" (limited to the value of the collateral) as part of the plan.[158] To prevent a repetition of *Pine Gate*, creditors presented a draft of section 1111(b), a section new to the law.

157. 10 COLLIER BANKR. CAS. (MB) 581 (N.D. Ga. 1976).

158. The result in *Pine Gate* was provided by two factors: First, the creditors, for reasons of their own, had agreed to look for repayment of their loans only to the value of the collateral. They thought that they knew enough about the intrinsic value of the project to feel confident that if the project ran into temporary financial difficulties, they could foreclose their mortgage, and if the outside bids were unsatisfactory, they could bid on the property and hold it for the expected return to its real value. Second, the language of § 461(11) of chapter XII was overlooked. This language invited the court to reach the conclusion that if the debtor could pay in cash the then depressed value of the collateral; the debtor, and not the creditors, could await its return to its hoped-for intrinsic value. *See* Anderson & Ziegler, *Real Property Arrangements Under the Old and New Bankruptcy Acts*, 25 LOY. L. REV. 713, 730–34, 739–42 (1979); Note, *From Debtor's Shield to Creditor's*

Subsection (3) of section 1124 must be read in the light of sections 1111(b)(1) and (2). First, look to the language of 1124(3) which provides:

> [A class is not impaired if the plan]
>
> (3) provides that, on the effective date of the plan, the holder of such claim or interest receives, on account of such claim or interest, cash equal to (A) with respect to a claim, the allowed amount of such claim . . . .

Section 1111(b) is an attempt to avoid the *Pine Gate* result under either of two subsections.[159] Section 1111(b)(1) would have allowed the *Pine Gate* creditor to have asserted a deficiency claim equal to the difference between the value of his collateral and the amount of the debt, in spite of the fact that the contract had provided otherwise. In other words, section 1111(b)(1) creates a deficiency claim—a recourse claim against the debtor—where none existed before.[160] The debtor owes a secured debt measured by the value of the collateral[161] and by operation of section 1111(b)(l), he now owes an unsecured debt for the excess.[162]

An illustration may help explain these difficult concepts. Debtor has purchased, under a purchase money security interest, a printing press on which he has made a considerable number of payments. Due to improvements in the art, and wear and tear on the machine, the printing press is not presently worth the amount of the unpaid debt. Under section 506, the bankruptcy judge, at an earlier stage, had ruled that the printing press was worth no more than one-half of the debt balance amount. That finding is not dis-

*Sword: Cram Down Under the Chandler Act and the Bankrutcy Reform Act*, 55 CHI.-KENT L. REV. 713, 726–34 (1979).

159. *See generally* 1 BANKR. SERV. LAW. ED. § 6:134 (1979); Kaplan, *Nonrecourse Unsecured Creditors Under New Chapter 11—The Section 1111(b) Election: Already a Need for Change*, 53 AM. BANKR. L.J. 269 (1979).

160. Treating A's nonrecourse claim as though it were a full recourse claim could increase the total claims to the point where distribution to unsecured creditors could be a problem. An unsecured creditor might have extended credit on the assumption that as to non-mortgaged assets he would not be competing with an unsecured claim of the partially secured creditor.

161. 11 U.S.C. § 506(a) (Supp. III 1979).

162. *Id.* § 1111(b)(1)(A)(ii). In the real estate construction financing typified by *Pine Gate*, there are likely to be few unsecured creditors, and their claims are likely to be nominal in amount. The existence of this new deficiency claim may allow the secured creditor (in its capacity as an unsecured creditor) to control the unsecured creditor class. In the unsecured creditor class, the secured creditor can sometimes prevent the debtor's plan from being confirmed, even if the debtor could "cram down" the secured creditor as such under § 1129(b)(2); under (B)(ii) classes below the unpaid unsecured creditor are eliminated. Without regard to the value of the unsecured claims the full amount must be paid before juniors can take anything.

puted. The creditor, therefore, has a secured claim for one-half of the debt and an unsecured claim for one-half of the debt. The debtor's business could not survive the secured party's repossession of the printing press. The debtor is prepared to remove that threat by paying the secured debt. Unlike the real estate project in *Pine Gate*, the debtor has a substantial unsecured creditor class. The debtor hopes that the deficiency will be swallowed up by a large group of unsecured creditors willing to accept the plan. If only subsection (1) of section 1111(b) is applicable, the debtor can keep the printing press if he pays the amount of the secured portion under section 1124(3). The existence of the unsecured deficiency claim will not expose him to the possible loss of the needed printing press.

Subsection (b)(2) of section 1111 is more complicated.[163] We put aside the exceptions. If two-thirds of the secured class so elects, the class may convert its combination of the unsecured portion and the secured portion of the debt into a secured claim for the total. The class thereby gives up its unsecured claim and any strategic value it may have is lost.

Now the situation changes. If the plan proponent attempts a cash-out, both the immediate cash cost to the debtor and the cash return to the secured class at confirmation increase. By exercising the magic power of section 1111(b)(2), the secured creditor converts the entire claim into a secured claim. In the process, the debtor loses his chance to keep the press by paying only its present value. If the section 1124(3) cash-out is not thwarted by the increase in its cash cost to the debtor, the secured party wins his 1111(b)(2) bet. In the absence of a section 1124(3) cash-out by the debtor, this class election eventually may prove unwise from the secured creditor's viewpoint. The appreciation which the secured creditors hoped for in *Pine Gate* is unlikely to occur in the value of the printing press. The secured party class has lost its unsecured claim and its strategic value in a section 1129(b)(2)(B) cramdown.

