ORIGINAL

TRANSCRIPT OF PROCEEDINGS

IN THE SUPREME COURT OF THE UNITED STATES

NORTHWEST BANK WORTHINGTON, ET AL.	)	
Petitioners,	)	
V.	)	No. 86-958
JAMES R. AHLERS, ET UX.	)	
	)	
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IN THE SUPREME COURT OF THE UNITED STATES

NORWEST BANK WORTHINGTON, ET AL., Petitioners, v. JAMES R. AHLERS, ET UX. : No. 86-958

Washington, D.C.

Tuesday, January 12, 1988

The above-entitled matter came on for oral argument before the Supreme Court of the United States at 11:02 a.m.

APPEARANCES:

GORDON B. CONN, JR., ESQ., Minneapolis, Minnesota; on behalf of the Petitioners.

WILLIAM L. NEEDLER, ESQ., Chicago, Illinois; on behalf of the Respondents.

C O N T E N T S

P R O C E E D I N G S

CHIEF JUSTICE REHNQUIST: We will hear argument next in Number 86-958, Norwest Bank Worthington v. James Ahlers.

Mr. Conn, we will wait just a minute until the crowd subsides.

Very well, Mr. Conn. You may proceed whenever you are ready.

ORAL ARGUMENT OF GORDON B. CONN, JR., ESQUIRE

ON BEHALF OF PETITIONERS

MR. CONN: Thank you, Mr. Chief Justice, and may it please the Court:

This is a bankruptcy case on certiorari to the Court of Appeals for the Eighth Circuit. The case involves the so-called "sweat equity" issue in Chapter 11 reorganization proceedings.

The issue on which this Court has granted review, slightly paraphrased, is whether a Chapter 11 debtor, in this case a farmer, may cram down a plan of reorganization over the objections of unpaid creditors, where the creditors will not be paid out under the plan, but where the debtor will retain all his property in exchange for a promise in the future to contribute his labor, experience and expertise in the business operation of the organization.

The Court of Appeals, by a divided panel decision, held in favor of the debtor on this issue.

In doing so, the Court of Appeals reversed the factual findings of both the Bankruptcy Court and the District Court, regarding the lack of adequate protection for the secured creditors' interest in the property, and also regarding the feasibility of reorganization of this particular debtor.

The panel decision held that a Chapter 11 reorganization of this debtor in this case would be feasible, notwithstanding the opposite finding by the District Court.

In this case, the Court of Appeals held that reorganization would be feasible because number one, the debtor in this case would have no present obligation to provide adequate protection of his secured creditors' interests in collateral, thereby freeing up funds for reorganization that would otherwise need to be used to pay adequate protection, and number two, that reorganization would be feasible because the debtor could overcome what is known as the "absolute priority" rule of 11 U.S.C. Section 1129(B), previously reflected in this Court's decisions in Case v. Los Angeles Lumber, and others, that the "absolute priority" rule could be overcome by the debtor's promising in the plan to devote his future labor, experience and expertise to the reorganized operation.

The essence of it is that, notwithstanding the statute, and the prior decisions of this Court, a bankruptcy debtor under this decision may retain property by a future promise of working without paying his creditors.

The case arises out of the following general facts: The Petitioners are creditors of the debtor who in this case is a farmer. The Petitioners include the Federal Land Bank of St. Paul and Norwest Bank of Worthington.

The Land Bank's interest began in about 1965 when it made various real estate loans to Mr. Ahlers, and the interests of Norwest Bank Worthington arose in about 1982 when that bank extended various operating loans, all secured by second mortgages on real estate, and by security interests in other collateral.

The debtors' borrowings from these two institutions amounted to in the neighborhood of $1 million. By late 1984, the debtors' were in serious default under their loans and filed for protection, under Chapter 11 of the Bankruptcy Code.

Shortly following that filing the Land Bank and Norwest promptly moved for relief from the bankruptcy automatic stay under Section 362(D) of the Bankruptcy Code to permit foreclose of their mortgages and security interests.

At this time, I think it is common knowledge, the farm economy, particularly in the Midwest, was in a troubled state and secured creditors in particular were seeing the values of their collateral diminish. Land values in particular had declined sharply and were continuing on the downside.

Indications, Justice White, are that the corner may have been turned, I believe.

QUESTION: I'm glad to know that.

MR. CONN: There may be some dispute about that.

In seeking relief from the stay to permit foreclosure, the two creditors here moved both to lift the stay for lack of adequate protection of their interests in the collateral under Section 362(d)(1), and also moved for relief from stay under Section 362(d)(2), which provides for relief from stay where the debtor has no equity in the property, and the property in question is not necessary for an effective reorganization.

In moving under this latter section, the Petitioners took the position that the property was not necessary for an effective reorganization, because the debtors' financial condition was so desperate that no reorganization could in any instance be feasible in this case.

The Bankruptcy Court granted relief from the stay, holding that adequate protection was required to protect Petitioners' interest in the property and that the debtors' officers of adequate protection were not sufficient to provide that protection.

Accordingly, the Bankruptcy Court ordered that the automatic stay be lifted to permit the creditors to foreclose their interest.

The District Court affirmed and the debtor then sought relief in the Court of Appeals to stay the effect of the

orders of the lower Court.

The Court of Appeals did stay the orders, pending appeal, and also directed, in connection with one of those interim orders, that the District Court undertake a specific examination of the feasibility of reorganization for these debtors.

