

**CONFIRMATION ISSUES AFFECTING BUSINESSES WHOSE PRIMARY  
BUSINESS ACTIVITY IS BASED UPON THE OWNERSHIP, AND  
OPERATIONS ASSOCIATED WITH, REAL ESTATE**

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I. General Setting and Economic Considerations.

This section considers issues affecting formulation and confirmation of a plan of reorganization where the debtor's primary business activity is based upon ownership, and operations associated with, real estate. A common feature of real estate based Chapter 11 cases is a single secured creditor with a lien against the debtor's real property assets, whose secured claim is larger, sometimes overwhelmingly larger, than all other claims in the case. The loan is in default and the secured lender wants to exit the credit, through foreclosing and selling its collateral. Conversely, the debtor, that is, the debtor's owners, hope to restructure the secured loan, in order to hold on to the real estate and, hopefully, realize future appreciation, whether from ordinary market conditions (*i.e.*, the historic tendency of real estate to appreciate over time) or just simply stabilization of the underlying asset. The more extreme the debtor's financial situation (a single undersecured creditor, with a large deficiency claim, and no or virtually no other creditors), the more difficult confirmation will be. The case law addressing the extreme fact pattern is helpful in formulating a plan of reorganization, but not definitive as to how issues will be resolved in the course of confirmation.

The focal point of virtually all Chapter 11 filings is confirmation of a plan of reorganization – the mechanism to force a restructuring of loans and other debts on dissenting creditors. That focal point is no different for a Chapter 11 debtor whose business consists primarily of the ownership and incidental operations associated with real estate. A plan of reorganization under Chapter 11 constitutes a contract between the debtor and its creditors for the satisfaction of creditors' claims. *See, e.g., In re Winslow*, 123 B.R. 641, 643 (D. Colo. 1991). But unlike ordinary "contracts" (voluntary undertakings among consenting parties), a non-consenting creditor can be bound by a plan of reorganization if the bankruptcy court confirms the plan under Bankruptcy Code § 1129. *See, e.g., In re City of Colorado Springs, Springs Creek General Improvement District*, 187 B.R. 683, 690 (Bankr. D. Colo. 1995). The potential that a debtor can force a restructuring on unwilling creditors, by (a) classifying the dissenting creditor in an accepting class or (b) outright cram-down of the dissenting class under Bankruptcy Code § 1129(b), is the reason many, if not most, troubled real estate based businesses ultimately seek relief under Chapter 11. The battleground in a real estate business seeking confirmation of a plan of reorganization typically centers on forcing revised payment terms on a creditor or group of creditors who do not consent to the debtor's plan of reorganization.

Fundamentally, whether a debtor can achieve its business objectives through Chapter 11 depends on the combination of the debtor's specific business facts and the legal requirements for confirmation contained in Bankruptcy Code § 1129. The plan proponent, whether debtor or creditor, bears the burden of proof on all confirmation issues. *In re Martin*, 66 B.R. 921, 925 (Bankr. D. Mont. 1986). Outside of the unique facts of a specific debtor, the significance of the legal requirements for confirmation set forth in Bankruptcy Code § 1129 is not obvious. But within the context of the specific financial situation of a business and the essential financial relief the debtor hopes to achieve through Chapter 11, the legal requirements for confirmation take on significant meaning, indeed, those requirements set the limits of the restructuring that can be ***forced on non-consenting creditors***. The Chapter 11 process typically plays itself out in a series of negotiations, which commonly begin with some creditors before the bankruptcy case is even filed and continue throughout the pendency of the Chapter 11. Those negotiations are always weighted against the debtor's ability to confirm a plan of reorganization over the objection of a creditor or a group of creditors. Both sides, the objecting creditors or the debtor, have the full force of the legal requirements contained in Bankruptcy Code § 1129 and the case law applying those requirements on their side. The degree of power each side has in such negotiations depends on a range of facts, the assets and liabilities of the debtor, the debtor's operating cash flows, and the nature of the debt relief needed by the debtor to achieve its objectives.

The fundamental question in formulating a plan of reorganization is to determine the debtor's basic business objective, that is, what result does the client want or hope to achieve through a plan of reorganization? Financially troubled real estate based businesses typically need more time: (1) more time to sell some or all of its assets, which may require some sort of development, (2) more time to increase operating revenue, (3) more time to pay its debts, that is, extension of a maturity date and re-amortization, or (4) more time for some combination of these. Does the debtor need more time to obtain a loan or just to continue to market its property? Does the debtor need more time to develop its real property assets; if so, what impact will its contemplated development have on repayment of debt; will the development increase the sales price or increase cash flow and, if so, what are the costs associated with the development?