The other situation where section 1111 might change the result is a cramdown under section 1129(b)(2)(A)(i)(II). Should a cramdown of the secured party occur under that section, the amount of the secured claim goes up, but that is no guarantee of any increase in value which would make that increase meaningful.

163. *Id.* § 1111(b)(2). This subsection provides: "If such an election is made, then notwithstanding section 506(a) of this title, such claim is a secured claim to the extent that such claim is allowed." *Id.*

It is possible that even where the plan provides that the creditor will receive a cash payment on the date of confirmation, he still might have reasons to reject the plan if he is paid only the value of the collateral. But if the partially secured creditor is paid in full under subsection (3) of 1124 rather than treated under (1) or (2), the problem discussed above of rejection versus "deemed to accept" would seem to evaporate.

Eliminating a class by a cash payment in the full amount of the debt, particularly where the class elects to treat the entire debt as though it were secured fully when it is not, often will not be attractive to the plan proponent. Such a procedure may be attractive where a piece of collateral has a particularly high value to the debtor, and the amount of cash required is not prohibitive. The creditors committee, representing the unsecured creditors, may be willing to see the debtor part with scarce cash equal to the value of the collateral, but not in the full amount of one creditor's claim, when half in reality is unsecured. Counsel for the committee recommends that the present cash drain required under section 1124(3) be avoided through a long-term pay-out under section 1129(b)(2)(A). The section 1111(b)(2) election is now a gamble. The new Bankruptcy Rules, not yet final, will determine the time after which the creditor class cannot reverse its choice.

### F. *Section 1129(a)(7)—The "Best Interest of Creditors" Test*

A basic test of chapter XI, that the plan of arrangement be in the "best interest of creditors," is continued in section 1129(a)(7).[164] In that section, unlike some other subsections of section 1129(a), the test is applied not to classes, but to each member of a class.[165] Any member of a class, therefore, can complain that he is getting less under the plan than under a chapter 7 liquidation. If a class member convinces the judge of this deprivation, no confirmation is possible. If, however, a partially secured class elects, under section 1111(b)(2), to relinquish its unsecured claim with the hope that the collateral will be enough to liquidate the claim, the class member cannot complain that under the plan he gets nothing on his unsecured claim whereas he would have received something in a liquidation proceeding. That member's

164. *See infra* notes 200–04 and accompanying text.

165. Bankruptcy Act of 1938, ch. 575, § 1(366(2)), 52 Stat. 840, 911. *See* S. REP. No. 989, 95th Cong., 2d Sess. 1, *reprinted in* 1978 U.S. CODE CONG. & AD. *News* 5787.

class has made its own bed. This principle is contained within section 1129(a)(7)(B) which states:

> [I]f 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 creditor's interest in the estate's interest in the property that secures such claims.[166]

### G. *Section 1129(a)(9)—Priority Claims*

Section 1129(a)(9) refers to claims accorded priority by section 507. Any priority claim holder can agree to take less than the statute gives him. With some types of priority debt, the class majority of claim holders can agree on behalf of the entire class to take less than the statute allows. Thus, certain priority claim holders will be required by a class vote to accept less under section 1129(a)(9)(B)(i), thereby losing some of their full rights. Only individual holders of certain other priority claims can waive their rights to cash payments.[167]

Certain priorities, including claims related to administrative expenses and claims resulting from the failure of "adequate protection" under sections 362, 363 or 364 to have been in fact adequate, must be paid in cash unless the particular holder agrees otherwise. A plan, therefore, might be defeated by the debtor's inability to pay a substantial administrative claim in cash, including the repayment loans made under section 364(a) to persuade each holder to accept something else. A holder who wishes to see the plan confirmed may, only at his election, accept other compensation such as deferred cash payments.

Certain cash payments for nongovernmental claims may be waived by a class.[168] These claims include those given priority for wages,[169] contributions to employee benefit plans,[170] or certain

166. 11 U.S.C. § 1129(a)(9)(B)(i) (Supp. III 1979). Section 1129(a) contains a number of provisions which do not merit full discussion here. Presumably any member of a class can object to a plan that does not conform to subsection 1129(a)(1) or (2) (general compliance with the code); subsection (3) (good faith); information as to subsections (4) (certain payments), (5) (affiliations of insiders), or (6) (regulatory commission approval); as well as to subsections (7) (previously discussed); (9) (certain priorities not governed by class action); (10) (acceptance by at least one class); or (11) (feasibility). Subsection (8), however, is different; it applies to the class rather than the individual members of the class (the majority binds the minority).

167. *Id.* § 1129(a)(9)(B).

168. *Id.* § 1129(a)(9)(B)(i).

169. *Id.* § 1129(a)(9)(B)(i), (ii).

customer deposits.[171] In these circumstances, an individual claim holder must accept the decision of the class, even though as a class member, his claim would receive a section 507 priority.

Under section 1129(a)(9)(C),[172] certain claims by governmental entities may be deferred without the consent of the holder or of the class for a maximum of six years. This provision does not resolve the question of whether regular installments must be paid during the six-year period. Since Congress postponed action on certain tax aspects of reorganization in 1978 and covered some tax issues not found in the Bankruptcy Code in 1980, plan proponents will be well-advised to check the current status of the bankruptcy tax legislation.

### H. *Section 1129(a)(10)—The Plan Must Be Accepted by at Least One Class of Claims, Determined Without Including an Insider of Such Class*

If a debtor has only one class of creditors, he cannot have a plan confirmed without acceptance by that class. In contrast, section 1129(a)(10) is satisfied automatically by an acceptance of a plan by each impaired class under section 1129(a)(8). Prior to a cramdown of a class under section 1129(b), however, at least one other class must have accepted to the plan[173] without including any acceptance by each impaired insider within the class.[174] Had Senate Bill 689 of the 96th Congress passed, it would have required actual acceptance by an impaired class, rather than a deemed acceptance, in accordance with the provisions of sections 1124 and 1126(f). We have treated this problem in connection with sections 1124 and 1126(f) and need not repeat.[175]

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170. *Id.* § 507(a)(3).