The District Court did so, and in an Opinion included in our Appendix, the District Court undertook an analysis of the debtors' financial operations and projections from the Bankruptcy Court file and concluded that the debtors' situation was so dire that there was utter unfeasibility of reorganization.

The matter then went back to the Eighth Circuit, and on that further appeal, in a divided panel decision, the Court of Appeals reversed the lower Court's holding that no adequate protection was required as to the real estate because of a timing issue that would hold under the applicable state law that no protection would be required for a year and six weeks, thereby freeing up substantial funds for use by the debtor while retaining the property, and number two, and this is the issue involved in this proceeding, that reorganization of this debtor would be feasible, despite the findings of the District Court.

The basis on which the panel decision found that reorganization would be feasible, which I will address in more

detail in a moment, was that the debtor, despite not being able to pay creditors in a plan of reorganization, should nonetheless be allowed to retain all the property under a plan in exchange for the debtors' willingness to provide work over the years of the plan, which might or might not result in some additional payment to creditors that would not be received in a liquidation.

Following that decision, the Petitioners moved for rehearing with a suggestion for rehearing en banc.

The decision of the Court of Appeals was a five to four vote in favor of rehearing, but rehearing was nonetheless denied because of lack of an absolute majority of the Judges on the Eighth Circuit.

The tenth Judge had recused himself from participation because of prior representation of the Land Bank.

Petitioners then sought relief in this Court through the Petition for Certiorari, on three grounds: number one, the lack of adequate protection; two, the en banc question; and three, the absolute priority issue, which his sometimes described as the sweat equity issue.

The certiorari was granted as to the absolute priority issue.

We believe in this proceeding that the decision of the Court of Appeals on that issue is in error and should be reversed.

QUESTION: Mr. Conn, can I ask you one question before you get into the main part of your argument?

Your clients are partially secured creditors and they are also partially general creditors, because they are undersecured, is the way it works out.

MR. CONN: That is correct.

QUESTION: And I take there probably were some general creditors who had no secured interest at all.

Was there a creditors' committee or something? Did they have a position in the litigation, the creditors?

MR. CONN: I am not specifically sure, Justice Stevens. The amount of unsecured creditors who were not in this dual position, as are the two banks, was very, very small. I believe the total indebtedness reflected there was something like $70,000 as compared to $500,000 in the unsecured portion of the Petitioners.

To my knowledge, those other creditors have been inactive throughout the proceedings.

QUESTION: Thank you.

MR. CONN: We believe that the decision of the Eighth Circuit Panel is error, basically for three reasons.

First, allowing the retention of property by a debtor without satisfying objecting creditors in full is contrary to the plain language of the relevant portion of the statute. The relevant portion is 11 U.S.C. Section 1129(b)(2)(B).

Second, to the extent that the prior decisions of this Court on the absolute priority issue survive enactment of the 1978 Bankruptcy Code, the decision of the Court of Appeals is clearly contrary to the rule of law announced in Case v. Los Angeles Lumber, the Boyd case, and several others previously announced by this Court.

Finally, and from a broader perspective, we believe that the decision of the Court of Appeals seriously upsets the balance of rights and remedies and bargaining mix, if you will, that Congress established in enacting the 1978 Bankruptcy Code, and in doing so, unfairly expands the so-called cram down power of debtors to the severe detriment of creditors.

On the first point, which I think is the clearest, that is, the language of the statute.

QUESTION: Mr. Conn, you are not arguing, as the Government's amicus brief does, that even non-sweat equity cannot be crammed down, are you? Or are you?

MR. CONN: Your Honor, I have difficulty with that position. There is a substantial attraction to the bright line test that is suggested in the Solicitor General's brief that would avoid any difficulty of valuing new contributions by former owners.

In reviewing the legislative history of the absolute priority provisions of the Bankruptcy Code, I am frankly not c certain whether Congress intended totally to abrogate the prior

rule of Los Angeles Lumber.

I would have to say that there does not appear at least to me to be a specific intent to overrule prior case law.

However, what does appear to me, in reviewing that legislative history, is that there was clearly no intention on the part of Congress to in any way expand whatever exception there might have been to absolute priority under those cases.

I think the contrary is true, and that can be seen by the fact that in defining the term "fair and equitable" out of which the absolute priority rule had evolved in judicial decisions, Congress chose expressly to define "fair and equitable" to exclude the retention of property without full payment of senior creditors.

QUESTION: You say, in other words, that the Bankruptcy Code went no further in favor of debtors than Los Angeles lumber.

MR. CONN: The Bankruptcy Code went much further in favor of debtors in several cases.

QUESTION: But on this particular point.

MR. CONN: Not on this point. In fact, the key point on that, Your Honor, is that when the Tulsa revision of the bankruptcy laws was proposed by the Bankruptcy Commission, there was recognition that there were some special difficulties for individual debtors and there was recognition that maybe the rule of Los Angeles Lumber of this Court was too harsh.

The Commission suggested that the laws be amended to relax the absolute priority rule in general to allow equity participation by former owners, and in particular to allow participation by individuals, after a period of time in a plan.

Congress, by enacting the 1978 Code, expressly did not follow those recommendations of the Commission.

Instead, what Congress did was to enact the specific provisions in 1129(b)(2)(B) which expressly state that a debtor cannot retain property under a plan over the objection of his creditors without satisfying those prior claims in full under the plan.

The absolute priority rule, which is codified now in the statute, has something of a harsh ring to it, and indeed, the very language of it is by its terms, absolute.

