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THE CRAM DOWN AND VALUATION UNDER CHAPTER 11 OF THE BANKRUPTCY CODE

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I. INTRODUCTION

Chapter 11 of the Bankruptcy Code[1] establishes a procedure under which the rights of creditors or equity holders of a debtor may be readjusted by way of a plan, even without the consent of all parties whose rights are to be modified by the plan. The confirmation of a plan[2] by the court requires, however, that certain conditions be met. The contents of the plan must comply with section 1123 of the Code,[3] which specifies the mandatory and permissible features of a plan. Certain disclosures must be made to creditors and equity holders before the plan is submitted to them for their acceptance or rejection.[4] Moreover, various conditions to confirmation spelled out in section 1129(a)[5] must be met.

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1. 11 U.S.C.A. §§ 1101-1174 (West 1979).

2. A plan that is confirmed by the court binds every creditor, equity security holder, and general partner of the debtor, whether or not the creditor, equity holder, or partner has accepted the plan. *See id.* § 1141(a).

3. *Id.* § 1123.

4. *See id.* § 1125.

5. *Id.* § 1129(a) provides that:

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

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

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

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

(4)(A) Any payment made or promised by the proponent, by the debtor, or by a person issuing securities or acquiring property under the plan, for services or for costs and expenses in, or in connection with, the case, or in connection with the plan and incident to the case, has been disclosed to the court; and

(B)(i) any such payment made before confirmation of the plan is reasonable; or

(ii) if such payment is to be fixed after confirmation of the plan, such payment is subject to the approval of the court as reasonable.

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

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

These conditions include good faith on the part of the plan's proponent;[6] the disclosure of payments relating to the plan and the case and of the identity of proposed directors, officers, or voting trustees; the payment of administrative claims; and the feasibility of the plan.

The confirmation of a plan does not, however, require that it be accepted by all claim holders and equity holders whose rights are modified by the plan. If the other conditions for confirmation specified in section 1129(a) are met, a plan may be confirmed when it has been

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

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

(7) With respect to each class—

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

(i) has accepted the plan; or

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

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

(8) With respect to each class—

(A) such class has accepted the plan; or

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

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

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

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

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

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

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

(10) At least one class of claims has accepted the plan, determined without including any acceptance of the plan by any insider holding a claim of such class.

(11) Confirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to debtor under the plan, unless such liquidation or reorganization is proposed in the plan.

Id. § 1129(a).

6. A "proponent" is the party who proposes the plan. Under § 1121 of the Code, a party in interest other than the debtor may file a plan if a trustee has been appointed or if the debtor does not file a plan and obtain acceptances of same within the time periods specified. *Id.* § 1121.

"accepted" by all classes of claims and equity interests that are "impaired"[7] by the plan.[8] A class of claims is deemed to have "accepted" a plan if it is accepted by the holders of at least two-thirds in amount and more than one-half in number of the allowed claims of the class held by creditors two-thirds who actually vote on the plan.[9] A class of interests is deemed to have "accepted" the plan if it is accepted by the holders of at least two-thirds in amount of the allowed interests in the class that vote on the plan.[10] Thus, a plan may be confirmed despite the existence of dissenting minorities within one or more classes.

Moreover, a plan may be confirmed even when it is not accepted by all impaired classes.[11] Indeed, the Code is susceptible to the construction that a plan might be confirmed even if it is not accepted by *any* impaired class.[12] The statutory provisions that permit a plan to be confirmed over the opposition of a dissenting class or classes are often referred to as the "cram down" provisions.[13]

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7. Section 1124 of the Code provides that a class of claims or interests is "impaired" by a plan unless one of the following three conditions is met with respect to each claim or interest within the class:

(1) The plan does not alter the legal, equitable, or contractual rights of the claim or interest.

(2) The plan simply provides for the cure of any default that gave rise to an acceleration of the claim or interest, reinstates the maturity of the claim or interest as it existed before the default, and compensates the holder of the claim or interest for any damages incurred in reasonable reliance on the provision permitting acceleration; or

(3) The holder of the claim or interest will, in the case of the holder of a claim, receive cash equal to the allowed amount of the claim, or, in the case of the holder of an equity interest, receive any fixed liquidation preference to which the equity holder is entitled or any fixed price for which the debtor might redeem the security. *Id.* § 1124.

8. *See id.* § 1129(a)(8).

9. *Id.* § 1126(c).

10. *Id.* § 1126(d).

11. *See id.* § 1129(b).

12. Although *id.* § 1129(a)(10) requires that at least one class of claims accept the plan, a class of claims that is not impaired will automatically be deemed to have accepted the plan. *See id.* § 1126(f). Thus, unless § 1129(a)(10) is construed to require that there must be an affirmative acceptance of the plan by at least one impaired class, the requirement of § 1129(a)(10) could apparently be met by leaving one class unimpaired. *See generally* note 7 *supra*.

13. The term "cram down" was originally applied to those provisions of the old Bankruptcy Act, (codified in former 11 U.S.C. §§ 1-1103 (1976) (repealed 1978)), that permitted plans under Chapter X of the Act, (codified in former 11 U.S.C. §§ 501-676 (1976) (repealed 1978)), and under Chapter XII of the Act, (codified in former 11 U.S.C. §§ 801-926 (1976) (repealed 1978)), to be confirmed over the opposition of a dissenting class if the plan met certain economic criteria with respect to the dissenting class. *See* 11 U.S.C. §§ 579, 616(7)-(8), 861(11), 868 (1976) (repealed 1978).

The situation in which a plan is confirmed despite the existence of a nonconsenting class of impaired claims or interests is to be distinguished from the situation in which a plan is confirmed despite the existence of a dissenting minority of claims or interests within a class that has accepted the plan by the requisite majority. The term "cram down" does not apply to the latter situation, even though the nonconsenting parties may feel that the plan is being crammed down their throats.

The Code attempts to protect dissenting claim holders, equity holders, and classes who will be bound by a plan by requiring that, in order for the plan to be confirmed, the value of the property to be received under the plan by any holder of a claim or interest who does not accept the plan, and by any class that does not accept the plan, must meet certain statutorily defined standards of adequacy.[14] The standards of adequacy of value that must be met by the proposed distribution with respect to dissenting claim holders or equity holders within a class that has accepted the plan differ from those that must be met with respect to dissenting classes under the "cram down" provisions.[15] In either event, the determination of whether the proposed distribution to dissenters meets the applicable standards of adequacy of consideration will require a valuation of the property to be received by dissenting claim holders, equity holders, and classes under the plan, and, in the case of a dissenting secured creditor, a valuation of that creditor's interest in its collateral. This Article will examine the standards of adequacy of value that must be met by the proposed distribution to dissenting claim holders, equity holders, and classes under a plan, and the methods of valuation that will probably be used in implementing those standards.

II. CLASSIFICATION OF CLAIMS AND INTERESTS

A. General Principles of Classification

The concept of a "class" of claims or interests is critical in determining the adequacy of the proposed distribution to dissenters under a plan. The economic protection that the holder of a given claim or interest must receive under the plan in order for it to be confirmed will depend on whether the class of which the claim or interest is a part has accepted the plan. If the class has not accepted the plan, each claim or interest in the class will be entitled to the additional protection afforded to dissenting classes under the cram down provisions.[16] In addition, the protection to which a claim holder or equity holder is entitled will depend on whether the claim or interest is part of a junior or senior class.[17] Hence, a grasp of the basic principles of classification is essential to a proper understanding of the cram down provisions.

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14. *See* 11 U.S.C.A. §§ 1129(a)(7), 1129(b) (West 1979).
15. *Compare id.* § 1129(a)(7) *with id.* § 1129(b).
16. *See id.* § 1129(b).
17. *See* text accompanying notes 104-110 *infra.* Proper classification of claims and interests is also important because each holder of a claim or interest within a given class must receive the

The Code provides that a claim or equity interest may be placed in a particular class only if it is "substantially similar" to the other claims or interests in the class.[18] The legislative history suggests that this section is intended to codify the case law under the former Bankruptcy Act[19] regarding the proper classification of claims and interests.[20] The cardinal principle of classification under the former Bankruptcy Act was that creditors or equity holders of equal rank, with claims against the same property, should be placed in the same class, whereas creditors or equity holders of different ranks, or whose claims are against different property, should be separately classified.[21] The Code, however, may have altered this basic principle.

The Code identifies three general classes—secured claims, unsecured claims, and "interests."[22] Separate classifications, however, may be required or permitted within each of these general classes. For example, secured creditors who hold liens on different items of property, or who hold liens of a different rank on the same property, should be separately classified.[23] As a practical matter, each secured claim is likely to be in a separate class, unless two or more creditors have liens of equal rank on the same property.

With respect to unsecured creditors, cases under the former Bankruptcy Act held that unsecured claims should ordinarily be placed in a

same treatment under the plan, unless such holder agrees to accept less favorable treatment. *See* 11 U.S.C.A. § 1123(a)(4) (West 1979).

18. 11 U.S.C.A. § 1122(a) (West 1979). A statutory exception to this principle permits a plan to "designate a separate class of claims consisting only of every unsecured claim that is less than or [is] reduced to an amount that the court approves as reasonable and necessary for administrative convenience." *Id.* § 1122(b).

19. 11 U.S.C. §§ 1-1103 (1976) (repealed 1978).

20. *See* H.R. REP. No. 595, 95th Cong., 1st Sess. 406, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5963, 6362 [hereinafter cited as H.R. REP.].

21. *See, e.g.*, Scherck v. Newton, 152 F.2d 747, 751 (10th Cir. 1945); *In re* Los Angeles Land & Investments, Ltd., 282 F. Supp. 448, 453 (D. Haw. 1968); 6 COLLIER ON BANKRUPTCY pt. 2, ¶¶ 9.10, 9.12 (14th ed. 1978).

22. *See* 11 U.S.C.A. § 1129(b) (West 1979). The term "interest" is not defined in the Act. The legislative history indicates, however, that the term refers to the ownership rights a shareholder, limited or general partner, or sole proprietor has in the enterprise. *See* 124 CONG. REC. H11,093 (daily ed. Sept. 28, 1978) (remarks of Rep. Edwards) [hereinafter cited as HOUSE RECORD]; 124 CONG. REC. S17,410 (daily ed. October 6, 1978) (remarks of Sen. DeConcini) [hereinafter cited as SENATE RECORD].

23. *See* Mokava Corp. v. Dolan, 147 F.2d 340, 344 (2d Cir. 1945) (error to lump two first mortgages on different property into one class); Kyser v. MacAdam, 117 F.2d 232, 237 (2d Cir. 1941) (mortgage that was either prior to or subordinate to mechanics' liens should not be placed in same class with those liens); St. Louis Union Trust Co. v. Champion Shoe Mach. Co., 109 F.2d 313, 316 (8th Cir. 1940) (when series of bonds was secured by same collateral, but payment of some had been subordinated to payment to others, two groups of bonds should have been separately classified).

single class, regardless of any difference in the basis of the claims.[24] This result may not be required under the Code. Section 1122 of the Code,[25] which governs classification, does not require that all claims or interests that are substantially similar be placed in the same class; instead, it simply provides that a particular claim or interest may be placed in a particular class only if it is "substantially similar" to other claims or interests in a class. This requirement could be met even if the unsecured claims were subclassified into a number of different classes of equal rank. For example, if the plan divided the unsecured claims into bank debt and "trade" debt, a claim in either subclass would be "substantially similar" to the other claims in the subclass.