171. *Id.* § 507(a)(4).

172. *Id.* § 507(a)(5).

173. *Id.* § 1129(a)(9)(C). Section 507(a)(6) lists a number of unsecured government claims given priority. These include income, property, employment, and excise tax, customs duty or an associated penalty owed or uncollected at the time the petition is filed.

174. *Id.* § 1129(a)(10). In determining whether the statutory majority of each impaired class will consent to a plan under § 1129(a)(8), it is interesting to note the standards which the majority class applies. Essentially, each class consents when the plan seems reasonable to the particular class. The motives of each class may well differ, as may the reason for giving consent.

175. *See infra* notes 123-26, 146, 152-54 and accompanying text.

### I. *Section 1129(a)(11)—The Plan Must Provide More than Temporary Relief—It Must be Feasible*

The text of section 1129(a)(11) is self- explanatory. The section states that the court should confirm the plan only if "[c]onfirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan, unless such liquidation or reorganization is proposed in the plan."[176]

It is possible that each class would consent to a plan which left the debtor with such a debt- heavy capital structure, and necessarily with an inadequate equity capital, that the judge or one of the parties might call into play section 1129(a)(11). Furthermore, if a cramdown satisfying the secured debt requirements of section 1129(b)(2)(A) were to leave the reorganized company with an overload of debt, section 1129(a)(11) could prevent a court from confirming the plan.[177]

### J. *Section 1129(a)(8)—When Each Impaired Class Accepts*

Subsection (a)(8) may be the most important subsection of section 1129. If the parties have complied with the other provisions of section 1129(a) and the consent of each impaired class is obtained, the judge must confirm the plan. Some other subsections of section 1129(a) prescribe the procedure to be followed, while still other provisions contain the actual requirements for a confirmation. Under section 1129(a)(8), the parties, acting through a statutory majority of each class, may accept the plan. A statutory majority or minority may cause the plan to fail confirmation by making it impossible for the plan proponent to obtain a statutory majority. An individual member of a class might prevent confirmation by persuading the judge that some requirement of section (a) has not been met.

Section 1129(a)(8) partially rejects the teaching of *Case v. Los Angeles Lumber Products, Ltd.*,[178] a section 77B case which required the judge to make findings before the class approvals could become effective. The judge was required to find that the plan was "fair and equitable, and feasible." The incorporation of the

176. 11 U.S.C. § 1129(a)(11) (Supp. III 1979).

177. *See, e.g.*, *In re* Landmark at Park Plaza, Ltd., 7 Bankr. 653 (D. N.J. 1980) (confirmation denied under § 1129(a)(111); the court anticipated liquidation or further financial reorganization likely). *Cf. In re* Hollanger and Hollanger, 15 Bankr. 35 (D. La. 1981) (plan confirmed notwithstanding objections of some creditors).

178. 308 U.S. 106 (1939). *See supra* notes 57 & 118–21 and accompanying text.

fair and equitable rule in various chapters in 1938, its repeal as to some proceedings in 1953, and its retention as to different proceedings under the act are beyond the scope of this Article. Suffice it to say that immediately prior to the adoption of chapter 11, the rule applied to a proceeding under section 77 and chapter X, but not to one under Chapter XI. Chapter 11 makes it possible to effect confirmation of a plan without the "fair and equitable" finding if section 1129(a), including 1129(a)(8), is satisfied. Prior to the effective date of chapter 11, that plan, under chapter X or section 77 of the old act, could have been confirmed only if that finding had been made. Section 1129(a)(8), therefore, is one of the significant sections of the new Bankruptcy Code.

Chapter 11, like one of its predecessors, chapter XI, allows and almost compels the parties to negotiate with each other. While chapter X turned over the reorganization problem to outside experts—the trustee, the judge, and the SEC— chapter 11, like chapter XI, leaves the problem in the hands of those financially interested—the debtor, the creditors, the equity holders, and their committees. The parties call on the judge only when they cannot reach agreement among themselves. Unless called on by a party in interest, the judge's role may not be too great. The judge's hardest problems arise where a plan proponent asks the judge to force a class to take a plan it has rejected—a cramdown under section 1129(b). Reorganization is seldom primarily a product of the judicial process but, instead, as summarized by one of the writer's mentors in corporate reorganization matters, arises from persuading many persons with diverse interests to think similarly at the same time. The debtor or any of the parties may be the chief persuader. Persuasion includes peer pressure which may be found within any class of more than one member. A converted creditor, formerly a dissenter, may persuade another member of a dissenting class to "go along" with the prosposed plan. Trade creditors may persuade another class— say the banks—to consent, with or without a modification of the plan. This converted class or member of a class then often can influence the class peers more effectively than could the debtor. The debtor may be convinced that a modification of its plan is the price of acceptance.

In determining whether to consent to a plan, a class may consider whether its claims are accorded the priority to which they would have been entitled under chapter X's "fair and equitable" (full priority) rule. Furthermore, in making this decision, a class may request or demand from the debtor an estimate of the debtor's future earnings, or they may make their own estimate. Neither the earnings estimate nor compliance or noncompliance with the fair and equitable rule has any magic significance under section 1129(a)(8), but either factor may aid wavering creditors in deciding to accept or reject the plan. To paraphrase Justice Oliver Wendell Holmes, the participants may make their decisions on intuitions deeper than logic.[179] Refined mathematical analysis may convince a class that the corpse cannot be revived; it seldom will convince a class as to when a reorganization can be affected. The quality of future management is often the critical factor as to death or survival of the entity. There are few statistical measures of that quality. A few influential members of a class "feel" that management can or cannot "make it," and acceptances follow.