In commenting on that, I would like to observe that in what I perceive at least to be the real world of bankruptcy, it does not work that way. Under the 1978 Bankruptcy Code, in order to confirm a plan of reorganization, a debtor need not invariably satisfy that absolute priority rule, which was the case under the earlier case law of Case v. Los Angeles Lumber Company, where that rule had to be satisfied notwithstanding the fact that creditors favored allowing participation.

Under the 1978 Bankruptcy Code, all a debtor needs to do to overcome the absolute priority rule, is to convince his creditors that they will fare better in a reorganization in

which the debtor retains an interest than they would in a liquidation.

This is part of the mix of bargaining rights that I believe was established by Congress under the Code and it is only in a rare situation where a debtor is either unable or unwilling to make a satisfactory offer to his creditors that the issue of cram down comes into play or that the veto power of the absolute priority rule if you will, comes into play.

In the briefs submitted by the Respondents and their amicus curiae supporters, there seems to be an argument made that the absolute priority provisions of the Bankruptcy Code somehow should make a distinction between individual debtors and corporate debtors, such that, while it is appropriate to apply the absolute priority rule to prevent shareholders of a corporation from retaining equity interest, it is somehow not appropriate to apply that rule where the debtor is an individual.

I think the response to that argument is twofold. First, the plain language of the absolute priority rule in the statute does not admit of any distinction between individual and corporate debtors.

Throughout the Bankruptcy Code, it is clear that when Congress chosen to deal with particular needs of particular classes of debtors, it has done so.

For example, only individuals can exempt certain

property from the estate under Section 522. Only individuals can avoid liens on exempt property under that same section. Only individuals are entitled to a complete discharge of debt under Section 727.

Only farmers are immune from involuntary bankruptcy cases under Section 03.

In addition, Congress has made special provisions for individuals and farmers in Chapters 12 and 13.

I think the implication is fairly clear, that had Congress chosen to do so, in the absolute priority rule, it could have. Indeed, that was specifically suggested by the Bankruptcy Commission, and was not enacted by Congress.

The decision below looks around, I think, the clear language of the statute and seeks to rely on this Court's decision in Case v. Los Angeles Lumber for support for the notion that a debtor may in effect buy into a reorganization thorough a promise of future work or service.

With all respect, I think that the ruling in Case v. Los Angeles Lumber is to the contrary and does not support the position of the panel decision in the Court of Appeals.

In fact, the Los Angeles Lumber case reversed decisions of the lower Courts which allowed equity owners' retention of equity interests in a bankruptcy where the consideration, if you will, for that retention was their future management standing in the community and the like.

That is very close, I think, to what the Court of Appeals has done below in this case, and Case v. Los Angeles Lumber simply doesn't support it.

What the Court of Appeals did and what the Respondents and their amicus supporters strive to do here, is to fit this sweat equity notion within the apparent exception of Case v. Los Angeles Lumber that would have allowed existing shareholders to participate in a reorganization in exchange for an infusion of new capital.

The argument goes that because the debtor in this case will agree to provide services in the future, that is the equivalent of new capital for the operation and therefore it is not a violation of the absolute priority rule to allow the debtor to retain all interest in the property.

There are several problems with that. First, it would apply in virtually any Chapter 11 case involving an individual debtor because obviously it is implicit in any individual reorganization that the individual intends to keep working the business.

The next argument that is made by the Respondents is that the debtor really would not be retaining anything here, because what is being retained is of no value. The debtor has no equity in the property, therefore it is valueless, therefore it is not a retention.

The problem with that analysis is that obviously,

there is some going concern value here, or the parties would not have been litigating over it for the last three years.

This "no value" theory is, as I read the Attorney General's amicus brief, not endorsed by them. It is rejected by Professor Nimmer's article on which they rely. And with the exception of the Star City Rebuilders case, I believe that "no value" argument has been rejected by every lower court to consider it.

The next argument they make is that by agreeing to provide future services, the debtor is injecting new value to the organization which would enable, in effect, the purchase of the property over the objection of the creditors.

The problem with that argument is that the promise to provide future services is really nothing new. It is implicit in the original loan.

Any time I take out a loan for my business, implicit in my promise to repay is that I am going to work in the business to generate funds to repay.

What is happening in this situation is that the debtor is seeking to have the level of debt structured down in bankruptcy and then saying okay, now I am going to promise to repay this lower debt by working the business, which is precisely what the original promise implied.

In that context, there is nothing new.

Secondly, on that same point, the notion that the

debtor's services are providing consideration for buying the assets in substantial part involves bootstrapping. The return on use of this property is going to come from the debtor's use of the land, equipment, other cash collateral which is subject to the creditor's claims. Only a portion of whatever funds could be generated are solely attributable to the debtor's own services, and therefore, again it is not new value.

Finally, the exception, if that is what it is, in Los Angeles Lumber, speaking about allowing equity holders to buy in through a capital infusion, is clearly that the capital infusion must be in money or money's worth.

Now, the difficulty with the lower Court's decision in Ahlers is that an unenforceable promise to provide future services is not a current asset. As in Los Angeles Lumber, it is not an item that can be put on the balance sheet of the business organization. It has no present value for liquidation purposes.

In short, it does not enhance the estate for creditors at all.

If the plan fails, the promise of the debtor to work in the future does not give the creditors unpaid any further rights than they would have had before, and therefore, it is, I believe, a totally illusory obligation.