Whether a debtor can realistically achieve its restructuring goals through a plan of reorganization is a legal question fundamentally linked to the debtor's assets and liabilities. A debtor will have a pretty tough time confirming a plan of reorganization if the debtor's sole asset is worth less than the loan the asset secures, the lender is the debtor's only real creditor, the debtor has no employees, no operations, and no revenues and the Chapter 11 filing is a last ditch effort to forestall a pending foreclosure. In such extreme circumstances, the debtor is unlikely to even get the chance to file a plan because the Chapter 11 filing will likely be dismissed as a "bad faith" filing. *See, e.g., Udall v. FDIC (In re Nursery Land Development, Inc.)*, 91 F.3d 1414 (10<sup>th</sup> Cir. 1996). Of course, most Chapter 11 cases do not have such extreme facts. More commonly, the debtor is either (a) marginally solvent and in need of modest restructuring -- slight reduction in interest rates, extended maturity date and payments terms on vendor debts, or (b) insolvent and in need of more aggressive modification of its existing debts, which consist

of one or more secured lenders and a mix of general unsecured creditors, such as tenants, trade vendors, equipment lessors, taxing authorities and others. If the debtor is insolvent, then it will be difficult at best to confirm a plan of reorganization without the consent of all impaired classes. That is clearly one message from *Bank of America v. 203 North LaSalle Street Partnership*, 526 U.S. 434 (1999) and *Norwest Bank v. Ahlers*, 485 U.S. 197 (1988). In contrast, if the underlying real estate has a stable, high asset-to-debt ratio, the debtor may be able to exit Chapter 11 with a negative-amortization plan even though current revenues are not sufficient to fund the debtor's post-reorganization operations and make payments under the plan immediately after confirmation. See, e.g., *Travelers Ins. Co. v. Pikes Peak Water Co. (In re Pikes Peak Water Co.)*, 779 F.2d 1456 (10<sup>th</sup> Cir. 1985); *Ames v. Sundance State Bank (In re Ames)*, 973 F.2d 849 (10<sup>th</sup> Cir. 1992); *Affiliated National Bank v. TMA Associates, Ltd. (In re TMA Associates, Ltd.)*, 160 B.R. 172 (D. Colo. 1993); *In re 8315 Fourth Ave. Corp.*, 172 B.R. 725 (Bankr. E.D.N.Y. 1994); *In re EFH Grove Tower Associates*, 105 B.R. 310 (Bankr. E.D.N.C. 1989); *In re Memphis Partners, L.P.*, 99 B.R. 385 (Bankr. M.D. Tenn 1989); Honorable Barry Schermer & Keith W. Bartz, *Negative Amortization and Plan Confirmation: Is it Fair and Equitable Under Section 1129(b) of the Bankruptcy Code*, 8 Bankr. Dev. J. 1 (1991).

Owners, of course, set the business objective to be achieved at the outset and, most often, throughout a real estate based Chapter 11 case. Owners typically hope to maintain their ownership interests, either direct or indirect ownership, in the underlying real property assets. For example, owners may hope to realize future appreciation or to mitigate tax consequences arising from disposition of the underlying real estate, but restructuring of existing obligations is necessary in light of existing conditions, whether internal, external or both; reaching a stabilized state takes time.

Creditors, individually or in groups, may agree to a proposed restructuring of the obligations of the debtor, in which case there is a fully consensual plan, see Bankruptcy Code § 1129(a)(8), and there is no need to ask the court for confirmation under Bankruptcy Code § 1129(b). This is not unusual. Despite the dichotomy of their preferred outcomes in the insolvent real estate based case, lenders and borrowers can have essential agreement on the basic economic situation, which often lends itself to common understandings. But even if all classes have accepted the plan, the plan must still meet the best interests test of Bankruptcy Code § 1129(a)(7). A plan must provide creditors with a distribution equal to the distribution in a Chapter 7 case, the so-called liquidation value of the debtor. This is not an insubstantial confirmation issue in that a single dissenting creditor can make this a contested issue. Since real estate based plans typically contemplate payments over time, the degree of risk attendant to performance over time, the difference between cash today and cash tomorrow, becomes a necessary consideration. See Bankruptcy Code § 1129(a)(11) (feasibility). This difference of opinion regarding present/future cash is generally what fuels the confirmation battle on a wider basis, when a secured lender or other classes of creditors dispute the payment terms being offered under a plan.

When the owners' goal of "more time" conflicts with the creditors' goal of "payment now," and a class or classes reject the plan, a debtor will attempt to confirm the

plan under Bankruptcy Code § 1129(b). It is the inter-play between Sections 1129(a)(8), (a)(10) and (b) that has caused at least some of the recurring issues in single asset real estate cases, such as gerrymandering, artificial impairment, and insider status. In the context of § 1129(b), parties in interest are considered in their capacity as either secured creditor, unsecured creditor or owner. The interests of each group must be accorded the following treatments: (a) a secured creditor must be paid the lesser of the value of its collateral or full amount owing under the debt instrument; (b) if that is satisfied, then the rejecting unsecured creditor class must be paid in full, unless owners' equity interests in the debtor business entity are being cancelled. In other words, owners can retain their pre-petition equity interest in the debtor only if (a) all impaired classes accept the plan or (b) secured creditors are paid the full value of their collateral (meaning payment in full if the collateral value exceeds the amount owing) and unsecured creditors are being paid in full.

The following sections consider some of the legal and economic issues affecting plan formulation and confirmation of real estate based businesses.

## II. Consenting, impaired class of non-insider creditors.

One key confirmation issue in a real estate based Chapter 11 case is Bankruptcy Code § 1129(a)(10). Section 1129(a)(10) provides that if a plan of reorganization creates an impaired class, then at least one impaired class of non-insider creditors must vote to accept the plan. Unless an impaired class accepts the plan, the debtor will be unable to attempt a cramdown of the plan on that rejecting class under § 1129(b). Section 1129(a)(10) sets a limit to what the debtor can do under a plan. The debtor must propose some treatment to some impaired class such that that impaired class will accept the plan. Section 1129(a)(10) also sets a limit for a dissenting creditor – either control voting or face potential cramdown. For this reason, it is not uncommon for a secured lender to consider purchasing other claims in the cases to control voting.