A sense of timing, or the lack of it, may make or destroy a plan. Two equally skillful counsel were casually discussing at lunch stray problems of a debtor in possession. One was counsel for the debtor, the other was counsel for the creditors' committee. Counsel for the debtor: "Have you considered asking your committee to do [thus and so]?" Without hesitation, counsel for the committee replied:

> I have indeed given that a great deal of thought. This is not the time to propose any action. The members of the committee are now at that initial stage where they attribute all their problems to misfeasance of the debtor. It will require a little time for them to realize how much deeper the problem is. I think I can make your suggestion in about two weeks.

As each resumed eating his sandwich, it was apparent that no futher discussion was needed.

We assume now that the plan proponent cannot, or will not, rely on sections 1124 or 1126(f) as removing the right of the dissenting class to reject by having that class treated as unimpaired under section 1124(1), or more likely by a cure under section 1124(2) and less likely by a cash-out under section 1124(3).[180] The

179. The process of accepting or rejecting a plan could have been well-articulated in Chicago, Burlington & Quincy Ry. v. Babcock, 204 U.S. 585 (1907). Justice Holmes stated that "[t]he action does not appear to have been artibrary except in the sense in which many honest and sensible judgments are so. They express in intuition of experience which outruns analysis and sums up many unnamed and tangled impressions; impressions which may lie beneath consciousness without losing their worth." *Id.* at 598. In a recent California reorganization case, Judge Katz stated that in a highly charged case, scarcely a single issue was settled on the basis of business judgment. *In re* Nite Lite Inns, 6 COLLIER BANKR. CAS. 2d (MB) 107, 110 (1982).

180. 11 U.S.C. § 1124 (Supp. III 1979). This section states that claims or interests are impaired unless the claim or interest is therein declared to be unimpaired under the plan.

plan proponent gives up hope of obtaining the acceptance of each class that might have made a possible confirmation under section 1129(a)(8).

In sum, if the plan proponent cannot persuade the statutory majority to consent, thereby failing to gain confirmation under section 1129(a)(8), and cannot deprive the nonassenting class of the right to reject under section 1126, the plan proponent may not yet abandon his plan. The plan proponent can consider amending his plan so that class acceptances can be gained, and with it, confirmation under section 1129(a)(8). If no other alternative is feasible, the proponent also might consider resorting to a "cramdown" under section 1129(b). Under that section, the plan proponent might be able to cramdown the plan onto members of a class of holders of claims or interests. This cramdown, however, may not be an easy task.

An acceptance of a plan is much harder to obtain than a rejection. The statutory majority of each class is needed for a section 1129(a) confirmation. Confirmation under section 1129(b)(8) is impossible if holders of one-third plus one dollar in amount of a single class of claims or interests or holders of a half in number of claims reject the plan. When the statutory minority of a single class rejects the plan, and thus confirmation under section 1129(a)(8) cannot be had, the plan must be abandoned, or resort to another provision is required. We have discussed section 1124 and section 1126(f), but some repitition and some additional considerations may be necessary to an understanding of some difficult concepts.

Subsection (B) of section 1129(a)(8) raises an interesting question. To repeat the text:

> (a) the court shall confirm if all of the following conditions are met:
> (A) Such class has accepted the plan; or
> (B) such class is not impaired under the plan.

This subsection (B) must be read with sections 1124, as to when a class is not impaired, 1126(f), which provides that a class not impaired is "deemed to have acepted the plan," and the first sentence of 1126(a) which seems to give every holder a chance to accept or reject. On one interpretation, a plan proponent can disenfranchise a class by fitting it into subsections (1), (2) or (3) of 1124.

On what appears to be a literal reading of the statute, the plan proponent might be able to get assistance from sections 1124, 1126(f) and 1129(a)(8)(B) by, in effect, disenfranchising the rejecting class. If the proponent's purposes cannot be achieved through section 1124, and if the proponent cannot change the score by negotiating with those who have dissented, the plan proponent then would be faced with abandonment of the plan or the perils of a section 1129(b) cramdown.

We have noted that a few early cases and a number of commentators question this interpretation of these sections. The question: did Congress, in section 1126(f), mean that if a class of claims can be brought into a class which either section 1124(1), (2), or (3) dictates is not impaired by the plan, the class is conclusively "deemed to have accepted the plan," or does "deemed" merely create a presumption that the class accepts this plan if it does not actively reject? A recent case, *In re Barrington Oaks General Partnership*,[181] reviews the literature on the controversy. That case explores the legislative history and holds that it is illogical to deem a class to have accepted when in fact it rejected the plan.[182]

We postpone the exploration of the mechanics of section 1124 until we explore the question: Can a plan proponent who has persuaded a majority of each class, except one, force that class to take some treatment which it does not vote to accept and still operate under section 1129(a)(8) rather than under the cramdown of section 1129(b)?[183]

An acceptance of a plan is much harder to obtain than a rejection. The chapter 11 statutory majority of each class needed for a section 1129(a) confirmation may be harder to obtain than the less demanding majority under chapter XI. Confirmation under section 1129(a)(8) is impossible if holders of one-third plus one dollar in amount of a single class reject the plan. Confirmation is also impossible if a majority in number of claim holders reject. (It might be easier to obtain a majority under chapter 11 than under old chapter XI in that the nonvoters do not count as rejectors.) When the statutory minority of a single class rejects the plan, and thus makes satisfaction of section 1129(a)(8) impossible, the plan must be abandoned, or resort to another provision of chapter 11 is required. On one interpretation of sections 1124 and 1126(f), the plan proponent may be fortunate enough to get help by in effect disenfranchising the objecting class under those two sections.[184] If he cannot achieve his purpose through section 1124, and he can-

181. 15 Bankr. 952 (D. Utah 1981).
182. *Id.* at 967–70.
183. *See infra* notes 185–204 and accompanying text.
184. *See supra* notes 123–24 and accompanying text.

not change the score by negotiating with those who have dissented, the plan proponent would then be faced with abandonment of the plan or with the perils of a section 1129(b) cramdown of the rejecting class.