Finally, and I think in the broader context here, the difficulty with what Ahlers does in the overall context of the

Bankruptcy Code is that it severely upsets the relative bargaining positions between the debtor on the one hand and the creditors on the other.

It gives a very strong tool to debtors in virtually ever case involving an individual reorganization, which is a far departure from what at least I believe Congress had in mind.

The real upshot of Ahlers is that, contrary to the provisions of the Bankruptcy Code, which contemplated that a secured creditor should be able, if criteria were met, to obtain a decision on a lift stay motion within 30 days after making that motion, and if the stay were not lifted that the creditor would receive protection of its interest during the duration of the bankruptcy case that has been turned upside down by the Ahlers decision.

What has been seen in this case is that the Petitioners, who started out as secured creditors and now hold dual roles, have been precluded for three years from enforcing their rights in collateral, which has probably been declining during the interim, and they are now confronted, if the Ahlers decision were upheld, with seeing their debts restructured at a lower level and proceeding over a longer period with continuing risk to ride with the debtor.

Now, on policy arguments, one can argue that that might be an appropriate approach to attempting to assist the

troubled farm economy. The response to that is, that is precisely what Congress has done, or attempted to do, in enacting Chapter 12 of the Bankruptcy Code.

The responses to these problems as perceived are invariably legislative responses rather than calling for changing dramatically the provisions of Chapter 11 of the Bankruptcy Code.

I think that Congress, through Chapter 12, and the various state legislatures through their Farm Mediation Acts and the like, have demonstrated an ability to address that problem, and I believe that the effort of the Court of Appeals to do it by judicial means is inappropriate.

I would like to reserve the balance of my time, if I may.

CHIEF JUSTICE REHNQUIST: Thank you, Mr. Conn.

We will hear now from you, Mr. Needler.

ORAL ARGUMENT OF WILLIAM L. NEEDLER, ESQUIRE

ON BEHALF OF RESPONDENTS

MR. NEEDLER: Mr. Chief Justice, and may it please the Court:

I am here on behalf of James and Maria Ahlers, farmers from Fulda, Minnesota, and here on behalf of many other farmers from all the states in the Union who looked at the Ahlers case as a relief, a rock in the middle of this storm.

We have upset the balance, says Mr. Conn. We have

upset the balance between the creditor and the debtor. And yet, in the very next case we had with this same farm credit system, they brag that there has never been a successful farmer reorganization in the District of Minnesota.

Against that background came the Ahlers case. We went to Court. They had filed a replevin. They were going to take his machinery. We filed a Chapter 11. He came to Chicago. We filed that Chapter 11 to protect his assets.

We immediately prepared a plan of reorganization. We immediately prepared a disclosure statement. We went into the Court and we asked for cash collateral. Under 363 of the Code we requested living expenses. At the same time we had the relief of stay.

We asked for food to eat. We were denied. We asked for food to apply and run our farm. We were denied. The Federal Land Bank system, our Federal agency, our instrumentality of the United States Government if you will, the one who went to the President last week and got the bailout said here's $2,000.00.

So we had $2,000 to run our farm. They then said to me, as counsel, give back your retainer, Mr. Needler, so that they can eat. The retainer was not asked back.

I want you to have some of the background of this case. This is a serious farm case in a district where there were no rights.

We went to the United States District Court. The Opinion came out. I filed a Chapter 11. You never should have filed, you should have liquidated. You are the wrong attorney. You should not practice here. All those things when we went to the United States District Court.

We argued the case up there. We filed our brief. We said, we have a plan. We're right in the beginning of the case. We are a Chapter 11 debtor. We are a qualified farmer.

In the hearing before the Bankruptcy Court, Mr. Ahlers, who is here today, was on that stand and testified as to his income, as to his crops,as to his costs. They were irrefuted. There was no evidence that he did not have $126,000 at the end of this period now to reorganize.

The Court found there is no evidence he can make it. He can't make it. The plan is not feasible.

That is the background.

And we went to the United States District Court. We lost there. They came up with some new formulas. There is too much debt. Since when is a Chapter 11 debtor precluded from filing Chapter 11 or seeking reorganization in this United States of America because he has, quote, "too much debt."

Since when is a Chapter 11 debtor going to be measured against a formula, if you will, a formula proposed by the United States District Court.

QUESTION: It is not a formula proposed by United

States District Court. It is simply a question of whether he has so much debt that nobody is willing to loan him money to try to run the business. Isn't that what is at issue?

MR. NEEDLER: What is at issue here, Your Honor, is one, the issue here is a narrow one of absolute priority. He has talked about the problems in the lower Court with regard to adequate protection.

QUESTION: Are you going to talk about those problems?

MR. NEEDLER: Am I going to talk about those problems not before the Court? I would be glad to talk about them, but I do not think that is the issue here.

QUESTION: The problem before the Court.

MR. NEEDLER: The problem before the Court is whether the absolute priority rule which is set forth in 1129 applies to Mr. Ahlers and Mr. Ahlers and farmers in like circumstances.

And we say that does not apply. We say that he has the right to reorganize. If that rule is applied to Mr. Ahlers, then I submit to you, gentlemen, there is not a farmer in the United States, there is not a small businessman in the United States, who is going to be able to reorganize during this crisis.

If creditors are going to be allowed to use the theory which is put forth by Mr. Conn and the Federal instrumentality here that Mr. Ahlers has to have fresh outside

capital, then I submit there is no fresh outside capital today for our farmers.