Other provisions of the Code also suggest that claims of equal rank might be subclassified. Section 1102(a)(1) provides that the court shall appoint a committee of creditors holding unsecured claims.[26] Section 1102(b)(1) requires that such a committee ordinarily consist of those

> willing to serve that hold the seven largest claims against the debtor of the kinds represented on such committee, or of the members of a committee organized by creditors before the order for relief under this chapter, if that committee was fairly chosen and is representative of the different kinds of claims to be represented.[27]

Thus, the Code contemplates that there may be different "kinds" of unsecured claims, that the interests or viewpoint of the holders of certain kinds of unsecured claims might differ from those of the holders of other kinds of claims, and that each of the various kinds of unsecured claims should be represented on the unsecured creditors committee in order to ensure that the interests of the various types of unsecured claim holders are adequately represented.[28]

On the other hand, there are at least two considerations that suggest that the subclassification of unsecured claims ordinarily ought not to be permitted. First, section 1122(b) specifically permits a plan to

24. That unsecured claims might take different forms, such as notes, accounts, written contracts, torts, or the like, was held not to justify separate classification. *See, e.g., In re* Los Angeles Land & Investments, Ltd., 282 F. Supp. 448, 454 (D. Haw. 1968).

25. 11 U.S.C.A. § 1122 (West 1979).

26. *Id.* § 1102(a)(1).

27. *Id.* § 1102(b)(1).

28. Regarding the subclassification of claims of equal rank, § 1129(b)(1) requires that in order for a plan to be confirmed, it must not "discriminate unfairly" against any dissenting class. *Id.* § 1129(b)(1). This requirement appears designed to ensure nondiscriminatory treatment of a dissenting class vis-à-vis other classes of equal rank. Although its primary concern is apparently the situation in which classes of equal rank occupy unequal positions with respect to the claims of a third class because of a partial subordination of claims of the third class, the requirement would appear to apply even absent a partial subordination agreement.

"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."[29] This provision would be unnecessary if section 1122(a) permitted the subclassification of claims of the same rank.

Second, section 1123(a)(4)[30] requires that a plan provide the same treatment for each claim or interest in a particular class, unless the holder of a particular claim or interest in the class agrees to less favorable treatment. It is hard to believe that Congress intended to permit the proponent of a plan to circumvent this requirement by separately classifying certain claims that are to be treated less favorably than others of equal rank. Were this method of classification allowed, the majority of the disfavored subclass required to accept the plan could bind the minority of dissenters to take less favorable treatment than other claims of equal rank.[31]

Regardless of whether claims of equal rank may ordinarily be subclassified, the existence of contractual subordination agreements among unsecured creditors will require separate classification of the claims that benefit from the subordination agreements, the claims that are contractually subordinated, and the claims that are unaffected by those agreements.[32] Likewise, the interests of stockholders should be separately classified if there is preferred and common stock outstanding.[33]

The Code contemplates that when the claim of a secured creditor exceeds the value of its collateral, the creditor really has two claims that should be separately classified. Under section 506(a),[34] the allowed claim[35] of a secured creditor is a secured claim to the extent of the value of the secured creditor's interest in the collateral,[36] and is an un-

29. *Id.* § 1122(b).

30. *Id.* § 1123(a)(4).

31. If the class consisting of the claims that were to receive less favorable treatment did not accept the plan, the plan could not be confirmed unless it was found not to "discriminate unfairly" against the dissenting class. *See id.* § 1129(b). There appears, however, to be no requirement that a plan not discriminate unfairly against a class that has accepted the plan. *See id.* § 1129(a).

32. *See Collier on Bankruptcy*, *supra* note 21, ¶ 9.10 at 1602. *See generally* H.R. REP., *supra* note 20, at 416-17, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS at 6372-73. Section 510(a) of the Code, 11 U.S.C.A. § 510(a) (West 1979), recognizes the enforceability of subordination agreements in bankruptcy.

33. *Cf.* 11 U.S.C.A. § 1102(b)(2) (West 1979) (referring to "kinds" of equity securities).

34. *Id.* § 506(a).

35. The term "allowed claim" apparently refers to the amount in which a claim is allowed after applying the rules governing the allowance of claims and interests contained in §§ 502 and 506 of the Code. *See id.* §§ 502, 506.

36. The Code speaks not of "collateral," but of "the creditor's interest in the estate's interest in the property." *Id.* § 506. The use of the phrase "the estate's interest in the property" makes it

secured claim to the extent that the value of the secured creditor's interest in the collateral is less than the amount of the allowed claim. Thus, the claim of an inadequately secured creditor would be considered a secured claim only to the extent of the value of the collateral, and an unsecured claim to the extent of the deficiency. Moreover, if the secured creditor's claim is a nonrecourse claim—that is, one for which the creditor has recourse only to the collateral and has no recourse against the debtor for any unsecured deficiency—the creditor would have only a secured claim equal to the value of the collateral, and no claim for the unsecured deficiency.

B. *The Section 1111(b) Election*

The result of applying section 506(a) to the claim of a secured creditor is altered in a Chapter 11 case by the provisions of section 1111(b) of the Code.[37] Basically, section 1111(b) has two ramifications. First, an inadequately collateralized secured creditor holding a nonrecourse claim who would not otherwise be entitled to recover its unsecured deficiency against the debtor may have a claim for that deficiency. In this regard, section 1111(b)(1) provides that a secured claim is to be allowed or disallowed just as if the holder of the claim had personal recourse against the debtor on account of the claim, whether or not such recourse would otherwise be available under appli-

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clear that when parties other than the debtor hold an interest in the collateral, the secured claim would be limited to the value of the debtor's interest in the property—as opposed to the entire value of the property. Use of the phrase "the creditor's interest in" would seem designed to make it clear that the focus is on what the creditor has after deducting prior liens on, or other interests in, the debtor's interest in the property. Although the statute's phraseology is technically more accurate, the term "collateral" is substituted in this Article in the interest of simplification.

37. *Id.* § 1111(b) provides that:

> (b)(1)(A) A claim secured by a lien on property of the estate shall be allowed or disallowed under section 502 of this title the same as if the holder of such claim had recourse against the debtor on account of such claim, whether or not such holder has such recourse, unless—
>
> (i) The class of which such claim is a part elects, by at least two-thirds in amount and more than half in number of allowed claims of such class, application of paragraph (2) of this subsection; or
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> (ii) such holder does not have such recourse and such property is sold under section 363 of this title or is to be sold under the plan.
>
> (B) A class of claims may not elect application of paragraph (2) of this subsection if—
>
> (i) the interest on account of such claims of the holders of such claims in such property is of inconsequential value; or
>
> (ii) the holder of a claim of such class has recourse against the debtor on account of such claim and such property is sold under section 363 of this title or is to be sold under the plan.
>
> (2) 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.

cable state law, unless (1) the claim is a nonrecourse claim and the property is sold or is to be sold under the plan; or (2) the class of which the claim is a part elects to have the claim treated as a nonrecourse claim under section 1111(b)(2).

Second, with certain exceptions, a class of secured claims, whether recourse or nonrecourse, may elect to have its claims treated as nonrecourse claims under section 1111(b)(2).[38] The result of making this election is that the secured creditor is deemed to have a secured claim equal to the full amount of its allowed claim, instead of a secured claim equal only to the value of its collateral, and no claim for an unsecured deficiency. For example, a creditor with a recourse claim who is owed a debt of $100,000, the payment of which is secured by property worth $60,000, will have a secured claim for $60,000 and an unsecured claim for $40,000 if the creditor does not make the section 1111(b) election. The same creditor would have a secured claim for $100,000 and no unsecured claim if the creditor made the section 1111(b) election.

Despite the apparent complexities involved in the section 1111(b) election, the effect of the election is simple: an inadequately collateralized secured creditor who would otherwise have had a secured claim equal only to the value of its collateral will be deemed to have a secured claim equal to the full amount of its claim, but will be precluded from having any unsecured deficiency claim. The difference resulting from the section 1111(b) election will be felt most keenly in the context of determining whether a Chapter 11 plan can be confirmed over the secured creditor's dissent.

III. TESTING THE ADEQUACY OF THE PROPOSED DISTRIBUTION TO DISSENTING MINORITIES—THE "LIQUIDATION ALTERNATIVE" APPROACH

Section 1129(a)(7) of the Code[39] sets forth the minimum standard of value that the proposed distribution under a plan must meet with respect to dissenting claim holders and equity holders for the plan to be confirmed. Under section 1129(a)(7)(A), each claim holder or equity holder who does not accept the plan, other than the holder of a secured

38. This election is not available when the creditor's interest in the collateral is of inconsequential value, or when the claim is a recourse claim and the collateral is sold under the plan. *See* 11 U.S.C. § 1111(b)(1)(B) (West 1979). A typical situation in which the secured creditor's interest in the property may be of inconsequential value is when the collateral is insufficient, or barely sufficient, to satisfy encumbrances senior to that of the secured creditor.

39. *Id.* § 1129(a)(7).

claim who has made the section 1111(b) election, must receive or retain on account of the claim or interest property having a value, as of the "effective date of the plan,"[40] not less than the amount that the dissenter would receive or retain were the debtor to be liquidated in a straight bankruptcy liquidation under Chapter 7 of the Code.[41] The manifest purpose of this requirement is to ensure that dissenters are no worse off under the plan than they would be if the debtor were simply liquidated. This concept represents a codification of the judicial gloss placed on the "best interest of creditors" test that applied to the confirmation of plans under Chapter XI of the old Bankruptcy Act[42] and is likely to be referred to as the "best interests" test.

A different standard applies to the dissenting holder of a secured claim that is part of a class that has made the section 1111(b) election.[43] Under section 1129(a)(7)(B),[44] each holder of a secured claim within such a class must receive or retain property whose value as of the effective date of the plan is no less than the value of the creditor's interest in the collateral. This special standard apparently is necessary because there is no analogue to the section 1111(b) election in a straight bankruptcy proceeding under Chapter 7 of the Code. Absent the special provisions of section 1129(a)(7)(B), the holder of a recourse claim that was part of a class that had made the section 1111(b) election to give up the claim for any unsecured deficiency might successfully contend that,

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40. The concept of the "effective date of the plan" is important under the Code because that is the date as of which the value of the proposed distribution to dissenting claim holders, equity holders, and classes must be tested. Nevertheless, the Code does not define the phrase. It has been suggested that this date should correspond to the first day after the order confirming the plan becomes final. *See* Klee, *All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code*, 53 AM. BANKR. L.J. 133, 137 n.24 (1979). This approach would make it impossible, however, to make any of the valuations that may become necessary in order to determine whether the plan can be confirmed, because the likelihood of an appeal from the confirmation order and the date when the appeal will be resolved cannot be determined in advance of confirmation.

Ordinarily, the "effective date of the plan" should probably conform to the date the plan is confirmed, because the plan becomes "effective" to the extent of eliminating creditor and stockholder rights not preserved in the plan upon confirmation. *See* 11 U.S.C.A. § 1141 (West 1979). On the other hand, the choice of the term "effective date" rather than "confirmation date" suggests that the two need not invariably coincide, and that the plan might designate some other effective date.

41. 11 U.S.C.A. §§ 701-728 (West 1979).