## VI. SECTION 1129(b)—THE CRAMDOWN

If confirmation of a plan under section 1129(a)(8) can be likened (with variations) to confirmation of an arrangement under the simple provisions of old chapter XI, confirmation of a plan under section 1129(b) can be compared (again with variations) to confirmation under chapter X in what might be one of its most complicated forms. Where the parties cannot agree on changes in rights of the respective parties, the role of the judge becomes more important, and the law must be more specific as to what the judge can and cannot do. Section 1129(b), with its detailed requirements, now controls. That section, in effect, substitutes the judge's determination for that of the statutory majority of the rejecting class on the question: Is the plan fair and equitable to and does it not discriminate against that class? To what extent can a judge under subection (b) of section 1129 require a rejecting class to accept a plan which has been accepted by a majority of each other impaired class?

Subsections (a) and (b) of section 1129 differ from each other as the day differs from the night. If the plan proponent can obtain consent of a statutory majority of each class, with relatively minor restrictions, what the classes accept under section 1129(a)(8) will be the plan. If this majority of each class allows participation by a class with no equity, so be it. If a majority of a class accepts moon rocks for a debt claim, if each other class accepts, the debtor can have his plan confirmed, unless some member of the class can prove that the value of the moon rocks is less than he would have recieved in a liquidation.

Even if the plan proponent must force a rejecting class to accept something it does not like, the bargain between the debtor and the accepting classes represented by the plan will not be disturbed by the judge. It is conceivable that if a lower priority class were to convince the judge that a higher priority class was given too much, the debtor and that class might have to agree that the higher class would get less.

With respect to the rejecting class, however, the role of the judge changes. The judge now must act more like the judge in an old chapter X case and make independent determinations within the closely circumscribed area of section 1129(b). The fair and equitable rule returns, but applies only to the rejecting class, and it is modified but not necessarily relaxed as to the protection given under section 1129(b) to the rejecting class. If the treatment of the rejecting class exhausts the estate, indirectly it will affect lower priority classes. The rejecting class can be crammed down only under rules in some ways more strict, in some ways less strict, than those under section 77 or chapter X.

Section 1129(b) consists of two separate parts, each with its own history and tests.

The first part, section 1129(b)(1), states:

> [I]f 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.

The judge is required to make findings on the two requirements of this section. First, the judge must determine that the plan does not discriminate against the class which has rejected the plan. The legislative history indicates that this provision means principally that no prior class is more than fully compensated. The second, and more difficult determination the judge must make under this section is that the plan is fair and equitable to the rejecting class. Again, we must resort to history to know what Congress had in mind. Briefly, this second test, going back to *Case v. Los Angeles Lumber Products Co.*[185] and equity receivership cases which long preceded it, requires that each member of a senior class receives full compensation before any junior class receives or retains an interest in the reorganized corporation, whether in securities of the new entity with earnings prospects or with voting power only, or with other property except for equivalent new value.[186]

*Case* did not involve the mechanics of determining values of new securities to be distributed. An early case which spelled out the mechanics of determining what was fair and equitable was

185. 308 U.S. 106 (1939).

186. Northern Pacific Ry. Co. v. Boyd, 228 U.S. 482 (1913) and cases cited therein. For an early case, see Railroad Co. v. Howard, 74 U.S. 392 (1868).

*Consolidated Rock Products Co. v. DuBois*.[187] That case (and the cases which followed it) generally is considered to have required that reorganization values of the reorganized entity be determined primarily by estimating future earnings of the reorganized corporation and capitalizing those estimated earnings by an appropriate multiple to produce a capitalized entity value. That figure, in turn, would set a ceiling on the amount of debt and stock which could be issued. When the 1940 railroad reorganization cases went up to the Supreme Court, the Court approved in *Ecker v. Great Western R.R. Corp.*,[188] an alternative method used by the Interstate Commerce Commission in railroad reorganizations. This method omitted capitalizing the estimated earnings and directly compared the available estimated earnings against the interest or dividend requirements of the securities to be issued in substitution for the old, taking the classes in the order of their priority. Under either test, when the stream of estimated earnings was exhausted, holders of the securities for which there were no estimated earnings available were given nothing—they were eliminated.

Under either test, the holders of the old senior securities had to be compensated in full. Under each test, estimated earnings were crucial in determining values. Under neither test, was there any pretense that the then market value of the new securities would equal the amount of the old claim replaced. It seems, therefore, that there was a hypothetical aspect to determining the "reorganization value" of the compensation—the value to come after appropriate seasoning of the new securities and based on predictions as to what the future would bring.

The determination of both the estimate of earnings and the earnings multiple allowed for considerable judgment. As Justice Douglas recognized in *Consolidated Rock Products*, the process produced at best "an educated guess."[189] The parties can only hope that it is not an uneducated guess. It may be that the chapter 11 judge will be even less equipped to pass on the reasonableness of that guess than was the judge under old section 77, or 77B, or chapter X. Under those statutes, the judge who passed on the reasonableness of the process would have been living with the case from its inception.