This bill that was signed by the President last week is not going to give outside capital to the Mr. Ahlers and all the farmers.

QUESTION: So Congress really has gotten around to addressing these severe problems?

MR. NEEDLER: You say Congress has gotten around to addressing the severe problems? Congress has passed a Chapter 12 bill, yes. Congress passed a Chapter 12 bill which restricts Chapter 12(A)to all those farmers who have never filed Chapter 11. (B) restricts it to those farmers who are of s certain size and stature.

Mr. Ahlers does not fit into that. Neither do many farmers in Arizona, Minnesota, all over the Union, do not fit within the Chapter 12.

QUESTION: Why is that? Are they too big, is that it?

MR. NEEDLER: They are too big, and the Courts in Minnesota, Your Honor, have already interpreted Chapter 12 to say that Mr. Ahlers, since he is in Chapter 11 and already filed Chapter 11, could not convert.

There is some language in the enabling clause of Chapter 12 which somehow prevents him.

Other states, South Dakota, North Dakota, Iowa,

Kansas, Nebraska, have allowed conversions of those farmers to Chapter 12, if they fit.

QUESTION: You mean District Courts in those states?

MR. NEEDLER: Bankruptcy Courts, District Courts, have denied the right of farmers like Ahlers to convert to Chapter 12.

Chapter 12, although promoted by Senator Grassley, Senator East and the Committee as a help to farmers -- it has helped; there is no question. It has helped the courts in the philosophy of looking at farmers. It has assisted. But there are many farmers, Your Honors should understand, who do not fit within this category. There are many farmers who need time.

Now, if you remember, one of the premises of Chapter 11 was quote: "We need a breathing spell." We're going to give them a breathing spell. We are going to have 362 to protect the creditor. Be it the farmer, be it Wicks or be it Johns Mansville, 362 is going to protect him.

In Chapter 12, there is no time. Chapter 12 says in 90 days you are going to file a plan and you are going to get confirmed right away.

Time, of course, is needed by a troubled debtor. If he could pay 100 cents on the dollar, like Mr. Conn suggests, to the unsecured portion of the unsecured claim, he would not be in Chapter 11 to start with. He would not be in bankruptcy.

He said this is a bankruptcy case. And I take issue

with that. This is not a bankruptcy case. This is a reorganization case of a family farmer and thousands of family farmers across this Nation.

If we allow the creditor who holds a secured claim to control the entire Chapter 11 proceeding, then I think you are going to be doing something that is inequitable.

QUESTION: Mr. Needles, I am going to ask you a question. I hope you will stop long enough to answer it.

The question on which we granted certiorari is: do the absolute priority provisions of Section 1129 of the Bankruptcy Code, 11 U.S.C. 1129, this Court's decision in Case v. Los Angeles Lumber Products Company, prohibit confirmation of a debtor's proposed reorganization plan under the circumstances given there?

I hope you will address that question sometime during the half an hour allotted you.

MR. NEEDLER: Thank you.

We say that the debtor, Your Honor -- Judge Heaney has said that the debtor has certain labors which have value, which have measurable value, that Mr. Ahlers' labors are measurable. The Court can measure them. They can determine how many hours he works, what the rate would be if you had to replace Mr. Ahlers --

QUESTION: He has not given them. He has not given them. He has promised to give them. Right?

MR. NEEDLER: He has promised to give them.

QUESTION: Suppose he promised to give money? What is the difference between promising to give his labor and promising to give money in the future?

MR. NEEDLER: If Mr. Ahlers confirmed a plan on a promise, Justice Scalia, and one month into the plan he did not deliver on the promise, then Mr. Conn could run into Court under Section 11(12)(B) and the case is dismissed.

QUESTION: So it works for money, too?

MR. NEEDLER: It works for anything.

QUESTION: So it's not just sweat equity, it is even non-sweat equity?

You would say that if the debtor comes in, the debtor who has already defaulted on one promise to pay money, if he comes in and says I promise to pay more money in the future, the Court has to allow a reorganization on the basis of that new promise?

MR. NEEDLER: What we're saying is, in answer to his question, Mr. Conn's question, is how do we protect the creditor if Mr. Ahlers does not perform on his promise of work and the work ethic?

QUESTION: Right.

MR. NEEDLER: The answer to that is that the minute he does not perform, the case can be dismissed under the appropriate provisions of the Bankruptcy Code.

QUESTION: And the same with a promise to give money. Right?

MR. NEEDLER: And any other promises under a plan.

QUESTION: Okay. So you are not just arguing sweat equity, you are arguing that you don't have to put up money. It is enough that you promise to put up money. And if and when you don't make good on that promise, then we'll undo the reorganization, but meanwhile we let it go.

MR. NEEDLER: What I am saying is that the Los Angeles Lumber Company case indicated that if there were substantial promises that were measurable in money or money's worth, that would be an exception. What Judge Heaney is saying is that his labors, Mr. Ahlers' labors, and his wife's labors, are money and money's worth, and can be provided as an exception to Los Angeles Lumber.

And in providing this labor and in going forward with the Chapter 11 and the confirmed plan, we are going to promise to pay unsecured creditors 100 cents on the dollar.

And remember in this plan the average farmer -- and Mr. Ahlers is the average farmer -- there is no equity for the unsecured creditors. They are going to get zero under this plan. They have no claim on the assets that have value.