Bankruptcy Code § 1129(a)(10) requires consideration of the following Sections of the Code: (a) Bankruptcy Code § 1122 which establishes the rules on classification; (b) Bankruptcy Code § 1124 which establishes the rules on impairment, (c) Bankruptcy Code § 1126 which establishes the voting rules, and (d) Bankruptcy Code § 101(31) providing the statutory definition of “insider.” Each of these sections is considered below.

### A. Classification: Bankruptcy Code § 1122.

Creditors whose claims will be subject to a plan of reorganization must be placed in “classes.” Bankruptcy Code § 1123(a)(1). Bankruptcy Code § 1122 provides the rules for classification. Except as provided in subsection (b), the so-called administrative convenience class, only “similar” claims may be placed in the same class. Bankruptcy Code § 1122(a); *see Herbert Construction Co. v. The Greater New York Sav. Bank (In re 455 CPW Assoc.)*, 225 F.3d 645 (2<sup>nd</sup> Cir. 2000) (not for publication); *In re Main Line Corp.*, 335 B.R. 476 (Bankr. S.D. Fla. 2005).

Clearly, secured claims are dissimilar to unsecured claims. *See, e.g., In re D&K Realty Corp.*, 165 B.R. 127, 129 (S.D.N.Y. 1994). Often in real estate based Chapter 11 cases the question is to what extent may a debtor place unsecured claims in different classes. *See In re Colorado Springs, Spring Creek General Improvement District*, 187 B.R. 683, 688 (Bankr. D. Colo. 1995) (in a Chapter 9 case, § 1122 does not mandate that all “similar” claims be classified together, only that if claims are placed in the same class, then those claims must be “substantially similar.”). The Second, Third, Fourth, Fifth, Sixth, Eighth and Eleventh Circuit Courts of Appeal have imposed limitations on the classification of similar claims in separate classes. *See, e.g., Boston Post Road Ltd. Partnership v. F.D.I.C. (In re Post Road Ltd. Partnership)*, 21 F.3d 477, 483 (2d Cir. 1994); *John Hancock Mut. Life Ins. Co. v. Route 37 Business Park Assoc.*, 987 F.2d 154, 159-60 (3d Cir. 1993); *Lumber Exch. Bldg. Ltd. Partnership v. Mutual Life Ins. Co. (In re Lumber Exch. Bldg. Ltd. Partnership)*, 968 F.2d 647, 649 (8<sup>th</sup> Cir. 1992); *Travelers Ins. Co. v. Bryson Properties, XVIII (In re Bryson Properties, XVIII)*, 961 F.2d 496, 502 (4<sup>th</sup> Cir. 1992); *Phoenix Mut. Life Ins. Co. v. Greystone III Joint Venture (Matter of Greystone III Joint Venture)*, 995 F.2d 1274, 1278-1279 (5<sup>th</sup> Cir. 1991); *Olympia & York Florida Equity Corp. v. Bank of N.Y. (In re Hollywell Corp.)*, 913 F.2d 873, 880 (11<sup>th</sup> Cir. 1990); *Teamsters Nat'l Freight Indus. Negotiating Committee v. U.S. Truck Co. (In re U.S. Truck Co.)*, 800 F.2d 581, 586 (6<sup>th</sup> Cir. 1986).

As those courts recognized, some plan proponents craft a plan so as to separately classify similar claims in order to create at least one impaired class that accepts the plan; however, “such manipulation is viewed as an abuse of Chapter 11,” *Colorado Springs*, 187 B.R. at 688, and courts have refused to permit such gerrymandering. The Fifth Circuit has set forth its own commandment: “[t]hou shalt not classify similar claims differently in order to gerrymander an affirmative vote on a reorganization plan.” *Greystone III Joint Venture*, 995 F.2d at 1279; *see also U.S. Truck Co.*, 800 F.2d at 586 (disapproving of gerrymandering, and noting that “[u]nless there is some requirement of keeping similar claims together, nothing would stand in the way of a debtor seeking out a few impaired creditors (or even one such creditor) who will vote for the plan and placing them in their own class”); *Route 37 Business Park Assoc.*, 987 F.2d at 158 (“[t]here must be some limit on the debtor's power to classify creditors . . . [T]he potential for abuse would be significant otherwise.”), *citing U.S. Truck Co.*, 800 F.2d at 586.

All of these Circuit Court decisions were decided before the 1994 Amendments. Since the amendments to Bankruptcy Code § 1124, the debate over “gerrymandering” may not be as viable as it once was. *See In re Greate Bay Hotel & Casino, Inc.*, 251 B.R. 213, 239-240 (Bankr. D.N.J. 2000).