187. 312 U.S. 510 (1941). *See supra* notes 58-60 and accompanying text.

188. 318 U.S. 448 (1943).

189. 312 U.S. at 526. *See supra* notes 58-61 and accompanying text.

### A. *Incorporation into the Fair and Equitable Rule of Cramdown Requirements—Old and New*

Under chapter 11, the judge may have little contact with the case in any form unless a party in interest raises a question that calls for a judicial decision; he is likely to have no background as to earnings or values until the parties recognize, by invoking section 1129(b), that they cannot settle these matters among themselves.

A reader who is unfamiliar with the predecessors of section 1129 may find it necessary to go back to history to understand what Congress had in mind in chapter 11. Subsection (1) of section 1129(b) is a modified carryover from the fair and equitable test as we knew it under old section 77B of the act and under the chapters which replaced and supplemented that section in 1938. The old rule is modified by section 1129(b)(1) principally in that, like its partner 1129(b)(2), it applies only to the rejecting class.

Subsection (2) of 1129(b) is different. Its statutory precursors most likely would not have been considered as a part of the fair and equitable rule which applied to reorganizations generally, but a separate doctrine which applied only to the rare case where a plan was crammed down on a nonassenting class. Since the fair and equitable rule applies under chapter 11 only to a cramdown, it is not too surprising that both subsections (1) and (2) are treated as part of the fair and equitable rule of section 1129(b).[190]

Section 1129(b)(2) was derived from different statutory precedents. While immediately prior to the enactment of chapter 11 a fair and equitable rule somewhat comparable to that of section 1129(b)(1) (it could be invoked by any member of any class) applied to all reorganization confirmations under section 77 or chapter X, each of those statutes and chapter XII had a separate provision, not considered part of the fair and equitable principle, which applied only to a class of creditors who were affected by and did not accept the plan by the majority required under the applicable statute. Section 216(7) of chapter X allowed confirmation despite rejection by a class of secured claims if the plan gave

190. Compare *In re* Bel Air Assoc., 4 BANKR. 168 (W.D. Okla. 1980) (sketchy analysis of earnings estimate) with the better reasoned cases *In re* Nite Lite Inns, 17 BANKR. 367 (S.D. Cal. 1982), and *In re* Landau Boat Co., 8 BANKR. 436 (W.D. Mo. 1981) (confirmation of plan first refused; plan later confirmed with modifications in 13 BANKR. 788 (W.D. Mo. 1981)). *See also In re* Landmark at Park Plaza, Ltd., 7 BANKR. 653 (D.N.J. 1980) (confirmation of plan denied after an analysis of economic factors bearing on the plan's feasibility).

> adequate protection for the realization by the holders of the value of their claims against the property dealt with by the plan and affected by such claims, either as provided in the plan or in the order confirming the plan (a) by the transfer or sale, or by the retention by the debtor, of such property subject to such claims [*cf.* section 1129(b)(2)(A)(i)]; or (b) by a sale of such property free of such claims, at not less than a fair upset price, and the transfer of such claims to the proceeds of such sale [*cf.* section 1129(b)(2)(ii)]; or (c) by appraisal and payment in cash of the value of such claims [*cf.* section 1124(3)]; or (d) by such method as will, under and consistent with the circumstances of the particular case, equitably and fairly provide such protection [*cf.* section 1129(b)(2)(A)(iii)] . . . ."[191]

It would seem that the chapter X draftsmen had secured, rather than unsecured, claims in mind. References to the "property subject to such claims" do not automatically fit unsecured claims.

Section 77(e) is more general: "Provided, that if the plan has not been so accepted, the judge may nevertheless confirm the plan if he is satisfied that it makes adequate provision for fair and equitable treatment for those rejecting it; that such rejection was not reasonably justified. . . ."

Section 1129(b)(2), by comparison, reflects quite different treatment. This section deals separately with secured claims in (A), with unsecured in (B), and with interests in (C).[192] The Act

191. Bankruptcy Act of 1938, ch. 575, § 1(216)(7), 52 Stat. 840, 896.

192. 11 U.S.C. § 1129(b)(2) (Supp. III 1979). This section 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* (emphasis added):
>
> (A) With respect to a class of secured claims, the plan provides
>
> (i)(I) that the holders of such claims retain the lien securing such claims, whether the property subject to such lien 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 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 on account of such junior claim or interest any property.

had no separate treatment now covered by (B) and (C).

It should be kept in mind that the above provisions of chapter X and section 77, unlike the fair and equitable rule in general, and like sections 1129(b)(l) and (2), applied only to the dissenting class. Under chapter X and section 77, the fair and equitable test, akin to that of section 1129(b)(1), applied to every member of every class. Under section 129(b), neither test need be applied except to the dissenting class or classes.

### B. *A Comparison of* Denver & Rio Grande *as Decided and as It Would Be Decided Under Section 1129(b)(2)*

In considering the position under section 1129(b)(2) of the secured creditor who rejects the plan, it is pertinent to compare the treatment given to the dissenting class in *Reconstruction Finance Corp. v. Denver & Rio Grande Western Railroad Co.*,[193] with the treatment that now would be given under section 1129(b)(2)(A) and perhaps also (B). For simplicity, we assume that Rio Grande's status as a railroad does not affect the operation of 1129(b). The Code is new in separating the secured and unsecured portions of what hopefully was secured debt. Perhaps contrary to fact, we will first assume that this class of bondholders, which was given the lowest priority by the ICC and who rejected the plan, were secured fully on an asset basis. The ICC found that there was no room in the capital structure, as dictated by estimated earnings of the railroad, for any participation by the old common or the old unsecured debt.[194] In fact, estimated earnings would allow the junior secured bondholders to receive only ten percent of the amount of their debt, and that ten percent would be in the form of common stock.[195] This junior secured class, as noted above, rejected the plan.[196]

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(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 claim 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, and 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.