So what Judge Heaney has said here will allow Ahlers to reorganize, will allow him to go forward, and will have in the plan as part of the plan that the monies over and above

those needed for reorganization are to go to pay off the unsecured creditors.

QUESTION: Mr. Needler, in Los Angeles Lumber, which I take it you say is still applicable under the Bankruptcy Code, the old business management law, the promise they would continue, they had financial standing in the community. And Justice Douglas' Opinion for the Court said that we will not permit valueless junior interests to participate their position in an enterprise on such ephemeral grounds.

How does your client's position differ from the people in Los Angeles Lumber?

MR. NEEDLER: In Los Angeles Lumber, as I understand what the Court said there is, financial standing in the community is not measurable.

QUESTION: And a willingness to continue to work in the business.

MR. NEEDLER: What I am saying here is with regard to the Ahlers and similar farmers in the United States, for example, if they went in to Fulda, Minnesota, and let us say he got a job managing the thousands of acres that the Land Bank now has, and he collected let us say $40,000 a year and he contributed that back into the Chapter 11, that would be money and money's worth.

His efforts as a farmer are measurable.

QUESTION: But so were the managers of Los Angeles

Lumber measurable.

MR. NEEDLER: As I read that case, it was negligible things like financial standing in the community, good reputation, those type of things.

We are talking about hard work and labor by the farmer over and above what he is taking out.

The farmer here is taking out $12,000 a year. He is working 12 hours a day, 52 weeks a year, et cetera.

That labor has a value. That labor is far more than the living expenses he is taking out. Judge Heaney has said, let us measure what commitment in dollars he is putting in. Judge Heaney says he is putting in $28,000 a year.

QUESTION: He is promising to put it in, that is the problem. He is not putting it in. He is promising to put it in. And it seems to me that that is no more valid than his promise to put in $200,000. That would not allow a reorganization to go forward.

The Court would say, bring in your $200,000. Put it in the kitty. And then we will go ahead. But the promise to do it is simply not the doing of it.

MR. NEEDLER: Justice Scalia, as I read the Boyd case, back before the turn of the century, the Court there said they could propose income bonds or they could propose preferred stock.

And I suggest to the Court that the income bond in

Boyd is nothing but a pure promise to pay, based on if there is any income.

What the Judge has said here is that Mr. Ahlers' labors are measurable, that they are money and money's worth.

For example, in the farm community, as I am sure you all know, if I am a farmer, I may trade my labors with Mr. Truax here. He may pay me, he may not pay me, he may pay me by coming back and working. There is a barter situation.

Where there is a portion of the economy where there are no credits available to it, this becomes value. This is the only value that these farmers have.

What we are also saying in our brief is that the secured creditor here is voting his secured claim, through his unsecured claim, and in effect liquidating out all the other merchants that are in this case.

The question was asked, was there a creditors' committee. No there was no creditor's committee, because we were right up front in this case. There was no creditors' committee to watch this case.

But the unsecured creditors have supported the Ahlers all the way through this case. There are a whole series of merchants on Main Street, other than these Federal Land Bank and Norwest Bank here. Sure, their amount is not as great as the Norwest Bank's or the Federal Land Bank's. But it is a sizable amount.

The creditor on Main Street, if you allow the position of the Federal Land Bank and the Federal instrumentality to prevail here, the creditor on Main Street is going to get zero.

The large secured creditor here is voting their secured claim through their unsecured claim to defeat this reorganization. That is not what was intended by the absolute priority rule. This is a Court of equity. And equity, we do not think, allows one in effect to vote one's claim against the other creditors.

There is a case which I think should be of interest to Your Honors. And that is the Securities Commission v. U.S. Realty, which was a 1940 case decided by this Court.

And I would quote, on Page 454: "In cases where subordinate creditors of stockholders or managers of its business, the preservation of going concern value through their continued management of the business may compensate for reduction for reduction of claims of the prior creditors without alteration of the managers' interest."

This, the dissent says, is an exception to Los Angeles Lumber, an additional exception, and that should apply to self-proprietors.

Under the Bankruptcy Code there is a definition and there is a class. And that class is in almost every plan, in every corporate plan, and that is class of equity security

holders. Nowhere is an individual debtor in that class. We say that there is no class that is junior to these creditors here.

Mr. Ahlers is not a class. He owns the land. He still own the land and he's not taking the land pursuant to this plan. So that that is an exception to 1129(b)(2)(B).

To allow -- and I would quote, Your Honors, from this case again. Your own case says that the Bankruptcy Court is a Court of equity. And the Bankruptcy Court, in its discretion, in the exercise of its jurisdiction, may safeguard the public interest.

What we are saying is here that Judge Heaney has safeguarded the public interest here. He has allowed the Ahlers and similar farmers to reorganize, allowed them to contribute the only thing that they have to contribute, which is their labors, and that that should stand and that the Ahlers should go forward and be allowed to reorganize.

1129 came out of Chapter 10, which was a corporate reorganization. It did not come out of Chapter 11. It did not come out of Chapter 12.

When they combined the code, they left it in there. And we say it is in there, as Boyd says, it is to protect the large corporation creditors from collusion between large corporation itself and the secured creditors to the exclusion of the unsecured creditors.

What we are saying here is the same equitable rule

should apply to protect the other unsecured creditors from the unscrupulous activities of the large, secured creditors who are willing for whatever reason, to get their collateral back, to get the farm back, to the detriment of all the unsecured creditors.