#### B. Impairment: Bankruptcy Code § 1124.

Bankruptcy Code § 1124 provides the rules for “impairment.” The concept of “impairment” determines which creditors are entitled to vote on a plan of reorganization. *L & J Anaheim Assoc. v. Kawaski Leasing International, Inc. (In re L & J Anaheim Assoc.)*, 995 F.2d 940, 942-43 (9<sup>th</sup> Cir. 1993). If a plan of reorganization (a) leaves a creditor’s legal, equitable and contractual rights unaltered or (b) provides for full cure of

any pre-bankruptcy default, then the creditor is deemed to be unimpaired and, accordingly, not entitled to vote on a plan. Bankruptcy Code §§ 1124(1) and (2). The Bankruptcy Code creates a presumption of impairment “so as to enable a creditor to vote on acceptance of the plan.” *In re Monclova Care Ctr., Inc.*, 254 B.R. 167, 178-79 (Bankr. N.D. Ohio 2000), *rev’d in part on other grounds*, 266 B.R. 792 (N.D. Ohio 2001).

Prior to the 1994 Amendments, impairment was a commonly debated issue in single-asset real estate cases of all sizes due to Bankruptcy Code § 1129(a)(10), leading some courts to the concept of “artificial” impairment. *See, e.g., Windsor On the the River Assocs., Ltd. (In re Windsor on the River Assocs., Ltd.)*, 7 F.3d 127, 132 (8<sup>th</sup> Cir. 1993); *In re Valley View Shopping Center, L.P.*, 260 B.R. 10, 32-33 (Bankr. D. Kan. 2001); *In re Global Ocean Carriers, Ltd.*, 251 B.R. 31, 41-42 (Bankr. D. Del. 2000). The 1994 Amendments deleted subsection (3) of Section 1124, which provided that payment in cash in full on the effective date of the plan did not constitute “impairment.” With the elimination of subsection (c), impairment would seem to be a less important issue. *See generally In Matter of Greate Bay Hotel & Casino, Inc.*, 251 B.R. 213, 239-240 (Bankr. D.N.J. 2000). Since payment in cash in full upon confirmation constitutes “impairment,” “debtors will not be forced to contrive an impaired class by placing certain creditors in a separate class and paying that class less than 100 cents on the dollar.” *Equitable Life Insurance Co. v. Atlanta-Stewart Partners (In re Atlanta-Stewart Partners)*, 193 B.R. 79, 82 (Bankr. N.D. Ga. 1996). However, the limitation placed on a claim by a statute, such as the cap on a damage claim under a commercial real property lease under Bankruptcy Code § 502(b)(6), does not create “impairment,” because that limitation is imposed by statute, not the plan. *Solow v. PPI Enterprises (U.S.), Inc. (In re PPI Enterprises (U.S.), Inc.)*, 324 F.3d 197 (3<sup>rd</sup> Cir. 2003).

### C. Acceptance and Rejection: Bankruptcy Code § 1126.

Bankruptcy Code § 1126 provides the rules on voting. Determination of acceptance or rejection of a plan of reorganization is determined on the basis of the number of creditors actually voting and by weighted vote. Bankruptcy Code § 1126(d). A class is deemed to have accepted the plan if more than fifty percent of the creditors in the class who actually vote, vote in favor of the plan and those accepting votes total at least two-thirds of the dollar amount of the votes cast. *Id.* As a result, creditors holding more than one-third of the dollar amount of claims in a particular class can block acceptance by that class. This dynamic results in different strategies.

From the debtor’s view, consideration will be given to structuring its classes so that potential or anticipated dissenting votes are dispersed in a class or classes of creditors likely to vote for the plan and, therefore, neutralize the effect of the dissenting vote. Alternatively, a debtor may place a large dissenting creditor in a separate class so that creditor does not control the vote of an impaired class that would otherwise accept the plan. The unique facts of each debtor determine how far these steps can be taken. A creditor finding itself in a class that accepts the plan will be bound by that plan, unless the creditor can defeat confirmation using one of the other subsections of Section 1129(a). *In*

*re City of Colorado Springs, Springs Creek General Improvement District*, 187 B.R. 683 (Bankr. D. Colo. 1995). Most often, that fight is waged either under Section 1129(a)(7) (best interest of creditors test) or Section 1129(a)(11) (feasibility), both of which can be expensive to attack.

From a creditor's view, a creditor may attempt to control voting by simply purchasing claims. *See generally*, Fortgang & Mayer, Trading Claims and Taking Control of Corporation in Chapter 11, 12 *Cardoza L. Rev.* 1 (1990); Africk, Trading Claims in Chapter 11: How Much Influence Can Be Purchased in Good Faith under Section 1126?, 139 *Univ. Pa. L. Rev.* 1393 (1991). A person who purchases claims or equity interests in bankruptcy generally acquires the full rights of the original creditor or equity security holder. *See, e.g., In re Applegate Property, Ltd.*, 133 B.R. 827, 833 (Bankr. W.D. Tex. 1991). This rule extends to both distribution and voting rights.<sup>1</sup> Claims purchasing contributes to the bankruptcy process in several ways, by supplying liquidity to creditors, enabling interested parties to counter adverse management decisions, consolidating claims or re-capitalizing the debtor. *See In re Marin Town Center*, 142 B.R. 374, 379 (N.D. Ca. 1992). Claims held, traded and voted by insiders create an exception to this general rule. *See Monroe v. Scofield*, 135 F.2d 725 (10<sup>th</sup> Cir. 1943) (limitations on insider purchasing claims of insolvent corporation). Where a claim was originally held by a non-insider creditor and is purchased by/assigned to an insider, the vote cast on account of that claim by the insider/purchaser will be deemed a vote by an insider. *Applegate Property*, 133 B.R. at 833; *In re Holly Knoll Partnership*, 167 B.R. 381, 385 (Bankr. E.D. Pa. 1994).