42. Under Chapter XI of the Bankruptcy Act, a plan that was not unanimously approved by each class of creditors affected by the plan had to be in the "best interests of creditors" in order to be confirmed. Bankruptcy Act § 366(2), 11 U.S.C. § 766(2) (1976) (repealed 1978). The "best interests" test was interpreted judicially to require that creditors receive something more than they would receive on a straight liquidation in bankruptcy. *See generally* 9 *Collier on Bankruptcy*, *supra* note 21, at ¶ 9.17.

43. *See generally* text accompanying notes 29 & 30 *supra*.

44. 11 U.S.C.A. § 1129(a)(7)(B) (West 1979).

because it would be entitled to an unsecured deficiency in a Chapter 7 liquidation, the value of the property that it is to receive under the plan must include not only what it would receive upon a liquidation of its collateral, but also the dividend that it would receive on its unsecured deficiency in a Chapter 7 liquidation.[45] Subsection (B) of section 1129(a)(7) precludes this argument by limiting the value of the property that must be received on account of a claim within a class that has made the section 1111(b) election to the value of the claimant's interest in the collateral.[46]

The application of the "best interests" test, and the special test for creditors who have made the section 1111(b) election, to the proposed distribution to dissenting claim holders and interest holders will require a valuation of the proposed distribution to the dissenters and, in the case of a dissenting secured creditor, a valuation of the creditor's interest in the collateral. The method of valuation that is likely to be used for these purposes is discussed elsewhere in this Article.[47]

IV. CRAMMING DOWN THE DISSENTING CLASS OF CLAIMS OR INTERESTS

Section 1129(a)(8) of the Code[48] requires that, in order for a plan to be confirmed, each class that is impaired under the plan must accept the plan by the requisite majority vote. Section 1129(b)(1) goes on, however, to provide that if all of the requirements for confirmation other than this requirement are met, then, notwithstanding the requirements of section 1129(a)(8), the plan should be confirmed on request of the proponent of the plan "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."[49] Thus, in

45. This argument could not plausibly be made by the holder of a claim that would be nonrecourse under state law or the terms of the obligation because the provisions of § 1111(b), which accord the nonrecourse secured creditor recourse status, apply only in a Chapter 11 case and not to a Chapter 7 liquidation.

46. *See* HOUSE RECORD, *supra* note 22, at H11,105; SENATE RECORD, *supra* note 22, at S17,421-22.

47. *See* text accompanying notes 120-27 *infra*.

48. 11 U.S.C.A. § 1129(a)(8) (West 1979).

49. 11 U.S.C.A. § 1129(b)(1) provides as follows:

> (b)(1) Notwithstanding Section 510(a) of this title, if all of the applicable requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court, on 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.

order for a plan to be "crammed down" over the opposition of a dissenting class, the plan must meet two requirements with respect to each dissenting class—it must not "discriminate unfairly" and it must be "fair and equitable."

A. The Requirement That a Plan Not Discriminate Unfairly

The Code itself does not articulate any standards for determining whether a plan "discriminates unfairly" with respect to a dissenting class. Nevertheless, the scope of the antidiscrimination requirement contained in section 1129 is suggested by considering what it does not cover. Section 1123(a) of the Code, which sets forth the required contents of a plan, already covers discrimination among members of a given class.[50] The treatment to be accorded to a class vis-à-vis unequal classes is dealt with by the "fair and equitable" requirement, which, when applicable, requires that a senior class be compensated in full before a junior class may participate in the plan.[51] By process of elimination, therefore, the requirement that a plan not "discriminate unfairly" seems to be designed to ensure that the dissenting class is not treated in an unfairly discriminatory manner vis-à-vis other classes of equal rank.[52] This standard is most likely to come into play when two classes of equal rank occupy unequal positions with respect to a third class.[53]

This situation typically arises when certain creditors have subordinated their claims to the claims of some, but not all, of the creditors who would otherwise fall within the same class absent the subordination agreement. For example, the unsecured claims may include debts to suppliers or "trade" debt; bank debt; and debentures that are contractually subordinated to the bank debt, but not to the trade debt. Absent the subordination agreement, all three types of claims would fall within the single class of unsecured claims. Because of the subordination agreement involving the debentures and the bank debt, however, it becomes necessary to subclassify the unsecured creditors into

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Id. § 1129(b)(1).

50. *Id.* § 1123(a)(4) provides that a plan shall "provide the same treatment for each claim or interest of a particular class, unless the holder of a particular claim or interest agrees to a less favorable treatment of such particular claim or interest."

51. *See generally* text accompanying notes 86-110 *infra*.

52. *See* H.R. REP., *supra* note 20, at 416-17, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS at 6372-73.

53. *See id.*

three classes.[54] In such a case, the class of bank claims would be senior to the class of debenture claims, but each of those classes would be of equal rank with the trade debt, which is not affected by the subordination agreement. The "fair and equitable" requirement would, if applicable, govern the fairness of the distribution as between the senior bank debt and the subordinated debenture debt.[55] The antidiscrimination requirement would govern the treatment of the dissenting subclass with respect to the subclass or subclasses to which it is equal.

The antidiscrimination requirement mandates that the subordination agreement be enforced to the extent of its terms, but no more. Accordingly, any subclass consisting of claims that are neither subordinated nor the beneficiaries of any subordination agreement should receive its aliquot share of the total distribution made under the plan on account of all of the claims that would otherwise fall within the same class absent the subordination agreement. The aliquot share of that total distribution to which the subordinated creditors would otherwise be entitled should be paid over to the beneficiaries of the subordination agreement up to the amount which, when added to the beneficiaries' aliquot share of the total distribution, would cause them to receive property of a value equal to their allowed claims.[56]

For example, suppose that unsecured debt includes $100,000 in trade debt, $200,000 in bank debt, and $100,000 in debentures, and the debentures contain a provision subordinating the claims of the debenture holders to the claims of the banks. The plan provides for an aggregate distribution of $60,000 to the three classes of unsecured claims. The plan would not unfairly discriminate against any of the three classes if it provided for the payment of $15,000 to the class of trade creditors, $45,000 to the class of bank creditors, and nothing to the class of debenture holders. Under this distribution the trade creditors would receive exactly what they would have received under the plan had there been no subordination agreement (that is, 25 percent of $60,000), and the $15,000 dividend that would otherwise have gone to the class of debenture holders as its aliquot share of the distribution absent the subordination agreement is instead paid over to the holders of the bank

54. *See id. See generally* text accompanying note 32 *supra*; 6 COLLIER ON BANKRUPTCY, *supra* note 21, ¶ 9.10 at 1602-03 (discussing Chapter X of the Bankruptcy Act).

55. *See generally* text accompanying notes 86-110 *infra*.

56. *Cf.* Bird & Sons Sales Corp. v. Tobin, 78 F.2d 371, 372 (8th Cir. 1935) (dividend that would ordinarily be paid to creditors who signed subordination agreement should be withheld and paid over to beneficiaries of agreement until beneficiaries' claims are paid in full). *See generally* H.R. REP., *supra* note 20, at 416-17, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS at 6372-73.

debt, who have not been paid in full. The plan would unfairly discriminate against the subclass of trade debt, however, if it received less than $15,000, and would unfairly discriminate against the subclass of bank debt if it received less than $45,000.[57]

B. The "Fair and Equitable" Test

1. Application Under Chapter X of the Bankruptcy Act

The phrase "fair and equitable" is not a newcomer to the nomenclature of reorganization. Under Chapter X of the Bankruptcy Act,[58] a plan had to be "fair and equitable" in order to be approved or confirmed, whether or not it was accepted by the requisite majorities of each class.[59] The Chapter X requirement that a plan be "fair and equitable" was read to embody the "absolute priority" rule, which requires that each class of claims and interests, in descending rank, must receive full compensation for any rights surrendered before any junior class may properly participate in the plan. In other words, "absolute priority" dictated that junior claims or interests could not participate in the plan unless there was some equity in the debtor's assets after full satisfaction of prior claims.[60]

The determination of whether a plan was "fair and equitable" under Chapter X—that is, whether it complied with the "absolute priority" rule—required a determination of whether there was any value left for junior classes, and whether senior creditors were being fully compensated for their rights in a plan in which junior claims or interests were being permitted to participate.[61] A valuation of the debtor and of the proposed distribution to each class was therefore necessary before the reorganization court could determine whether the proposed distribution under a plan was "fair and equitable."[62]

The method of valuation adopted by the courts for determining

57. The situation can become even more complicated if the debtor has issued two series of debentures, one of which is subordinated only to certain types of debt (*e.g.*, trade debt), and the other of which is subordinated to a different type of debt (*e.g.*, bank debt); one series of debentures is subordinated to the other; and there are claims other than trade debt or bank debt, to which *none* of the debentures would be subordinated. In such a case, the unsecured debt would have to be subclassified into five classes: the two debentures, trade debt, bank debt, and "other" debt.

58. 11 U.S.C. §§ 501-676 (1976) (repealed 1978).

59. *See* 11 U.S.C. § 621(2) (1976) (repealed 1978).

60. *See* 6A COLLIER ON BANKRUPTCY ¶ 11.06 at 206-16 (rev. ed. 1977).

61. *See, e.g.*, Consolidated Rock Prods. Co. v. Du Bois, 312 U.S. 510 (1941); 6A COLLIER ON BANKRUPTCY, *supra* note 60, ¶ 11.05 at 184-85. *See generally* 6 COLLIER ON BANKRUPTCY, *supra* note 21, ¶ 9.02[1] at 1503-07.

62. *See* Consolidated Rock Prods. Co. v. Du Bois, 312 U.S. 510, 524-25 (1941).

the business debtor's "reorganization value"[63] was the "going concern" value based on a capitalization of prospective earnings.[64] This approach was justified by the fact that the very purpose of a reorganization proceeding is to avoid a forced sale of assets and to preserve the going concern value of the business by continuing its operations. It is incongruous to value a business that is being reorganized on the basis of the price its assets could fetch on a piecemeal liquidation when the entire theory of the reorganization is that the debtor is being preserved as a going concern. Accordingly, the business was properly valued as an integrated unit, not as discrete pieces of property to be sold. Moreover, the use of going concern value was thought to free reorganization value from prices pegged by forced sales, temporary conditions of the market place, or an artificially depressed market caused by the reorganization proceeding itself.[65]

The use of "going concern value" for purposes of applying the absolute priority rule could also be justified as consistent with the judgment underlying that rule. The rule reflected judicial rejection of the philosophy that a plan permitting junior interests to participate without fully compensating senior classes could be justified because the senior classes would fare even worse under a forced liquidation.[66] On the contrary, the judgment underlying the absolute priority rule was that the prospective value of the debtor as a going concern should not be appropriated by junior classes until senior classes share in that prospective value to the full extent of their claims.[67] Consistent with this philosophy, the debtor was properly valued on a going concern basis in order to permit junior classes to obtain any going concern value that exists over and above the value necessary to satisfy the claims of senior classes.

Because "going concern value" will continue to be used for certain purposes under the Code,[68] it is important to understand that method of valuation. Although the valuation of an enterprise on the basis of a capitalization of prospective earnings is a difficult process, the theory is

63. The term "reorganization value" refers to the value of the reorganized debtor. *See In re* Equity Funding Corp. of Am., 391 F. Supp. 768, 772 (C.D. Cal. 1975).

64. *See* Consolidated Rock Prods. Co. v. Du Bois, 312 U.S. 510 (1941); *In re* Equity Funding Corp. of Am., 391 F. Supp. 768, 772 (C.D. Cal. 1975); Note, *The Proposed Bankruptcy Act: Changes in the Absolute Priority Rule for Corporate Reorganizations*, 87 Harv. L. Rev. 1786, 1793 (1974).