They are voting their unsecured claim in an inequitable way to the damage of all other creditors.

If the Equity Court of the United States and the Bankruptcy Court and the Supreme Court protected the unsecured creditors against the bondholders and the debtor's activity in Boyd, then why shouldn't the Bankruptcy Court and this Court protect all the other unsecured creditors in this case against the unscrupulous activities of the Federal instrumentality that is seeking to subvert the efforts of the farmer.

What the farmer is retaining here, has no present value. You cannot liquidate Mr. Ahlers' farm and get anything to pay on the unsecured claim. We are dealing with a valueless unsecured claim. Judge Heaney has given it value, and hopefully, over time, Ahlers will pay back his creditors 100 cents on the dollar.

Why the creditors and the banks do not stand behind us in the Ahlers case, I will never understand. If the banks and the Federal instrumentality here had thousands of Ahlers out there, every day, paying off these loans, every day making a profit, we would not have the financial crisis that we have

today, because these loans would have value. You would not need a bailout.

Now, at the present time -- I checked with Mr. Ahlers last night -- he has $300,000 in the bank. So under this Ahlers case, he has been doing fairly well.

I would point out to Your Honors, under 1129, and throughout the Code, the Congress has put in the words "includes" and "including." In 1129, when we talk about the provision that has been called the absolute priority rule and the fair and equitable, I would point out to Your Honor that the terms "include," "including," are put in there, which to me, and I think to other people in this business, mean that there are other interpretations of this hard and fast rule.

If the hard and fast rule were allowed to apply, the Ahlers could not reorganize, because they could not pay off their creditors 100 cents on the dollar. No farmer could, and none of the businessmen on Main Street could, either.

We believe that the secured creditor is estopped here --

QUESTION: Where is this including language that you are referring to?

MR. NEEDLER: In 1129, as it is in 363, as it is in others, in 1129(b)(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.

QUESTION: (e)(2), 1129?

MR. NEEDLER: We're talking about 1129(b)(2)(B).

QUESTION: (b)(2).

QUESTION: Page (a)98 of the Joint Petition.

MR. NEEDLER: By the use of the word "includes," Congress has said this is not the exclusive rule. We believe that by using that term, Congress meant to include the back case law in all the other cases. It meant to include Boyd, it meant to include Your Honors' own case of Security Commission v. U.S. Realty.

QUESTION: It says it includes the following requirements, one of which is the requirement that you assert need not be observed here. The fact that it may include other requirements as well does not mean that it excludes one of the requirements that it includes. Or at least, not the way I reason it.

MR. NEEDLER: With respect to a class of unsecured claims, the plan provides each holder of a class to receive or retain on account of such claim property of value as of the effective date of the plan, equal to the allowed amount of the claim.

That we cannot do.

QUESTION: But it includes that requirement, is what the statute says.

MR. NEEDLER: That is correct.

QUESTION: That requirement is included.

MR. NEEDLER: Or, the holder of any claim or interest that is junior to the claims of such class. We say that there is no interest junior to the class of unsecured creditors here.

Equity security interests in the Code are defined as stockholders. Mr. Ahlers is not a stockholder. He is not a class under the plan. He is not a class under the plan that has been filed here.

He has his property by operation of law. When he filed his Chapter 11, he was a debtor in possession. He didn't need any other property to give him the property. It is not like Chapter 10 where there is a trustee, the old Chapter 10, and the trustee has the property. Ahlers has the property.

Then it goes on to say, will not receive or retain under the plan, on account of such junior claim. He is not retaining anything on account of such junior claim. He already has it. Or interest in property. And we think where the word property is used, it meant value.

We don't think this section has to do with the worthless value equity of an individual. And we believe that the history of the Chapter proceedings of old Chapter 10, of old Chapter 11 and old Chapter 11 and 12 will show that what came into the Code was the absolute priority rule in 10, and that is in here for shareholders and large corporations to prevent the overreaching in Boyd, and is further recognized by

this Court. It does not apply to individual entrepreneurs, as the exception is shown in Securities Commission v. U.S. Realty, and should not apply to the farmers who are operating either as an individual farmer or as an alter ego corporation.

Where we have farm land with no value, where we have equipment which has far gone below the value of the loan, and these large, secured creditors are totally unsecured with their claim, it would be a miscarriage of justice to allow those unsecured creditors to vote against this plan to the detriment of the reorganization of all the farmers in this country and to vote their unsecured claim to basically allow them to liquidate.

The farmers in this country need help. The small businessman in this country needs help. The crisis is still out there. It is on Main Street of very farm community in this country.

Without a way to reorganize, you are going to have wholesale liquidations. This Court, in its Opinion in Securities v. U.S. Realty indicated that the Bankruptcy Court has a responsibility to operate in the public interest, has a responsibility to make certain that debtors have an opportunity to reorganize.

The statute was promulgated originally because we prefer reorganization over liquidation. Your Honors, in the various decisions of this Court over the centuries, have

indicated that liquidations cause a serious crisis.

The liquidations proposed here by the Land Banks across the country are going to promote crises.

One of the reasons that we read in the paper, in my opinion, that the situation has stabilized, is that because since the Ahlers case, there have been reorganizations. In the Minnesota District, the score is not zero any more. There are cases that have been reorganized. There are numerous farmers who have reorganized in the District.

As Judge O'Brien himself said, after this decision came down, I have been instructed now by the Circuit to help farmers and not usher them down the tube. I am not going to initially grant motions to dismiss as I did before. And the next case after Ahlers was confirmed within a very, very short time.