The italicized words in subsection (2) make it clear that compliance with subsection (2) is not an alternative to compliance with subsection (1).

193. 328 U.S. 495 (1946).

194. *Id.* at 501–02.

195. *Id.* at 502.

196. *Id.* at 501.

One test was whether the holders had been unreasonable in rejecting the plan. The Supreme Court held that since the class had received everything remaining after the satisfaction of prior claims, the class had been unreasonable in rejecting.[197] The district court's order of confirmation was upheld. Had chapter 11 applied, that treatment of a secured class, to the extent it was secured, would not fit any subsection of section 1129(b)(2)(A).

We have supposed that the bonds were truly secured on an asset basis. Suppose that the assets serving the debt were assets of a line to be discontinued and thus had no earning power. Could there then be a cramdown under section 1129(b)(2)(A)(i)(I) or (II)? These sections provide that old secured debt can be replaced only with new secured debt. Certainly no issuance of a new secured debt—or unsecured debt—equal to the amount of the old debt would be consistent with the future earnings valuation and the feasibility requirements of section 77 and, if it had applied, section 1129(a)(11). Perhaps the discontinued line could be sold for something under section 1129(b)(2)(A)(ii). The proceeds could not be invested pursuant to clause (1) for the reason given above—only bonds were permitted by that section, and feasibility tests prohibited more bonds. Perhaps some property other than a security could be given under subsection (A)(iii). Perhaps there was some kind of property other than unsecured debt or common stock of the debtor which might have satisfied the indubitable equivalent under subsection (iii). The legislative history indicates that neither unsecured debt nor the issuer's stock is the indubitable equivalent of secured debt.[198]

The greater possibility is that if section 506 had applied, the bonds in *Denver Rio Grande* would have been found to be partially secured or not secured at all. A senior class may have used up the collateral on which the bonds had a junior lien. Determinations under section 506 were not res judicata. The bondholders, as holders of unsecured claims, could be treated under section 1129(b)(2)(B)—either given some property equal in value to the amount of the debt under subsection (B)(i) or all junior interests eliminated under subsection (B)(ii). There would still be no room in the capital structure for the lower amount of new secured debt required by section 1129(b)(2)(A) to the extent the debt was secured. The 1940 railroad reorganization cases demonstrated that

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197. *Id.* at 535.

198. 124 CONG. REC. S 17,421 (daily ed. Oct. 6, 1978).

the fair and equitable rule meant the elimination of all classes below the undercompensated prior class.[199] The secured creditor, even if only partly secured, cannot, to the extent secured under subsections 1129(b)(2)(A)(i) and (ii), be required to accept property other than new secured debt, and no more secured debt can be issued. To the extent the old debt was unsecured, the treatment under section 77 of chapter X and 1129(b)(2)(B) would appear to be about the same—if the old debt is not compensated in full junior interests are eliminated, and the old debt can be satisfied with whatever is left.

If the old debt had been secured, the plan proponent had much greater freedom under section 77 regarding the form of the compensation if the plan gave the rejecting class the required value. In the case of a nonrailroad debtor, we could contrast the comparative freedom of old section 216(7)[200] with the straightjacket of new section 1129(b)(2)(A); there is some similarity between what we may fairly call the "catch-all" of the two sections. With respect to a class of secured claims, section 1129(b)(2)(A)(iii) states that a plan provides for "the realization by such holders of the indubitable equivalent of such claims."[201] Under section 216(7)(d), a reorganization plan must provide "for the realization . . . of the value of their claims against the property dealt with by the plan and affected by such claims, either as provided in the plan or . . . by such method as will, under and consistent with the circumstances of the particular case, equitably and fairly provide [adequate] protection."[202]

Although the "indubitable equivalent" language of section 1129(b)(2)(A)(iii) seems similar to the language of section 216(7), recall that section 1129's legislative history indicates that stock or unsecured debt of the debtor cannot satisfy that "indubitable equivalent."[203] Property other than the debtor's own stock or unsecured debt might be sufficient.[204] If the debtor has some asset not essential to its continued operations, could some distribution of the excess property to the rejecting class satisfy the "indubitable equivalent" test of section 1129(b)(2)(A)(iii)?

199. *See, e.g.*, Group of Institutional Investors v. Chicago, Milwaukee, St. Paul & Pac. R.R., 318 U.S. 523 (1943); Ecker v. Western Pac. R.R., 318 U.S. 448 (1943).

200. Bankruptcy Act of 1938, ch. 575, § 1(216)(7), 52 Stat. 840, 896.

201. 11 U.S.C. § 1129(b)(2)(A)(iii) (Supp. III 1979).

202. Bankruptcy Act of 1938, ch. 575, § 1(216)(7)(d), 52 Stat. 840, 896.

203. *See* 124 CONG. REC. H 11,104 (daily ed. Sept. 28, 1978).

204. *See* S. REP. No. 989, 95th Cong., 2d Sess. 1, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5787.

It is not at all impossible for a court to have determined that the claim is fully or partially secured under section 506(a) and later determine that there is no room in a future capital structure for the new bonds to replace the old to the extent secured. A section 506(a) determination may have been made at an earlier stage in the case and may have been properly based on asset value. The capitalized earnings value which sets a ceiling on the new capital structure has little or no relation to asset values. It is possible that an imaginative plan proponent can satisfy the requirements of section 1129(b)(2)(A)(iii) by giving the rejecting secured class assets which have little or no earning power in the reorganized enterprise but which have value for some other purpose. It is almost inevitable that there will be cases where the capital structure must be reduced, that there is value for a junior secured party, but the property to be given cannot be fitted into section 1129(b)(2)(A) and 1129(a)(11).