65. *See In re* Equity Funding Corp. of Am., 391 F. Supp. 768, 772-73 (C.D. Cal. 1975).

66. *See* Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106 (1939).

67. *See In re* Dutch Woodcraft Shops, 14 F. Supp. 467, 469 (W.D. Mich. 1935).

68. *See* text accompanying note 149 *infra*.

simple. A projected stream of income in the future has a discounted present value based upon an interest factor, to account for the time value of money, and a risk factor, to account for the possibility that the projected stream of income may never be realized. The process of enterprise valuation thus requires projecting the enterprise's income stream and then determining a discounted present value for that income stream by multiplying the average annual projected income by a multiplier based on an appropriate capitalization rate.[69]

Thus, the determination of the debtor's value as a going concern actually requires two determinations. First, the future earnings of the reorganized debtor must be projected. These projections must be based, not on past earnings alone, but on factors that may influence income in the future.[70] Of course, mathematical precision in these projections is neither possible nor required.[71]

Second, once earnings are projected, the average annual projected earnings are discounted to a present value on the basis of a capitalization rate that reflects the expected annual rate of return that investors would require on an investment of comparable risk. This discounting is accomplished by multiplying the average annual projected earnings by a multiplier that is the inverse of the capitalization rate. For example, if the capitalization rate (that is, the expected rate of return) were 20 percent, the multiplier would be 5; if the capitalization rate were 10 percent, the multiplier would be 10. Thus, the higher the expected rate of return required by investors, the lower the multiplier and thus the lower the going concern value of the debtor.

The general standard for determining the appropriate capitalization rate is that the capitalization rate should be consonant with the " 'risk factor of the particular enterprise, measured largely by its past experience and the experiences of businesses similarly situated.' "[72] The uncertainty inherent in attempting to fix a capitalization rate can

69. The process of determining reorganization value on the basis of the capitalization of earnings approach has been explained thusly:

> [R]eorganization value is a forecast of future earnings converted to present value by a capitalization or discount rate. This capitalization or discount rate reflects the expected annual rate of return on an investment and the choice of this rate is a question of judgment which must reasonably relate to the rates of return generally expected by investors from comparable investment opportunities.

In re Equity Funding Corp., 391 F. Supp. 768, 772 (C.D. Cal. 1975).

70. Protective Comm. v. Anderson, 390 U.S. 414, 451-53 (1968) (lower court erred in relying only on past earnings as basis for valuation).

71. *See, e.g.*, Consolidated Rock Prods. Co. v. Du Bois, 312 U.S. 510, 526 (1941).

72. 6A COLLIER ON BANKRUPTCY, *supra* note 60, ¶ 11.05 at 199 (quoting Note, *Distribution of Securities in Corporate Reorganization*, 51 YALE L.J. 85, 90 (1941)).

be mitigated when a court has available to it information regarding price/earnings ratios employed in the sale of comparable enterprises under more or less similar conditions, or capitalization rates employed in fixing the market price of securities of comparable companies.[73]

There were two exceptions under old Chapter X, however, to the use of going concern valuation to determine reorganization value. First, nonproductive assets, such as excess working capital or cash, excess or abandoned plants, other nonproductive real or personal property held for liquidation, and generally any assets not necessary to produce the anticipated income stream, would be valued separately and their value added to going concern value in determining reorganization value.[74] Conversely, if additional working capital had to be infused into the debtor in order to enable it to achieve the projected income stream, that amount was deducted from reorganization value.[75] Second, when a valuation based on liquidation was *higher* than one based on projected future earnings, liquidation was the appropriate method of valuation because liquidation was the only economically justifiable course of action.[76]

Once the "reorganization value" of the debtor was computed in the manner outlined above, that value would be used as the basis for valuing the securities to be distributed to particular classes in order to determine whether senior classes were being fully compensated. The value ascribed to the equity securities that were to be distributed pursu-

73. Gardner, *The SEC and Valuation Under Chapter X*, 91 U. PA. L. REV. 440, 453 (1943); *see In re* Yuba Consol. Indus., Inc., 242 F. Supp. 561 (N.D. Cal. 1965) (capitalization rates determined with reference to average price/earnings ratios on sales of stock of similar companies).

74. *See* Gardner, *supra* note 73, at 443; 6A *Collier on Bankruptcy*, *supra* note 60, ¶ 11.05 at 200.

Tax savings that may result from using a tax loss carry forward to offset future earnings also belong in this category of nonproductive or "excess" assets. Because the use of a tax loss carry forward to effect tax savings is an extraordinary and nonrecurring item, projected earnings are estimated without accounting for tax savings that will result from the use of a tax loss carry forward. The present value of the anticipated use of the tax loss to effect tax savings in the future—*i.e.*, the discounted value of the tax savings that are expected to result from using the tax loss—is then added to the going concern value of the company to determine its reorganization value. *See In re* Yuba Consol. Indus., Inc., 242 F. Supp. 561, 566 (N.D. Cal. 1965); *In re* Third Ave. Transit Corp., 37 S.E.C. 258, 270 (1957) (capitalized earnings augmented by amount of excess cash and discounted value of tax benefit of use of tax loss carry forwards); *In re* Green River Steel Corp., 37 S.E.C. 507, 519-20, 522-23 (1957); *In re* Northeastern Steel Corp., 38 S.E.C. 41, 53 (1957) (upward adjustment in value made to take into account ability to use past losses to reduce federal income taxes payable in future profitable years).

75. *See, e.g., In re* Northeastern Steel Corp., 38 S.E.C. 41, 52-53 (1957) (capitalized value decreased to reflect additional investment in plants necessary to produce projected income stream).

76. *See In re* Porto Rican Am. Tobacco Co., 112 F.2d 655, 656-57 (2d Cir. 1940); 6A COLLIER ON BANKRUPTCY, *supra* note 60, ¶ 11.05 at 200-01.

ant to a plan of reorganization would be the difference between the reorganization value of the enterprise as a whole and the indebtedness with which the reorganized company would emerge under the plan. For example, if the value of the debtor on a "going concern" basis was found to be $11 million and the plan provided for the debtor to emerge with indebtedness of $6 million, the equity securities to be issued under the plan would be valued at $5 million.[77] The actual market value of the securities issued by the reorganized debtor immediately following their issuance would not necessarily correspond to the "reorganization value" of those securities.[78] Nevertheless, it was deemed appropriate to use the "investment" value or "intrinsic" value of the securities, based on a "going concern" valuation, rather than "spot market value" as the basis for valuation.[79]

One might think that if the "going concern" valuation of the debtor were conducted correctly, the market value of its securities should correspond to their value based on a capitalization of anticipated income. Nevertheless, at least two explanations could be offered for a discrepancy between the two values, especially in the period immediately following reorganization. First, the capitalization rate used to determine going concern value is likely to be determined with reference to price/earnings ratios of stock in other companies in the same industry. The "comparable" companies whose stocks are used to arrive at a capitalization rate, however, may be something less than fully comparable to the debtor because they have not just emerged from a Chapter 11 reorganization and they have an earnings record more consistent and reliable than that of the debtor. In the short term, at least, one would expect investors to demand a higher rate of return than is available from investments in the "comparable" companies to compensate them for the greater perceived risk of investing in the resuscitated debtor. Second, investors simply may not believe the projections of income that were used to value the debtor, and thus they may wait to see if projections, which may deviate sharply from the debtor's past earnings or loss experience, are borne out.

The use of "going concern" value assumes that, regardless of short-run market reaction to the debtor's securities, the value of the

77. *See In re* Northeastern Steel Corp., 38 S.E.C. REP. 41, 59 (1957).

78. *Cf. In re* New York, N.H. & H. R.R., 304 F. Supp. 793, 808-09 (D. Conn. 1969), *modified*, 399 U.S. 392 (1970) (value ascribed to stock on basis of anticipated earnings exceeded market price by $20 million).

79. *See id.*; *In re* Equity Funding Corp., 391 F. Supp. 768, 772 (C.D. Cal. 1975); *In re* Green River Steel Corp., 37 S.E.C. 507, 527-28 (1957).

debtor's stock should conform to its reorganization value in the long run,[80] presumably because the market will eventually recognize the "intrinsic value" of the debtor's stock. Theoretically, the greater perceived risk, which may cause investors to demand a higher rate of return on an investment in the reorganized debtor, should diminish as the debtor continues to operate profitably. The expected result would be that the price/earnings ratio of the debtor's stock should eventually correspond to those of other companies in the industry. Nevertheless, the result of using "going concern" value was that a junior class might be entitled to participate in a plan under the absolute priority rule, even though the immediate market value of the securities issued to a senior class was less than the claims of that senior class, if the "reorganization value" of the securities issued to the senior class equaled the amount of the claims of that class.[81]

Another concept that evolved in connection with the implementation of the absolute priority rule was that senior classes that received a grade of securities equivalent to that given to junior classes should be compensated for their loss of priority by receiving securities with a "reorganization value" in excess of the amount of their claims. The requirement of "full compensation" for senior classes was broad enough to include compensation for a step-down in priority, as well as compensation for the amount of a claim, because the "bundle of rights" of a senior class included the right to priority.[82] As compensation for its loss of priority, a creditor could receive securities beyond the amount whose value would equal the face amount of the creditor's claim.[83] Thus, for taking the increased risk of nonpayment posed by the demotion to inferior securities, the creditor would be compensated by the prospect of recovering something more than the face amount of its claim if the business succeeded.[84] This principle was known as the

80. *See* Blum, *The Law and Language of Corporate Reorganization*, 17 U. CHI. L. REV. 565, 571-79 (1950).

81. *See generally* cases cited in note 79 *supra*.

82. *See In re* Imperial '400' Nat'l, Inc., 374 F. Supp. 949, 976-77 (D.N.J. 1974).

83. *See In re* Inland Gas Corp., 211 F.2d 381, 385 (6th Cir. 1954); Standard Gas & Elec. Co. v. Deep Rock Oil Corp., 117 F.2d 615, 617 (10th Cir.), *cert. denied*, 313 U.S. 564 (1941).

84. The principle of the "step-up" can also be justified by the uncertainties involved in computing "reorganization value." On its face, the process of determining reorganization value has a beguiling air of exactitude because it always produces a dollars and cents figure that looks mathematically precise. The apparent exactitude of the figure, however, disguises the highly inexact nature of the process of determining going concern value on the basis of a capitalization of projected future earnings. The process of projecting earnings is an inexact one based on a combination of past performance, foreseeable capital needs, and estimated revenues and costs. Likewise, the capitalization rate applied to the projected earnings is a matter of judgment, which necessarily involves many judgments concerning hazards, business stability, and future development. For

"step-up."[85]

2. The "Fair and Equitable" Test Under Chapter 11 of the Code

The provisions of Chapter 11 represent a marked departure from the "absolute priority" rule, as it was applied in Chapter X, in one critical respect. Under Chapter 11 the absolute priority rule is applied only to the dissenting class or classes and not to all classes.[86] A majority of a senior class may bind the minority to take something less than "full compensation" for its rights in a plan in which junior claims or interests are permitted to participate.[87] Moreover, senior classes may give up value to junior classes as long as no dissenting intermediate class receives property of a lesser value than the amount of its allowed claims.[88]

In addition, unlike Chapter X, Chapter 11 attempts to codify certain minimum conditions that must be met in order for a plan to be "fair and equitable" with respect to a given dissenting class.[89] The legislative history makes it clear, however, that section 1129(b) does not contain an exhaustive enumeration of the components of the "fair and equitable" test, and that additional factors beyond those specified in the statute could be found by the courts to be "fundamental" to "fair and equitable" treatment of a dissenting class.[90] One of these additional requirements is that a dissenting class should be assured that no senior class receives more than 100 percent of its claims.[91]

The legislative history also suggests a second additional require-

example, it is difficult to "prove" objectively that a 10% capitalization rate is "correct" and that an 11% capitalization rate is "incorrect," even though the choice of the capitalization rate may determine whether there is any value available to the junior classes. *See generally* Blum & Kaplan, *The Absolute Priority Doctrine in Corporate Reorganizations*, 41 U. CHI. L. REV. 651, 655 (1974). Among other things, the "step-up" provides the senior class, which has been forced to take inferior securities, with some protection against the risk that the actual experience of the reorganized debtor does not correspond to the projections used as the basis for valuing those securities.