In Chapter 9 and 11 cases, votes may be disenfranchised under Bankruptcy Code § 1126(e) if the votes were not cast in "good faith" or were "not solicited or procured in good faith." When a creditor has purchased claims in order to control voting, a debtor may attempt to invalidate those votes as having been cast in "bad faith." Bankruptcy Code § 1126(e). The court's discretion under § 1126(e) extends to sanctioning "any conduct that taints the voting process." *Century Glove, Inc. v. First American Bank*, 860 F.2d 94, 97 (3d Cir. 1988). Typically, "good faith" is not defined in the Bankruptcy Code. Rather, Congress intentionally left it to the courts to give meaning to "good faith" in the voting context, within the facts and circumstances of specific cases. *See, e.g. In re A.D.W., Inc.*, 90 B.R. 645, 648 (Bankr. D.N.J. 1988).

"Good faith" is to be found in the motive of the claimholder. *In re Pine Hill Collieries Co.*, 46 F. Supp. 669 (E.D. Pa. 1942). But motive is a murky area and court findings regarding "motive" are typically made by inference. Not surprisingly, the

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<sup>1</sup> Note that only allowed claims are entitled to vote. A claim that is scheduled as contingent, unliquidated or disputed is not an allowed claim. A filed proof of claim is deemed allowed until objected to. Bankruptcy Code § 501. A debtor may file an objection to a claim in order to block a creditor's vote. If a creditor is listed with a disputed claim or a claim objection is pending, the creditor must take the initiative to seek estimation of its claim for voting as provided under Fed. R. Bankr. Pro. 3018(a). Similarly, if a creditor has filed a proof of claim in an amount deemed excessive by the debtor, a debtor can seek estimation of the claim for voting purposes under Rule 3018(a).

existing case law is not always easy to harmonize. Although courts have articulated various “tests” for the good-faith voting standard, in actual application, courts define “good faith” under § 1126(e) by way of *exclusion*. Courts generally start with the proposition that “anything goes” in voting on a plan and then describe certain limited conduct which is prohibited. The cases identify the conduct that is *not permitted*, because in the realm of purchasing claims and protecting one’s interest in bankruptcy, all other conduct is permitted. The balance is between self interest, on the one hand, and ulterior or, importantly, *coercive* motives, on the other.

In exercising voting rights, claim and interest holders are permitted and expected to pursue their unique view of their *personal self-interest*. See, e.g., *In re Landau Boat Co.*, 8 B.R. 432, 435-36 (Bankr. W.D. Mo. 1981). The mere purchasing of claims with the express intent to vote them, without more, does not constitute bad faith. *P-R Holding*, 147 F.2d 895. “It is well settled. . .that good faith in casting a vote does not require of the creditor a selfless disinterest. Each creditor is expected to cast his vote in accordance with his perception of his own self-interest . . .” *In re Frank Fehr Brewing Co.*, 268 F.2d 170, 180 (6<sup>th</sup> Cir. 1959), and only “coercive” and “ulterior” actions comprise the prohibited area of conduct.

A “*coercive*” motive has been described as one where the purchaser demands better treatment than the rest of its class. See, e.g., *Young v. Higbee Co.*, 324 U.S. 204 (1945) (shareholders); *In re Federal Support Co.*, 859 F.2d 17, 19 (4<sup>th</sup> Cir. 1988) (“One who casts his vote with a purpose of coercing payment to him of more than he might reasonably perceive as his fair share of the debtor’s estate, does not cast his vote in good faith.”). This should be distinguished from pursuing a course of action to realize on pre-existing rights, such as foreclosure. See, e.g., *Marin Town*, 142 B.R. 374.

An “*ulterior*” motive has been defined as one in aid of an interest other than that of a creditor. See, e.g., *In re P-R Holding Corp.*, 147 F.2d 895 (2<sup>nd</sup> Cir. 1945). “The test is whether a vote is cast for the ulterior purpose of securing some advantage to which the creditor would not otherwise have been entitled. Ulterior motives which have been held to constitute bad faith include ‘pure malice, “strikes,” and blackmail and the purpose to destroy an enterprise in order to advance the interest of a competing business.’ Thus, Section 1126(e) has been used to prevent minority creditors from extorting, and debtors from making, preferential payments in exchange for votes; it has also been used to prevent a competitor from advancing a competing business by blocking reorganization.” *Marin Town*, 142 B.R. at 378-79.

The difficulty in applying these tests is that what is “selfishness from the stand point of those who derive no benefit from the conduct under scrutiny often becomes enlightened self-interest if viewed from the stand point of those who gained by it. If a selfish motive were sufficient to condemn reorganization policies of interested parties, very few, if any, would pass muster.” *Pine Hill*, 46 F. Supp. at 671. The various articulations of the test for what constitutes “bad faith” seem to create standards which arguably include an almost unlimited range of conduct. However, when viewed in the

context of cases which have actually designated votes for lack of good faith, the conduct which is actually impermissible and, hence, to be avoided, is limited.