I suggest to you that the bargaining rights that have been protected here, that Ahlers has swung the pendulum back to the center, and now that there is bargaining -- there was no bargaining before. There was liquidation, liquidation and no confirmation.

The Ahlers case is a landmark case. Judge Heaney's efforts on behalf of the farmers and all businessmen in the United States are to be commended, and his Opinion has been read far and wide.

QUESTION: Have the rates that the land banks charge

for new loans gone up?

MR. NEEDLER: To my knowledge, I don't know of anybody making new loans, but those loans which they have made have gone down. They are advertising, last thing I knew, some 4.9 loans.

QUESTION: Don't you think they will be more careful about making new loans if we adopt the position that you are urging us to adopt?

MR. NEEDLER: Would they be more careful about making new loans?

QUESTION: Or do you believe in a free lunch?

MR. NEEDLER: I do not believe in a free lunch, sir.

QUESTION: Is it in the interest of the farmer to have a security system, including a bankruptcy system, that gives people who are contemplating lending money enough security that they will be willing to lend the money at a reasonable rate? And the less security you give them, the higher rates they are going to ask for or the less willing they are going to be to lend the money. Isn't that right?

MR. NEEDLER: There is no question that the lending practices in this country that led up to this disastrous period in the 1970s and 1980s, I am sure that the lenders are not going to repeat. They have been lending strictly on asset value and they were not looking at income value, and they admit that.

So yes, I think with the Ahlers case, and knowing that a farmer can stay on the land, but hopefully pay off an unsecured portion 100 cents on the dollar, may affect their lending practices. But I am not so sure which way. It might help their lending practices to know that if we put a loan on the books with a farmer who has the ability to pay and will pay 100 cents on the dollar even if he goes into Chapter 11, it might even cause less of an interest rate.

QUESTION: But these banks, you say, loaned on asset value and they should have taken into consideration income. But all they are insisting on is that they have the benefit of what they made the loan on -- namely, an asset.

MR. NEEDLER: What we are saying, Justice White, is that we will pay them back the asset value. Judge Heaney says we will pay back the asset value as of the confirmation date. That is another important part of this Opinion that is monumental, because none of us knew what value when. Judge Heaney has said what value when. He says it is the value on the date of confirmation.

Now, the land values have gone up, so now, the Ahlers are going to pay a higher price for the land that they keep under their plan, so that this ruling has other ramifications. We are going to pay whatever the value of the land is and then we are hopeful that we are going to have a profit and we are going to pay that profit to unsecured creditors over the life

of the plan, I think.

CHIEF JUSTICE REHNQUIST: Thank you, Mr. Needler. Mr. Conn, you have four minutes remaining.

ORAL ARGUMENT OF GORDON B. CONN, JR., ESQUIRE

ON BEHALF OF PETITIONERS - REBUTTAL

MR. CONN: Thank you, Mr. Chief Justice.

I agree with Mr. Needler that the Ahlers decision has sweeping ramifications. It has had substantial ramifications in the Eighth Circuit, and, to a lesser degree, elsewhere.

Among the problems with the lower Court's decision in Ahlers is that it is not limited or limitable to the perceived problems with agriculture, but rather, it is equally applicable in any Chapter 11 reorganization proceeding.

It has substantially altered, as Judge Gibson said in dissent, substantially altered the relationship between debtor and creditor and it is far beyond anything that Congress intended.

With respect to the voting question raised by Mr. Needler, that the creditors should somehow be estopped from voting against whatever plan is proposed, the answer to that is that the Bankruptcy Code specifically provides that a secured creditor who becomes undersecured is treated as an unsecured creditor for the balance of its claim and is entitled to the same voting rights as any other unsecured creditor.

And if those creditors control the group of unsecured

creditors, in amount and number, they have the absolute right to vote.1

The absolute priority rule is by its terms, absolute. That has been the law for close to 100 years and was not changed by Congress in 1978. If anything, it was strengthened.

The tradeoff, however, is that the rule, although absolute, can now under the new law be waived by creditors. Therefore, all that is incumbent on a debtor is to convince his creditors that they will fare better under a plan of reorganization that leaves property in the hands and management of the debtor than they would under a liquidation.

If in a case where a liquidation would produce zero for the unsecured creditors, if the debtor can convince those creditors that they will get something by voting in favor of a plan.

QUESTION: Would you have to convince all of them?

MR. CONN: It goes by class, Your Honor.

QUESTION: A majority of each class?

MR. CONN: I believe it is two thirds in dollars and a majority in number, within each class.

If that agreement can be reached, reorganization can go forward without any need to pay off 100 cents on the dollar. The absolute priority rule exists for the protection of creditors where they either are not offered anything of value by the debtor or they have no confidence in the debtor's

ability to perform under whatever promises are made. That is the purpose of the rule. Congress did not change it. It tightened it. And until the Ahlers case came along, it has no been subject to any serious question.

Thank you.

CHIEF JUSTICE REHNQUIST: Thank you, Mr. Conn. The case is submitted.

(Whereupon, at 12:01 O'clock a.m., the case in the above-entitled matter was submitted.)41

REPORTER'S CERTIFICATE

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I hereby certify that the proceedings and evidence are contained fully and accurately on the tapes and notes reported by me at the hearing in the above case before the

Date: 1-19-88

Margaret Daly

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