85. *See, e.g., In re* Imperial '400' Nat'l Inc., 374 F. Supp. 949, 976-77 (D.N.J. 1974).

86. *See* 11 U.S.C.A. § 1129(b) (West 1979); H.R. REP., *supra* note 20, at 413, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS at 6370; HOUSE RECORD, *supra* note 22, at H11,104; SENATE RECORD, *supra* note 22, at S17,420.

87. If the requisite majority of the senior class has accepted the plan, then the plan has been accepted by the class, and the "fair and equitable" test would not apply. *See* 11 U.S.C.A. § 1129(b) (West 1979).

88. *See* H.R. REP., *supra* note 20, at 224, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS at 6184; HOUSE RECORD, *supra* note 22, at H11,104; SENATE RECORD, *supra* note 22, at S17,420.

89. *See* 11 U.S.C.A. § 1129(b)(2) (West 1979).

90. *See* HOUSE RECORD, *supra* note 22, at H11,104; SENATE RECORD, *supra* note 22, at S17,420.

91. *See* H.R. REP., *supra* note 20, at 414, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS at 6370; HOUSE RECORD, *supra* note 22, at H11,104; SENATE RECORD, *supra* note 22, at S17,420.

ment: senior creditors who are required to take securities in the reorganized debtor that are of equal priority with the securities given to a junior class should be compensated for their loss of priority and the increased risk that they are subjected to by that loss of priority.[92] The legislative history suggests that compensation for this loss of priority should be provided by assigning a lower value to the securities given to the senior creditors than to comparable securities given to junior creditors who have not lost a priority position.[93] To the extent that the legislative history evinces an intent to continue the requirement of the "step-up," however, the means suggested for the continued implementation of that requirement is inaccurate. The principle of the "step-up" under Chapter X was not predicated upon assigning a lower value to securities of the reorganized debtor given to one class than to securities of the same type given to another class. Instead, the value of a share of stock in the reorganized company was static, regardless of the identity of the ultimate recipient of the stock, but the senior class was compensated for its loss of priority by the receipt of securities with a "reorganization value" in excess of the amount of its claims.[94] This result would appear to conflict with the principle that no class should receive more than 100 percent of its claims.

The legislative history suggests that Congress saw no inconsistency between the requirement that no class receive more than 100 percent of its claims and the requirement that senior classes be compensated for a loss of priority.[95] Perhaps one way to resolve any inconsistency is to recognize that the components of a claim include not only the amount of the claim, but also the quality of the claim, reflected in its priority, and the corresponding effect on the likelihood of repayment. Using this definition of a claim, one can conclude that a post-reorganization claim or interest greater in amount but lesser in rank and likelihood of payment than its pre-reorganization counterpart really constitutes no more than 100 percent of its pre-reorganization value. Regardless of the mechanics of implementing the step-up, however, Congress apparently intended to continue that concept under the Code.[96]

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92. *See* H.R. REP., *supra* note 20, at 414, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS at 6370.

93. *See id.*

94. *See* Standard Gas & Elec. Corp. v. Deep Rock Oil Corp., 117 F.2d 615 (10th Cir.), *cert. denied*, 313 U.S. 564 (1941) (noteholders received cash and securities valued at $560,311 in excess of their claims).

95. *See* H.R. REP., *supra* note 20, at 414, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS at 6370.

96. One commentator on the Code has suggested that a dissenting class of creditors that is to

a. *Fair and equitable treatment of an impaired class of dissenting secured claims*

Section 1129(b)(2) of the Code[97] enumerates certain minimum requirements that must be met in order for a plan to be "fair and equitable" with respect to a dissenting class. With respect to a dissenting class of secured claims, section 1129(b)(2)(A)[98] requires that the proposed distribution to such a dissenting class meet one of three tests in order for the plan to be "fair and equitable" with respect to that class. Under alternative (i) the holders of claims within the class must retain the lien securing those claims to the extent of the allowed amount of their claims, and must receive deferred cash payments that total at least the allowed amount of the claims and whose value, as of the effective date of the plan, equals the value of their interest in the collateral.

In the case of an adequately collateralized secured creditor, this provision would require that the creditor receive deferred cash payments that total no less than the full amount of its allowed claim and that have a present value equal to the full amount of its allowed claim, secured by a lien for the full amount of its allowed claim. In the case of an inadequately collateralized secured creditor, the result required by alternative (i) will depend on whether the secured creditor has made the section 1111(b) election to waive any right to an unsecured deficiency, and to have the entirety of its claim treated as secured. Under alternative (i) the dissenting secured creditor who has not made the

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receive equity securities in satisfaction of a portion of its debt would be entitled only to securities with a reorganization value equal to the amount of the cancelled debt and no more. *See* Klee, *supra* note 40, at 149-50, 166. This conclusion appears questionable, however, in light of the apparent intent to preserve the concept of the "step-up" reflected in the House Report.

97. 11 U.S.C. § 1129(b)(2) (West 1979).

98. *Id.* § 1129(b)(2)(A) provides as follows:

> (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:
>
> (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.

section 1111(b) election must receive deferred cash payments having a present value no less than the value of its interest in the collateral, secured by a lien for not less than the value of its interest in the collateral. For example, if a secured creditor holds a claim of $100,000, which is secured by a first lien on collateral valued at only $60,000, and chooses not to make the section 1111(b) election, that creditor's allowed secured claim would be $60,000. Accordingly, the deferred cash payments under the plan, the present value of those payments as of the effective date of the plan, and the lien given to secure those payments, would all have to equal at least $60,000. This congruity of numbers results because the allowed amount of the secured claim equals the value of the secured creditor's interest in the collateral when the creditor has not made the section 1111(b) election.[99] As a practical matter, however, the sum of the deferred cash payments under the plan would have to exceed the allowed amount of the secured claim (that is, the value of the creditor's interest in the collateral); otherwise, the present discounted value of the deferred cash payments would, of necessity, be less than the allowed amount of the secured claim.

On the other hand, if the inadequately collateralized creditor makes the section 1111(b) election, that creditor will have an allowed secured claim equal to the full amount of its allowed claim, regardless of the value of the collateral, and will have no claim for an unsecured deficiency. In this situation, compliance with alternative (i) would require that the plan provide for the payment to the secured creditor of deferred cash payments equal to no less than the total amount of its allowed claim (rather than payments equal to no less than the value of the creditor's interest in the collateral), whose present value as of the effective date of the plan is not less than the value of the creditor's interest in the collateral, secured by a lien for not less than the full amount of the creditor's allowed claim. Using the example of the creditor owed $100,000 who holds collateral valued at $60,000, the effect of the section 1111(b) election would be that in order to meet alternative (i) for satisfying the "fair and equitable" requirement, the plan would have to provide for the payment to the secured creditor of deferred cash payments totalling $100,000, with a present discounted value as of the effective date of the plan of $60,000, secured by a lien for $100,000. Thus, by making the section 1111(b) election the dissenting secured creditor will have increased the minimum deferred cash payment required to permit a cram-down under alternative (i) from a sum equal to

99. *See* text accompanying note 30 *supra*.

the value of the creditor's interest in the collateral to a sum equal to the full amount of the secured creditor's claim. In addition, the dissenting secured creditor will be entitled to have that payment secured by a lien for the full amount of the secured creditor's claim, as opposed to a lien for only the value of the creditor's interest in the collateral. The present value, however, of the deferred cash payments required to comply with alternative (i) will be equal to the value of the creditor's interest in the collateral, regardless of whether or not the section 1111(b) election is made. Accordingly, the plan proponent can cope with the dissenting secured creditor who has made the section 1111(b) election by stretching the deferred payments out over a greater period of time. Thus, the practical economic benefit of the section 1111(b) election to the secured creditor faced with alternative (i) is that the effect of the election will be to require that the lien securing the deferred cash payments equal the full amount of the creditor's claim, rather than only the value of the creditor's interest in the collateral.

Under alternative (ii) a plan must provide for the sale of the secured creditor's collateral free and clear of its lien, with the lien to attach to the proceeds of the sale, and for the lien on the proceeds to be treated in accordance with alternative (i) or (iii).[100]

Finally, under alternative (iii) the plan must provide that the holder of the secured claim realize the "indubitable equivalent" of that claim.[101] The legislative history suggests that this requirement would

100. 11 U.S.C.A. § 1129(b)(2)(ii) (West 1979). One effect of such a sale is that the nonrecourse secured creditor would be denied the option of having an allowable unsecured claim for the unsecured deficiency that would otherwise be available under § 1111(b)(1). *See id.* § 1111(b)(1)(A)(ii). A second effect of a sale free and clear of liens under § 363 would be to preclude the inadequately secured recourse creditor from making the § 1111(b) election to have the total amount of its claim treated as an allowed secured claim. *See id.* § 1111(b)(1)(B)(ii). Consequently, compliance with alternative (i) for making a plan "fair and equitable" as to a dissenting class of recourse secured creditors could be had by providing for deferred cash payments that aggregate at least the value of the collateral, secured by a lien equal to the value of the collateral, instead of by deferred cash payments aggregating the full amount of the secured creditor's allowed claim, secured by a lien for the full amount of that claim.

It is less clear whether a nonrecourse creditor whose collateral is sold is precluded from making the § 1111(b) election. Section 1111(b)(1)(B)(i) precludes a class of *recourse* secured claims from making the § 1111(b) election when the property is to be sold under the plan. It does not, by its terms, preclude a class of nonrecourse secured claims whose collateral has been sold from making the election. Under § 1111(b)(1)(A)(ii), however, the nonrecourse creditor whose collateral has been sold will not be treated as a recourse creditor. It makes no sense to speak of a creditor's "electing" treatment as a nonrecourse creditor if the creditor has no choice. Moreover, the legislative history suggests that the secured creditor whose collateral is sold should be excluded from treatment under § 1111(b). *See* SENATE RECORD, *supra* note 22, at S17,420.