The general rule is that a vote found lacking in “good faith” results only in disenfranchising that vote, i.e., the “bad faith” vote is not counted. *See, e.g., Holly Knoll*, 167 B.R. at 385; *see also In re P-R Holding Corp.*, 147 F.2d 895 (2d Cir. 1945) (limiting remedy for lack of good faith to disregarding the votes). Section “1126(e) grants a limited discretion: the bankruptcy court may designate a vote or not. The section does not give the court discretion to impose other remedies, such as the payment of costs.” *Century Glove*, 860 F.2d at 97. However, where the seller has gained a benefit in excess of that obtained by others of the seller’s class and his claims trading is in breach of his fiduciary duty to others of his class, that purchaser may be required to account for the value of the benefit received. *Young v. Higbee Co.*, 324 U.S. 204 (1945) (unique facts dealing with a “class” appeal by shareholders where appealing shareholders were deemed not be class representatives and were thus barred from “selling” their appeal).

D. Insider: Bankruptcy Code § 101(31).

Since Bankruptcy Code § 1129(a)(10) counts only the votes of non-insiders, depending on the creditors voting in a particular class, a question can arise as to whether any of the creditors in a particular class are “insiders.” Bankruptcy Code § 101(31) provides a statutory definition of “insider.”

However, two types of insiders are recognized under applicable law: (a) those specifically identified in Section 101(31), known as “*per se*” insiders, and (b) those not specifically identified but who have a sufficiently close relationship with the debtor to be insiders, known as “non-statutory,” or “*de facto*,” insiders. *See, e.g., Gordon v. Vongsamphanph (In re Phongsavath)*, 328 B.R. 895, 898-99 (Bankr. N.D. Ga. 2005); *Pfeiffer v. Thomas (In re Reinbold)*, 182 B.R. 244, 246-47 (D.S.D. 1995). For example, in the case of *In re Enterprise Acquisition Partners, Inc.*, 319 B.R. 626 (9<sup>th</sup> Cir. BAP 2004), the court held that a corporation that was solely owned by a *per se* insider of the debtor corporation was not itself a *per se* insider which could be held liable on a preference theory for a transfer completed more than 90 days pre-petition. In that case, the United States Bankruptcy Appellate Panel of the 9<sup>th</sup> Circuit concluded “that the Bankruptcy Court erred in expanding the statutory list of *per se* insiders of a corporate debtor to include corporations that are solely owned by persons who qualify as *per se* insiders. Also, the statutory definition is limiting, those who do not qualify as *per se* insiders because they are not within the categories specifically listed in the definitional statute can qualify as insiders only if they meet the test for non-statutory insiders, which requires some showing of control of the debtor.” *Id.* at 633. Courts look to the control of a person over the debtor in determining whether that person constitutes a *de facto* insider. *See, e.g., In re Krehl*, 86 F.3d 737, 741 (7<sup>th</sup> Cir. 1996); *In re 9281 Shore Road Owners Corp.*, 187 B.R. 837, 853 (E.D.N.Y. 1995); *In re ABC Elec. Svcs., Inc.*, 190 B.R. 672, 675 (Bankr. M.D. Fla. 1995).

3. Non-consent: Cramdown vs. the Absolute Priority Rule.

## A. Introduction.

In a real estate based Chapter 11 case, a fundamental question is the extent that pre-petition claims can be modified “involuntarily,” that is, by court order over objection, under Bankruptcy Code § 1129(b). In a real estate context, that question typically centers on the debtor’s primary secured lender: can the secured lender’s claim be reduced in amount and changed in repayment terms; if so, to what extent? The answer to these questions lies in the balance between creditors’ rights and debtor’s rights that is struck in Bankruptcy Code § 1129(b).

Section 1129(b) is alternatively referred as “cramdown” and the “absolute priority rule.” *Bank of America Nat. Trust & Sav. Assn. v. 203 North LaSalle Street Partnership*, 526 U.S. 434 (1999). “Cramdown” signifies the binding effect of confirmation over an objecting class. The “absolute priority rule” is the right of a dissenting, impaired class to insist on “absolute priority” among parties in interest, that is, payment before other, junior interests share in the debtor’s value. *See, e.g., Northern Pac. Ry. Co. v. Boyd*, 228 U.S. 482 (1913) (absolute priority rule mandates full compensation to dissenting class before junior classes retain any interest in debtor or its assets); *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939). The absolute priority rule provides that any dissenting class must be paid in full before any junior class shares in the distributions under the plan. *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 202 (1988); *see also Unruh v. Rushville State Bank*, 987 F.2d 1506, 1508 (10<sup>th</sup> Cir. 1993). The key distinctions here are (a) secured creditors and unsecured creditors and (b) creditors and owners. It is a fundamental principle of corporate law that creditors have the first right to a business’ assets, that unless creditors are fully paid, owners may not receive a distribution of corporate assets. *See generally* Gregory V. Varallo & Daniel A. Dreishbach, *FUNDAMENTALS OF CORPORATE GOVERNANCE: A GUIDE FOR DIRECTORS AND CORPORATE COUNSEL*, pp. 1-25 & 90-125, ABA (1996). The so-called absolute priority rule is the bankruptcy recognition of that fundamental corporate principle, as is evident from a review of the long history of cases leading to the present embodiment of this rule. *See, e.g., Louisville Trust Co. v. Louisville, New Albany & Chicago Ry. Co.*, 174 U.S. 674, 684 (1899) (it has long been held in reorganization cases in the United States that “any arrangement of the parties by which the subordinate rights and interests of [owners] are attempted to be secured at the expense of the prior rights of . . . creditors comes within judicial denunciation.”); *Northern Pac. Ry. Co. v. Boyd*, 228 U.S. 482 (1913); *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939); *Consol. Rock Prod. Co. v. DuBois*, 312 U.S. 510 (1941).