Did Congress intend to give a class of secured creditors absolute veto power when the class rejects a plan but cannot be covered by the provisions of section 1129(b)(2)(A)? The policy determination is not simple, even if we assume that what is good for the secured creditor is good for the country. Secured creditors A, B, & C, for example, who are prior in right to D, the rejecting class, all believe that continuation of the enterprise is in the best interest of the class. Assume that section 1129(b)(1) presents no problem. Unfortunately, secured creditor D, in his opinion less generously treated under the plan, does not share the opinions of A, B, and C. The fair and equitable rule embodied in (b)(2), and supplemented by the feasibility requirement of section 1129(a)(11) has made it impossible for the plan to give anything to unsecured creditors and equity holders. If the lowest class of secured creditors is in fact secured, can that class be given anything? Are secured creditors A, B, & C absolutely stopped by secured party D who now can be forced to accept only cash under section 1124(3), or secured cash payments in the future under section 1129(b)(2)(A), or some property other than unsecured debt or common stock of the debtor? There is no cash for a section 1124 payment, and the estimated earnings ceiling on capitalization and the requirements of section 1129(a)(11) prevent issuance of the secured debt needed to satisfy section 1129(b)(2)(A).

There may be a practical answer to what is at least a theoretical problem—there will always be some normally secured debt which in fact is unsecured and can be treated under section 1129(b)(2)(B)(i) and (ii).

This brief discussion of section 1129(b) is by no means complete. We have not raised the question as to whether a full-fledged earnings valuation will be necessary in every case to determine whether the value of the deferred debt under section 1129(b)(2)(A)(i)(II) is at least equal to the value of the collateral. The requirements of section 1129(b)(2)(A)(i) that "holders . . . retain the lien . . ."[205] have not been mentioned. Under the fair and equitable rule embodied in section 1129(b)(l), it was well established that the substitute debt is not required to be secured and certainly not by the same collateral. In the railroad cases, it often was often necessary to consolidate divisional mortgages into a system mortgage which did not present any problems under the fair and equitable rule as long as any stepdown in quality was taken into account.[206] This consolidation would not be permitted under section 1129(b)(2)(A)(i)(I). The value of the deferred payment under section 1129(b)(2)(A)(ii) has not been explored.

We have not explored the problems of issuing securities in the amount of the old debt but with a value equal to that of the collateral. Will such an issuance square with the feasibility requirements of section 1129(a)(11)? We have examined only briefly the possibility that under section 1129(b)(2)(A) the collateral may be sold and the lien transferred to the proceeds when the debt of the rejecting class is secured by collateral which the entity does not need to effect a reorganization. Some or all of the collateral, however, is often so essential to continued operations that it must be retained.

More importantly, this Article has not discussed the possibility that a cramdown, at the request of a plan proponent who represents the equity interests, may effectively eliminate that interest if the entity cannot compensate in full the unsecured rejecting class with any kind of property. If section 1129(a)(2)(B)(i) cannot be satisfied, subsection (ii) permits confirmation only when the plan eliminates the classes below the secured debt. The fair and equitable rule of section 1129(b)(1) and the feasibility requirement of section 1129(a)(11) may prohibit issuance of stock to the rejecting class.

Subsection (C)(ii)(c) of section 1129(b)(2) deals with elimina-

205. 11 U.S.C. § 1129(b)(2)(A)(i) (Supp. III 1979).

206. *See supra* note 198.

tion of classes junior to the rejecting class, including stock or other equity interests. A junior class plan proponent is not likely intentionally to cramdown his own class. To eliminate these interests, it would seem that a member of a senior class would have to propose a plan which calls for the elimination of a junior class under section 1129(b)(2)(C). This plan often would involve a full-blown earnings valuation to determine whether the class has no equity.

The conclusion that it is wise to conduct negotiations aimed at producing a plan which will receive consent from the statutory majority of each class seems obvious. Perhaps the principal use of section 1129(b) will be as a bargaining club which dissidents on the one hand or plan proponents on the other may employ to reach agreement rather than face the trials and tribulations of a section 1129(b) proceeding.

## VII. A Conclusion and a Question

Apart from old chapter XII cramdowns of the *Pinegate* type, cramdowns have been rare. It is hoped they will continue to be rare in the future. The need to know what can be done to a non-accepting class under chapter 11, however, cannot be measured by the infrequency of cramdown occurrences. In determining how far a class may agree to go, it is important to know how far the class can be pushed.

This Article disregards the common notion held by Congress and others that the method by which the Bankruptcy Code was enacted made it inevitable that some dropped stitches would have to be picked up. Congress and students of the bankruptcy process are working on that task. When this task is complete, minor imperfections should be cured. It would seem that the process of confirming a reorganization through consent of a majority of each class as contemplated by section 1129(a) should be workable. Old chapter XI demonstrated that much can be done by consent of individual secured creditors without the aid of majority pressure on the minority of a class, and without that pressure on secured creditors or equity interests. The problems are more complicated when a reorganization plan is rejected by one or more classes. There will be occasions, therefore, when plans must be resolved through the judicial process rather than through agreement of the majority of each class. The need for protection of the rejecting class is obvious. If we accept the basic thesis of corporate reorganization law that liquidation is often an unacceptable method of handling an entity which seems to be economically viable, is there not a corresponding need to allow a reorganization where a class rejects a plan, with additional restraints, but comparable to the more flexible restraints imposed by section 77(e) in reorganization of a railroad or that of section 216(7) of chapter X for a nonrailroad entity?