101. The standard of "indubitable equivalence" appears to be taken from the reference to "indubitable equivalence" in *In re* Murel Holding Corp., 75 F.2d 941 (2d Cir. 1935). *See* HOUSE RECORD, *supra* note 22, at H11,104; SENATE RECORD, *supra* note 22, at S17,421. In Murel Hold-

be satisfied by abandoning the collateral to the secured creditor or by giving the creditor a lien on similar collateral.[102] Accordingly, this requirement could be met by a plan providing for the sale of the secured creditor's collateral free and clear of liens, with the secured creditor's lien to be transferred from the proceeds of the sale to some other collateral with a value equivalent to that which was sold. Thus, the proceeds of property that was subject to a lien might be freed for use by the reorganized debtor. On the other hand, Congress apparently thought that unsecured notes or equity securities in the reorganized debtor would not be the "indubitable equivalent" of a secured claim.[103]

b. *Fair and equitable treatment of an impaired class of dissenting unsecured claims*

Section 1129(b)(2)(B) provides for two tests, one of which must be met by a plan in order to make it fair and equitable with respect to a dissenting class of impaired unsecured claims.[104] Under alternative (i) the plan must provide that each holder of a claim in the class is to receive or retain on account of the claim, "property of a value, as of the effective date of the plan, equal to the allowed amount of such claim."[105] The reference to "property" in the context of the required distribution to a dissenting class of unsecured claims contrasts with the reference to "cash" in section 1129(b)(2)(A)(i) relating to secured claims and includes both tangible and intangible property, such as eq-

ing, the court held that the payment of the principal amount of a debt over time and without any interest was not completely compensatory to the secured creditor because payment over time is not generally the equivalent of payment now. The court stated that a creditor should not be deprived of his money or his security, "unless by a substitute of the most indubitable equivalence." 75 F.2d at 942.

102. *See* HOUSE RECORD, *supra* note 22, at H11,104; SENATE RECORD, *supra* note 22, at S17,421.

103. *See id.*

104. 11 U.S.C.A. § 1129(b)(2)(B) (West 1979) provides:

> (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:
>
> . . . .
>
> (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.

105. *Id.* § 1129(b)(2)(B)(i).

uity securities of the debtor.[106] Thus, unlike a dissenting class of secured claims, a dissenting class of unsecured claims may be compelled to accept equity securities of the reorganized debtor.

Under alternative (ii) the plan must provide that the holder of any claim or interest that is junior to the claim of the dissenting class will not receive or retain any property on account of its claim or interest.[107] Thus, no class junior to the dissenting class may participate in the plan unless the dissenting class is compensated to the full extent of its allowed claim.

c. Fair and equitable treatment of an impaired class of dissenting interests

Section 1129(a)(2)(C) provides for two tests, one of which must be met in order to make a plan fair and equitable with respect to a dissenting class of impaired interests.[108] These alternatives generally track those applicable to a dissenting class of impaired unsecured claims. Alternative (i) requires that each holder of an interest in the class must receive or retain on account of the interest property with 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 the holder is entitled, any fixed redemption price to which the holder is entitled, and the value of the holder's interest.[109] Under alternative (ii), and as in the case of a class of unsecured claims, the plan must provide that the holder of any interest junior to the dissenting class will not receive or retain under the plan any property on account of the junior interest.[110]

106. *See* H.R. REP., *supra* note 20, at 413, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS at 6369; HOUSE RECORD, *supra* note 22, at H11,104; SENATE RECORD, *supra* note 22, at S17,421.

107. 11 U.S.C.A. § 1129(b)(2)(B)(ii) (West 1979).

108. *Id.* § 1129(b)(2)(C) provides as follows:

> (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:
>
> . . . .
>
> (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 (sic) 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.

109. *Id.* § 1129(a)(2)(C)(i).

110. *Id.* § 1129(a)(2)(C)(ii).

V. Valuation Under Chapter 11

The foregoing analysis of the "best interests" and "fair and equitable" tests makes it clear that a valuation of some sort will be necessary both to test the sufficiency of the proposed distribution to a dissenting claim holder within a class that has accepted the plan, and to test the sufficiency of the proposed distribution to a dissenting class. The required valuation may include both a valuation of a secured creditor's interest in the collateral and a valuation of the proposed distribution to a class (other than immediate cash payment).

The value ascribed to an asset ultimately depends on the assumptions made regarding its use or disposition. For example, if one assumes that the property must be sold on a forced liquidation, the resulting valuation of the asset (often referred to as "liquidation value") may be less than would be the case if one assumes that the property is to be sold at arms' length between a willing buyer and seller, neither being required to sell or buy (often referred to as "fair market value"[111]). Similarly, the method of valuation used to value a business enterprise will depend on whether one assumes a liquidation of assets on a piecemeal basis or its operation as a going concern. In the latter case, the test of value is "going concern value" based on a capitalization of future earnings of the business.[112] Thus, any contest over the appropriate method of valuation to be adopted in any given context will necessarily focus on the assumed use or disposition of the asset that underlies the valuation.

The draftsmen of the Code apparently took to heart the Supreme Court's admonition that "value is a word of many meanings, [which] gathers its meaning in a particular situation from the purpose for which a valuation is being made,"[113] because the Code does not prescribe the method or methods of valuation to be used. Instead, section 506(a)[114] provides that the value of a secured creditor's collateral "shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property. . . ." The legislative history indicates that "value" may be liquidation value, going concern value, or something in between, based on "the facts of each case and the competing

111. *See In re* Pine Gate Assocs., Ltd., 3 B.C.D. 301, 308 (N.D. Ga. 1977) (Bankruptcy Judge). In fact, each of the two values described in the text is a liquidation value, because both assumptions envision liquidation of the asset.

112. *See generally* text accompanying notes 55-65 *supra*.

113. Group of Inst'l Investors v. Chicago, M., St. P. & Pac. R.R., 318 U.S. 523 (1943).

114. 11 U.S.C.A. § 506(a) (West 1979).

interests in the case."[115]

In light of the different purposes of the "best interests" test embodied in section 1129(a)(7) and the "fair and equitable" test contained in section 1129(b), the method used to value the same asset, and what it is that is being valued, is likely to differ, depending on the test applied. The purpose of the "best interests" standard is to ensure that each dissenting holder of a claim or interest fares at least as well under the plan as he would have in a straight bankruptcy liquidation under Chapter 7.[116] Accordingly, the focus of the valuation made for purposes of applying this test will be on what could be realized on the sale of each asset of the business in a liquidation conducted under the auspices of the bankruptcy court.

On the other hand, the proper focus of the valuation made for purposes of applying the "fair and equitable" standard is that of determining the "going concern" value of the business as a whole, with the assumption that the value of the whole will differ from the sum of the individual parts. The requirements of section 1129(a)(7) already deal with the problem of assuring each dissenting class that it will receive at least as much under the plan as it would receive upon a liquidation. The application of section 1129(b) presupposes that this first hurdle has been overcome; the issue then becomes one of the proper allocation of the "going concern" value of the debtor among the various classes of claims and interests.

These differences in the appropriate valuation methods arise out of the different judgments reflected in sections 1129(a)(7) and 1129(b). The formulation of the standard of economic protection to be applied to a dissenting claim holder, equity holder, or class requires an answer to the question whether dissenters are entitled to be compensated for their claims or interests on the basis of liquidation value or going concern value. This question may be framed in terms of who is entitled to receive the "going concern bonus"[117] of a reorganized debtor—creditors or stockholders. Section 1129(a)(7) reflects a judgment that if the requisite majority of a class is willing to accept a plan that does not

115. H.R. REP., *supra* note 20, at 356, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS at 6312. *See also id.* at 224, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS at 6183.

116. *See generally* H.R. REP., *supra* note 20, at 412, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS at 6368; HOUSE RECORD, *supra* note 22, at H11,103; SENATE RECORD, *supra* note 22, at S17,420.

117. The term "going concern bonus" has been used to describe the amount by which the going concern value of income-producing assets exceeds their liquidation value. *See In re* Jumpers Equities, Ltd., 4 B.C.D. 1269, 1270 (D. Md. 1978).

compensate the class in full, but that nevertheless permits junior classes to receive part of the going concern bonus, that decision will be binding on the majority. Accordingly, it is not anticipated that the court will be required to determine the going concern value of the business as a whole when the requisite majority of each class has accepted the plan,[118] because the dissenting majority of an accepting class must be guaranteed only that it will fare as well as it would in a liquidation and is not considered to be entitled to any portion of the going concern bonus. On the other hand, the fair and equitable test embodied in section 1129(b) represents a judgment that a senior dissenting class must share in the debtor's going concern value to the full extent of its claims or interests before any junior class can share in that value.[119] A going concern valuation therefore becomes necessary in the context of applying the fair and equitable test.

A. Valuation for Purposes of Section 1129(a)(7)

The application of the "best interests of creditors" standard embodied in section 1129(a)(7) may require valuation from three different perspectives. First, section 1129(a)(7)(A) requires that each dissenting holder of a claim or interest within a given class receive property of a value not less than the amount that the holder would receive if the debtor were liquidated under Chapter 7.[120] Hence, it will be necessary to determine the distribution that would probably be received by the dissenters in the event of a Chapter 7 liquidation in order to ascertain whether the plan should be confirmed. This determination will necessitate, among other things, an appraisal of the anticipated realization upon a liquidation of the debtor's assets in a straight bankruptcy proceeding.[121] This anticipated realization would ordinarily be determined on a "forced sale" basis because of factors such as the cost of storage and the risk of deterioration that are likely to compel expeditious disposition in the event of bankruptcy. When there is a strong

118. *See* H.R. REP., *supra* note 20, at 414, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS at 6370 ("While Section 1129(a) does not contemplate a valuation of the debtor's business, such a valuation will almost always be required under § 1129(b).").

119. *See* text accompanying notes 66 & 67 *supra.*

120. 11 U.S.C.A. § 1129(a)(7)(A) (West 1979); *see id.* § 701-766.

121. The determination of the distribution that would be made in a Chapter 7 liquidation would require not only a liquidation value appraisal of the debtor's assets but also an evaluation of any causes of action for the recovery of fraudulent conveyances, preferences, or the like that a trustee in a Chapter 7 liquidation might have, and an evaluation of what assets would be left for distribution after paying administrative and priority claims. *See* H.R. REP., *supra* note 20, at 412, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS at 6368.

possibility, however, that the trustee would have a practicable alternative to the "forced sale" approach, that possibility should militate in favor of a valuation somewhat greater than a "forced sale" appraisal.[122]

In determining the likely distribution in a liquidation the probable delay in distribution to creditors should be taken into account. Normally, in a Chapter 7 liquidation, the assets would have to be liquidated and the administration of the estate completed before any distribution could be made. Accordingly, in order to estimate the present value of the likely distribution in the event of a Chapter 7 liquidation, the court must estimate the number of years it would take to administer the estate under Chapter 7 and determine the present value of the anticipated future distribution.

Second, once the court determines the probable distribution that would be made to the dissenters in a hypothetical Chapter 7 liquidation, it must ascertain the "present value" of the property that they are to receive under the plan of reorganization in order to compare the present value of the two potential distributions. If the property to be distributed under the plan consists of an immediate cash payment on the effective date of the plan, the value of the property to be distributed is simply the amount of the cash.

If the property consists of deferred cash payments, those payments must be discounted to their present value.[123] The higher the discount rate chosen, the lower will be the present value of the deferred cash payments. In order to assure that each dissenting creditor fares at least as well as it would on a liquidation, the discount rate used to calculate present value should be based on a market rate of interest because the dissenting creditor could presumably take the cash that would be received on a liquidation and invest it at a market rate of interest. If any interest rate lower than a market rate of interest were used as the basis for discounting, the creditor would end up with deferred cash payments under the plan of reorganization that total less than those that would have been received had the creditor received its share of the distribution on a liquidation and reinvested it at a market rate of interest.

Determining a "market rate of interest" may not be an easy task, especially when the deferred cash payments will be made on a long-term basis. In such a case, the court would presumably have to predict

122. *See generally In re* American Kitchen Foods, Inc., 2 B.C.D. 715, 719-22 (D. Me. 1976) (Bankruptcy Judge).