In a real estate based Chapter 11, a debtor may want to change the payment terms of a secured claim, such as extending the maturity date, reducing an interest rate, changing the amortization schedule, reducing the amount of the secured claim, substituting collateral, mandating a release price, or other terms. Where the value of the collateral securing a claim is less than the amount owing on account of the underlying debt, a debtor may attempt to bifurcate the claim into secured and unsecured portions (as contemplated in Bankruptcy Code § 506(a)), then propose to pay the unsecured, deficiency portion differently from other unsecured classes by placing the unsecured

portion into its own class. The plan may provide that owners retain their pre-petition ownership interests in the debtor entity (a) for no consideration or (b) in exchange for some form of “new” value to the debtor. In a real estate context, issues of cramdown and absolute priority quite often play out in the context of a dissenting undersecured creditor.

To confirm a plan under Bankruptcy Code § 1129(b) over the rejection by an impaired class, the plan must (a) not discriminate unfairly among classes and (b) be fair and equitable.

B. Unfair discrimination: Bankruptcy Code § 1129(b)(1).

A plan must not discriminate unfairly among classes. Bankruptcy Code § 1129(b)(1). Every plan will treat classes at least somewhat differently, thus lending themselves to a claim of “unfair discrimination.” “Unfair discrimination” is not defined in the Code and courts have struggled to find a uniform meaning. *See In re Dow Corning Corp.*, 244 B.R. 696 (Bankr. E.D. Mich 1999) (discussing cases). At the least, a rational or legitimate basis for the difference in treatment must be established in order to satisfy Bankruptcy Code § 1129(b)(1). *Id.* *See also In re Simmons*, 288 B.R. 737 (Bankr. N.D. Tex. 2003); *In re Salem Suede, Inc.*, 219 B.R. 922 (Bankr. D. Mass 1998).

C. Fair and Equitable: Bankruptcy Code § 1129(b)(2).

The concept “fair and equitable” is defined under Bankruptcy Code § 1129(b)(2). Subsection (A) applies to secured creditors, subsection (B) applies to unsecured creditors and subsection (C) applies to owners. The first factual issue to be determined under Bankruptcy Code § 1129(b)(2)(A) with respect to a secured claim is the value of the underlying collateral; that sets the “amount” of the secured claim and, therefore, the amount that must be paid to the dissenting secured creditor in order to satisfy Bankruptcy Code § 1129(b)(2)(A). To determine the “secured” portion of the debt, Bankruptcy Code § 506(a) is applied. This entails valuing of the creditor’s collateral. *See Associated Commercial Corp. v. Rash*, 520 U.S. 953 (1997) (Chapter 13 context). Valuation is a business/economic issue, not a legal issue *per se*. If the value of the collateral is less than the amount owing to the creditor under the applicable loan documents, then the claim will be bifurcated into a secured and an unsecured portion. Bankruptcy Code § 506(a). The plan must pay the secured portion in full. Bankruptcy Code § 1129(b)(2)(A)(i)(II).

Since most often the repayment scheme under a plan of reorganization will provide for deferred cash payments over time, a key issue is the rate of interest that must be used to satisfy Bankruptcy Code § 1129(b)(2)(A)(i)(II). Accordingly, after valuation of the underlying collateral, the next fundamental issue is whether the plan provides the dissenting class with the appropriate rate of interest. Courts vary on the appropriate rate of interest (or, if one prefers, the discount rate) to use in cramdown. *See generally*, Patrick Halligan, *Cramdown Interest, Contract Damages, and Classical Economic Theory*, 11 AM. BANKR. INST. L. REV. 131 (Spring 2003). In *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004), the Supreme Court concluded that the cram-down interest rate in a Chapter 13 case is the formula approach. That rate is the “national prime rate”

adjusted for risk. *Id.* Whether this will become generally used in the Chapter 11 context is uncertain. *See, e.g., Mercury Capital Corp. v. Milford Connecticut Assoc., L.P.*, 2006 WL 2933895 (D. Conn. 2006) (favoring market rate if a market exists, but finding no error in applying *Till*'s formula approach where no market existed); *Interim Capital, LLC v. Hank's Dock, Inc. (In re Seaspan Development Corp.)*, slip op. 2006 WL 2672298 (E.D. Tenn. 2006); *In re Northwest Timberline Enterprises, Inc.*, 348 B.R. 412, 433 (Bankr. N.D. Tex. 2006) (taking cue from footnote 14 in *Till* and "not mechanically appl[ing] the 'formula approach'" in favor of exploring the market). Where a market exists for the debtor, courts seem willing to consider that evidence in determining the appropriate cramdown interest rate. *See Bank of Montreal v. Official Committee of Unsecured Creditors (In re American HomePatient, Inc.)*, 420 F.3d 559, 568 (6<sup>th</sup> Cir. 2005); *In the Matter of Cantwell*, 336 B.R. 688 (Bankr. D.N.J. 2006).