123. *See generally* H.R. REP., *supra* note 20, at 414-15, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS at 6370.

the market rate of interest for each of the years in which the deferred cash payments will be made in order to discount each cash payment to a present value. Given the recent experience of the American economy, any predictions about future interest rates could justifiably be viewed with skepticism. As a practical matter, courts should attempt to determine the market rate of interest by looking at the interest rates being charged with respect to obligations of comparable maturities in the debtor's locality. Focusing on the debtor's locality will enable the courts to take into account local peculiarities that might affect the market rate of interest, such as usury laws. Because interest rates typically include a risk factor, however, courts will have to attempt to find the rate being charged on an obligation of comparable maturity to a borrower of comparable creditworthiness. It may be difficult to find comparable loans involving debtors who have just emerged from the depths of a Chapter 11 case.

The trickiest problems of valuation with respect to testing the proposed distribution under section 1129(a)(7) are likely to be encountered when the property to be distributed under the plan consists of equity securities of the reorganized debtor. Theoretically, the ideal measure of value for this stock would be the fair market value of the stock following its distribution under the plan. If the market value of the securities to be received by a dissenter under the reorganization plan at least equalled the distribution that the dissenter would receive on a liquidation, there would be adequate assurance that the dissenter would do as well in reorganization as he or she would have done on a liquidation simply by selling the securities received under the plan.

The use of market value in such a situation is problematic, to say the least. There may be no active market in the debtor's securities from which a market value could be ascertained; indeed, the debtor might not have issued any securities prior to the Chapter 11 filing.[124] Even if the debtor had previously issued stock in which there had been active trading, the prices for which the debtor's stock previously sold may not be a very reliable index of the value of the stock that will be issued under the plan, because the market value of that stock may be affected by the dilution resulting from the issuance of additional shares and the alteration of the debtor's debt and equity structure required by the plan. Nevertheless, if the court can be satisfied as to the likely market value of the new securities by expert testimony that takes these factors

124. For example, the debtor might have previously operated under the partnership or sole proprietorship form.

into account, that value should be used because it enables the court to determine whether a dissenting creditor can fare as well in the reorganization as it would upon a liquidation by selling the new stock.

In cases in which a fair market valuation of the securities to be issued under the plan is impractical, the only method of valuation that would appear to be consistent with the liquidation orientation of the "best interests" test would be to determine the liquidation value of the debtor's assets, subtract from that value the indebtedness with which the reorganized debtor will emerge, and treat the difference as the liquidation value of the equity securities of the reorganized debtor. The value assigned to the stock distributed to a particular claimant would be his pro rata share of that equity.

It might be argued that, for purposes of applying section 1129(a)(7), the value of the equity securities to be distributed under the plan should be determined by valuing the debtor's business on a going concern basis. The legislative history would seem to preclude this result because it states that section 1129(a)(7) does not contemplate a valuation of the debtor's business.[125] Moreover, it is arguably inappropriate to compare the distribution a creditor would receive on a liquidation with the "going concern value" of the stock that it is to receive under the plan because that going concern value may not be reflected in the amount the creditor would realize if it attempted to sell that stock in the near future.[126] A creditor is not receiving as much as it would in a liquidation when it receives stock that it cannot expect to sell in the reasonably foreseeable future for an amount equal to what it would receive in a distribution upon a liquidation.

On the other hand, a distribution in a Chapter 7 liquidation would not take place immediately. It might take years to wind up the estate and make a distribution. If the court is convinced that the fair market value of the securities will approach going concern value within the time that it would take to make a distribution in a bankruptcy liquidation, it may be appropriate to look to the going concern value of the securities, even in the context of applying the "best interests" test. Whether such an approach is applied will, of course, depend on whether the court is convinced that the "intrinsic value" of the securities will be reflected in their market value at the time that the hypothetical Chapter 7 distribution would take place.

125. *See* H.R. REP., *supra* note 20, at 414, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 6370.

126. *See generally* text accompanying notes 20, 21, & 74 *supra*.

Finally, for purposes of the "best interests" test, it may be necessary to value a dissenting secured creditor's collateral for purposes of determining what that creditor would receive in the case of a Chapter 7 liquidation, or, in the case of a claim that is part of a class that has made the section 1111(b) election, for purposes of determining the value of the creditor's interest in the collateral. As a practical matter, the issue of valuing the secured creditor's collateral becomes important only when one of the proposed valuation methods would produce a value less than the amount of the creditor's claim. Because the thrust of section 1129(a)(7) is to protect the dissenter from receiving less than it would receive on a liquidation, liquidation value would seem to be the logical method of valuing the collateral in this context.

Whether this liquidation value would be based on a forced liquidation value or fair market value would depend on the disposition that the secured creditor could be expected to make of the collateral—that is, whether it would dispose of the collateral quickly or hold on to it in an attempt to get a better price. The court might also take into account the requirement of the Uniform Commercial Code that a disposition of collateral be "commercially reasonable."[127] Finally, the court should consider and deduct the costs that would be incurred in maintaining and selling the collateral because the amount that the secured creditor would net on a sale would be reduced by that amount.

The secured creditor who is collateralized by an income-producing asset might contend that, in the event of a Chapter 7 liquidation, it would purchase the asset at a sale by bidding in the full amount of its claim as permitted by section 363(k), operate the asset, and thereby attempt to realize the going concern value of the asset for itself. If the court in such a case is convinced of the genuineness of the creditor's representation that it would own and operate the asset, then the requirement of providing the secured creditor with property of a value equivalent to what it would get in a liquidation might be deemed to require that its collateral be valued on a going concern basis.

B. Valuation for Purposes of Applying the Fair and Equitable Test

Valuation for purposes of applying the "fair and equitable" test may come into play in two contexts. First, in order to determine whether the proposed distribution to the holder of a secured claim can

127. *See In re* American Kitchen Foods, Inc., 2 B.C.D. 715, 720-22 (D. Me. 1976) (Bankruptcy Judge).

pass muster under section 1129(b)(2)(A), it will be necessary to determine the value of the secured creditor's interest in the collateral.[128]

Second, it will be necessary to determine the present value of the property to be received by each dissenting class under the plan. In the case of a dissenting class of secured creditors, it will be necessary to determine the present value of the deferred cash payments to be made under the plan.[129] If there is a dissenting class of unsecured claims or interests, and some junior class is permitted to participate in the plan, it will be necessary to determine the value of the property given to the dissenting class, in order to determine whether it is receiving property of a value equal to the allowed amount of its claims or interests.[130]

With respect to the valuation of collateral, the method chosen to value a secured creditor's collateral will have a practical impact only if one or more of the alternative methods of valuation would produce a value less than the amount of the secured creditor's claim. If the value of the creditor's interest in the collateral is less than the full amount of its claim, the required present value of a fair and equitable distribution to the secured creditor under section 1129(b)(2)(A)(i) would be correspondingly less than the full amount of its claim.[131] The effect of using a valuation method that results in a higher value will be to require deferred cash payments of a correspondingly higher present value, up to a maximum of the full amount of the claim, to make the plan fair and equitable to the dissenting secured creditor.[132]

In the case of income-producing collateral, the battle between the proponent of the plan and the dissenting secured creditor will probably focus on whether forced liquidation value or going concern value is the appropriate measure of the value of the collateral.[133] The philosophical question implicit in the battle over valuation methods in this situation is whether the secured creditor is entitled to a portion of the going concern bonus inherent in its collateral.

There are a number of factors that may point to the use of going

128. *See* text accompanying notes 97-99 *supra.* Technically, the "fair and equitable test" would be applied to a dissenting class of secured claims. The discussion in the text is framed in terms of a secured creditor, rather than a secured class, in order to simplify the discussion. As a practical matter, each secured creditor is likely to be in a class by itself. *See* text accompanying note 23 *supra.*

129. *See* text accompanying notes 98 & 99 *supra.*

130. *See* text accompanying notes 106 & 107 *supra.*

131. *See generally* text accompanying notes 88-91 *supra.*

132. *See* text accompanying notes 97-99 *supra.*

133. *See In re* Pine Gate Assocs., Ltd., 3 B.C.D. 301 (N.D. Ga. 1977).

concern value as the basis for valuing income-producing collateral when applying the "fair and equitable" test. First, the inappropriateness of using liquidation value is suggested by the fact that, in order to satisfy the requirements of section 1129(a)(7), the plan will have had to provide for the secured creditor to receive property of a present value equal to that which the creditor would have received on a liquidation. The "fair and equitable" test would appear to add little to section 1129(a)(7) if the collateral were valued on the basis of liquidation value when applying the "fair and equitable" test.[134]

Second, as previously indicated, one of the philosophical underpinnings of the "fair and equitable" test was the judgment that junior classes should not participate in going concern value when senior classes are not being paid in full.[135] It would appear to be inconsistent with this judgment to limit the inadequately collateralized secured creditor to a distribution based on the liquidation value of the collateral, with the result that junior classes would be permitted to share in the going concern value of the collateral, even though the secured creditor was not receiving the full amount of its claim.

Finally, there is authority under the old Bankruptcy Act that suggests that, when the debtor is attempting to "cram down" a secured creditor whose collateral consists of an income-producing asset by paying the creditor the value of its interest in the collateral, the collateral should be valued on a "going concern" basis. The issue of the proper method of valuing the collateral of a crammed-down secured creditor appears to have arisen most often in the context of the cram down provisions of Chapter XII of the old Bankruptcy Act,[136] dealing with real property arrangements.[137] In a number of those cases, the courts

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134. It should be noted that, even if a liquidation value approach to valuing the collateral were used in the context of applying the "fair and equitable" test, the latter would still require a greater degree of protection for the secured creditor than the "best interests" test. In the first place, the "best interests" test can be satisfied by a plan giving the secured creditor "property" other than cash, e.g., securities. *See* 11 U.S.C.A. § 1129(a)(7)(A) (West 1979). The legislative history makes it clear that Congress, in using the word "property" instead of "cash" to describe the consideration that could be paid to a creditor, intended to encompass the distribution of equity securities in the debtor to the creditor. *See* H.R. REP., *supra* note 20, at 413, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS at 6369. In addition, compliance with alternative (i) of the "fair and equitable" test with respect to secured claims would require that the secured creditor retain his lien on the property. *See* 11 U.S.C.A. § 1129(b)(2)(A)(i) (West 1979). No similar requirement is contained in *id.* § 1129(a)(7)(A).

135. *See* text accompanying notes 66-67 *supra.*

136. 11 U.S.C. §§ 801 to 926 (1976) (repealed 1978).

137. Bankruptcy Act § 461(11), 11 U.S.C. § 861(11) (1976) (repealed 1978), required that a plan of arrangement under Chapter XII:

> provide for any class of creditors which is affected by and does not accept the arrange-

adopted the capitalization of prospective earnings approach to valuing income-producing collateral.[138] The justification for requiring this approach was that the entire theory of a reorganization proceeding is that a reorganization of a going business is taking place. As one court colorfully phrased it:

> Having declared itself a fish to be reorganized, it would be inconsistent for the court now to permit the Debtor to declare itself a fowl to be liquidated for purposes of "cramming down" a lower "appraised" value upon the secured Creditors. Therefore, a liquidation value, i.e., foreclosure value, is a procedure totally foreign to this matter and not a proper standard for valuation.[139]

On the other hand, there is some authority under the old Bankruptcy Act suggesting that the dissenting secured creditor collateralized by an income-producing asset need not receive the full going concern value inherent in that asset. In *In re Jumpers Equities, Ltd.*[140] the court indicated that the constitutionally required minimum valuation of a secured creditor's collateral in a reorganization proceeding for purposes of a cram down would be the present value of the net liquidation value of the collateral as of the date the proceeding was filed. In other words, the valuation of the collateral should allow the secured creditor to receive at least what it would have received had it, at the time the proceeding commenced, been permitted to foreclose on its security interest, sell its collateral for cash, and earn interest on the cash. The court went on to indicate that the entire going concern value need not be allocated to the secured creditor, and stated that the "going concern bonus" must be allocated on the basis of an "equitable apportionment" among all the parties.[141] The court did not elaborate on the considerations that should govern this "equitable apportionment."

There is some support in the legislative history for following this

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ment by the two-thirds majority in amount required under this chapter, adequate protection for the realization by them of the value of their debts against the property dealt with by the arrangement and affected by such debts, either, as provided in the arrangement or in the order confirming the arrangement, (a) by the transfer or sale, or by the retention by the debtor, of such property subject to such debts; or (b) by a sale of such property free of such debts, at not less than a fair upset price, and the transfer of such debts to the proceeds of such sale; or (c) by appraisal and payment in cash of the value of such debts; or (d) by such method as will, under and consistent with the circumstances of the particular case, equitably and fairly provide such protection; . . .

138. *See In re* Pembroke Manor Apts., 547 F.2d 805, 807-08 (4th Cir. 1977); *In re* Georgetown Apts., 3 B.C.D. 512, 514 (M.D. Fla. 1977).

139. *In re* Pine Gate Assocs., Ltd., 3 B.C.D. 301, 309 (N.D. Ga. 1977) (Bankruptcy Judge).

140. 4 B.C.D. 1269 (D. Md. 1978).

141. *Id.* at 1270.

approach under the Code.[142] The obvious question then becomes that of identifying those "equitable considerations" that might justify an apportionment of the going concern value of the collateral among various parties in interest.

One consideration is suggested by the cases that required that the crammed-down secured creditor receive the full benefit of the going concern value of the collateral. Those cases may have been predicated on the belief that the creditor has been deprived of the chance to foreclose on the collateral, acquire it at foreclosure by bidding in the debt, and appropriate the going concern value for itself.[143] If the creditor would not have operated the asset but would instead have sold it, the equities may not require that the creditor receive the full going concern value, but only the amount that it could have expected to receive had it been permitted to sell the property in the manner in which it was likely to sell it when the case was filed, plus any interest that it could have earned on the proceeds. Alternatively, a court dealing with a secured creditor who would not have kept and operated an income-producing asset might find it equitable to use a valuation that would give the secured creditor something more than it would have received had it been able to dispose of the property, while permitting the debtor to keep some of the "going concern bonus," on the theory that the secured creditor would not have obtained any portion of the bonus had the debtor not been willing to retain and continue operating the property.

Disputes as to valuation may arise even when the collateral is not, of itself, income-producing, but may have greater value as part of a going concern rather than on a liquidation. Assets such as inventory and accounts receivable can be converted into cash in the course of business of a going concern at prices substantially above those available on a liquidation in bankruptcy.[144] The secured creditor collateralized by such assets may contend that accounts of a going concern should be valued at face value, subject to an appropriate bad debt reserve, and that inventory should be valued at the price that would be obtained from customers in the ordinary course of business. This approach is more consistent with the debtor's operation as a going concern than is an approach based on liquidation values.[145] As a matter of

142. *See* text accompanying note 107 *supra*.

143. *See In re* Pine Gate Assocs., Ltd., 3 B.C.D. 301, 303 (N.D. Ga. 1977).

144. *See In re* American Kitchen Foods, Inc., 2 B.C.D. 715, 721 (D. Me. 1976) (Bankruptcy Judge).

145. *See generally id.*

fairness, however, the value of the inventory ought to be reduced by the cost of selling it, and the value of the accounts should be reduced not only by a bad debt reserve, but also by the cost of collecting them. In addition, it might be argued that because the value of the inventory and accounts would be drastically reduced if the debtor ceased operation, the difference between forced sale value and going concern value should be allocated in some fair manner between the secured creditor and other parties in interest. Although this approach might have been precluded under the strict rule of absolute priority applied under Chapter X of the old Bankruptcy Act, the concept of valuation under the Code, as explained in the legislative history, may be broad enough to permit such a result.[146]

Similar disputes may arise with respect to the valuation of non-income-producing collateral such as machinery, which, unlike inventory and accounts, may not be sold or realized upon in the near future as part of the debtor's business operations. With respect to such collateral, the battle will probably focus on forced liquidation value versus a "fair market" value. The use of a value greater than forced liquidation value seems appropriate because if forced liquidation value were used to determine whether a plan is fair and equitable to a secured creditor, the fair and equitable test would add little to the best interests test. Moreover, the "fair and equitable" test has traditionally been based on the notion that limiting senior classes to liquidation values in a case in which junior classes are to participate in the plan is unfair.

On the other hand, even if this collateral were sold for "fair market" value by an ongoing business under no compulsion to sell, certain costs would presumably have to be incurred to sell the property. As a practical matter, then, fair market value would represent only a gross price, and not net realizable value. Therefore, the fairest method of valuation would appear to be one that seeks to determine *net* fair market value, considering the costs that would have to be incurred if the asset was sold by an ongoing business in a manner designed to maximize the amount realized.[147]

146. *See* text accompanying note 115 *supra*.

147. The use of different methods of valuation in applying the "best interests" and "fair and equitable" tests may create confusion regarding the appropriate method of valuation for purposes of determining the unsecured deficiency of a secured creditor who does not make the § 1111(b) election. When the secured creditor's dissent to the plan requires that the "fair and equitable" test be applied to the proposed distribution to the creditor, and the secured creditor's collateral is, therefore, valued on a going concern basis, the method of valuation of the collateral used for purposes of calculating the unsecured deficiency should coincide with that used to determine the required distribution on account of the secured claim. If liquidation value were instead used for

The second context in which valuation becomes important in applying the "fair and equitable" test is that of determining the present value of the property to be received by the dissenting class. When the property consists of deferred cash payments, the present value of those deferred cash payments is to be determined by discounting the future payments on the basis of a discount rate that reflects a market rate of interest.[148]

When the property to be distributed under the plan consists of equity securities in the reorganized debtor, those securities should be valued on the basis of the going concern value of the debtor, as was the case in the context of applying the fair and equitable requirement under old Chapter X.[149] The going concern value of the business as a whole should be determined; the indebtedness with which the reorganized debtor will emerge under the plan should be deducted from that going concern value; and the balance—the "going concern equity"—should be allocated to the equity securities on a pro rata basis. Thus, application of the "fair and equitable" test will probably require valuation of the debtor's business as a whole on a going concern basis whenever the plan proposes to distribute equity securities to the dissenting classes.

On the other hand, a different method of valuation may come into play when the securities to be issued under the plan are to be issued, not by the debtor, but by some other entity—for example, in exchange for some or all of the debtor's assets. Cases decided under Chapter X of the Bankruptcy Act suggest that when the debtor's assets consist of securities that have a readily ascertainable market value, and that do

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purposes of calculating the unsecured deficiency to which the secured creditor as to whom the fair and equitable test must be met is entitled, the sum of the required present value of the deferred cash payments under the plan and the unsecured deficiency would exceed 100% of the secured creditor's claim in any case in which the going concern value of the collateral exceeded its liquidation value.

148. *See* text accompanying note 114 *supra.*

149. *See generally* text accompanying note 68-73 *supra.*

The conclusion that the test of value for purposes of applying the fair and equitable test under Chapter 11 is the same as that under old Chapter X is suggested by comments in the legislative history indicating that the fair and equitable test as applied under old Chapter X continues to apply to dissenting classes under Chapter 11. *See* H.R. REP. *supra* note 20, at 413, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS at 6370; HOUSE RECORD, *supra* note 22, at H11,104; SENATE RECORD, *supra* note 22, at S17,420. Congress was aware of the test applied under Chapter X and did not suggest that a different standard would be used in applying the fair and equitable test under Chapter 11. In fact, it was stated that the application of the rule would require "a full valuation of the debtor as the absolute priority rule does under current law." *Id.* at 223-24, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS at 6184. *See also id.* at 414, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS at 6370.

not represent a controlling interest, the appropriate method of valuation would be based on the fair market value of those securities, rather than on a determination of the "going concern" value of the issuer of the securities.[150] This approach can be justified because the use of an artificially constructed "going concern" value, based on a capitalization of prospective earnings, is predicated on the inability to ascertain the fair market value of the reorganized debtor's securities, coupled with a concern that the immediate value of those securities will be artificially depressed because the debtor has just emerged from a reorganization proceeding.[151] These concerns may be inapposite when the stock being distributed is that of an entity whose stock is actively traded, and which is not in a reorganization proceeding. The market value of this entity's stock would not be distorted by the cloud of a bankruptcy proceeding and should presumably reflect expectations of future earnings.

Nevertheless, the use of going concern value for purposes of valuing the securities of the acquiring entity may be appropriate when the assets of the debtor would comprise a substantial portion of the assets of the acquiring company after the acquisition. In this case, the fair market value of the acquiring company's stock prior to the acquisition would not necessarily bear any relationship to its fair market value after the acquisition had been completed. Moreover, the fair market value of the stock following the acquisition might be artificially depressed because a major portion of the acquiring company's operations would have just emerged from a reorganization proceeding. Hence, it may be appropriate to value the securities of the acquiring company to be distributed under the plan by calculating a going concern value for the company as a whole, after taking the acquisition into account, and allocating that value, less the prospective debt of the acquiring company, on a pro rata basis among all of its equity securities for purposes of determining the value of the securities to be received under the plan by any dissenting class of claims or interests.[152]

150. *See* Central States Elec. Corp. v. Austrian, 183 F.2d 879, 884 (4th Cir. 1950) (when debtor is holding company, with assets consisting of marketable securities, none of which represents a controlling interest, and which are readily valued by reference to market quotations, the proper method of valuing the stock is presently realizable value of securities on hand).

151. *See* text accompanying notes 65, 78-80 *supra.*

152. *But see In re* Northeastern Steel Corp., 38 S.E.C. 41 (1957) (plan contemplated that shares of stock would be issued to proponent in exchange for shares of proponent's common stock; S.E.C. valued stock of debtor being received by proponent on basis of "going concern value" of debtor, but valued stock of proponent on basis of "its fair market value as represented by fairly current market prices".). *See generally In re* New York, N.H. & H. R.R., 304 F. Supp. 793, 808-09 (D. Conn. 1969), *modified,* 399 U.S. 392 (1970).

VI. Conclusion

When one or more classes refuse to accept a plan, two different valuations will probably be necessary—one for applying the "best interests" test embodied in section 1129(a)(7), and one for applying the "fair and equitable" test embodied in section 1129(b). Consequently the same property may have two radically different values assigned to it at the same confirmation hearing. Although this result may seem bizarre, it is perfectly consistent with the different concerns and purposes that animate the two tests.

Determining and applying the proper method of valuation to be used in any given context may be extremely difficult and give rise to protracted litigation. The resulting uncertainty over the value that will be ascribed to assets or a business by the court should spur the parties in interest to reach compromises that will avoid a battle over valuation.