If a secured creditor's claim has been bifurcated into secured and unsecured portions as contemplated under Bankruptcy Code § 506(a), then the plan will have to also satisfy Bankruptcy Code § 1129(b)(2)(B), which applied the absolute priority rule to unsecured classes. This can be difficult, depending on the amount of the deficiency claim. A plan that is not paying a dissenting class of unsecured creditors in full, so that confirmation is proceeding through cramdown, commonly will be seeking application of the so-called new value exception to the absolute priority rule. *See Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106, 121-22 (1939). Clearly, new value does not consist of the debtor's post-confirmation "sweat equity." *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988).

The new value exception provides that even if all senior classes are not being paid in full, if a junior class is putting in money or money's worth, which is substantial and necessary, then that junior class may retain their pre-petition interest in the debtor. *See, e.g., Travelers Ins. Co. v. Bryson Properties, XVIII (In re Bryson Properties XVIII)*, 961 F.2d 496, 503 (4<sup>th</sup> Cir. 1992); *In re Deep River Warehouse, Inc.*, 2005 WL 2319201 (Bankr. M.D.N.C. 2005). The new value exception is invoked almost always by equity interest holders, who hope to retain their equity interest in the debtor in exchange for a new infusion of capital. Courts debate whether the new value exception under the Act was intended by Congress to be incorporated under the Code. *Bank of America v. 203 North LaSalle Street Partnership*, 526 U.S. 434 (1999). In light of *203 North LaSalle*, to have any hope of satisfying § 1129(b), pre-petition equity interests must not have the sole right to make the new capital contribution. For example, exclusivity must have expired or at least the right to buy the equity interests in the debtor must have been offered to the dissenting class in order to avoid violation of Bankruptcy Code § 1129(b)(2)(B).

D. Scope of Relief under Bankruptcy Code § 1129(b)(2)(A)(ii) vs Bankruptcy Code § 363(f).

Real estate debtors' business objective may include sale of some or all of their real property assets. In bankruptcy, that can be accomplished under either Bankruptcy Code § 363(f) or § 1129(b)(2)(A)(ii). These two sections are different.

In order to gain the protection provided under § 363(f), one of the five (5) subsections must be satisfied. Notably, under § 363(f)(3), the property cannot be sold if the property is being sold for less than the debt it secures. In contrast, property can be sold for less than the secured debt provided the lien of the dissenting creditor attaches to the sale proceeds. *See* Bankruptcy Code § 1129(b)(2)(A)(ii). In this regard, Bankruptcy Code § 1129(b)(2)(A)(ii) expands to the options for a debtor to dispose of real estate over a dissenting creditor beyond the rights contained in § 363(f).

Moreover, the scope of a discharge potentially available under Bankruptcy Code § 1141(d) is broader than the protections available under § 363(f). In appropriate circumstances, a court can even issue injunctions in favor of non-debtors under plans. *See Abel v. Shugrue (In re Ionosphere Clubs)*, 184 B.R. 648, 655 (S.D.N.Y. 1995) (injunction barring actions of creditors against non-debtors were integral to a final resolution of claims and were necessary to give finality to the plan. (*citing In re Drexel Burnham Lambert Group, Inc.*, 960 F.2d 285, 292 (2d Cir. 1992) (“In bankruptcy cases, a court may enjoin a creditor from suing a third party, provided the injunction plays an important part in the debtor’s reorganization plan. . . .”) (citations omitted), *cert. dismissed*, 113 S. Ct. 1070 (1993); *In re A.H. Robins Co.*, 880 F.2d 694, 700-02 (4th Cir.) (upholding an injunction under 11 U.S.C. § 105(a) against suits by creditors against certain third parties including the debtor’s directors and lawyers), *cert. denied*, 493 U.S. 959, 107 L. Ed. 2d 362, 110 S. Ct. 376 (1989); *In re Keene Corp.*, 164 Bankr. 844, 849 (S.D.N.Y. 1994) (bankruptcy court has the power to issue an appropriate injunction to ensure orderly reorganization).

#### 4. Other Considerations.

##### A. Bankruptcy Code §§ 1129(a)(1) and (2).

Under Bankruptcy Code § 1129(a)(1), the plan must be in technical compliance with Title 11. Under Bankruptcy Code § 1129(a)(2), a debtor, as the proponent of the Plan, must comply with all applicable provisions of Title 11. The debtor bears the burden of proof on these issues. *In re Global Water Tech., Inc.*, 311 B.R. 896, 902 (Bankr. D. Colo.2004) (citation omitted). A debtor who inadvertently pays a pre-petition debt or is not current on its financial reporting obligations can find itself fixing technical problems in order to exit Chapter 11.

##### B. Bankruptcy Code § 1129(a)(3).

Under Bankruptcy Code § 1129(a)(3), the plan must be proposed in good faith and not by any means forbidden by law. Although the Bankruptcy Code does not define “good faith,” courts have interpreted the phrase to mean, in the confirmation context, a likelihood that the plan will achieve a result consistent with the objectives and purposes of the Bankruptcy Code. *McCormick v. Bank One Leasing Corp. (In re McCormick)*, 49 F.3d 1524, 1526 (11<sup>th</sup> Cir. 1995); *In re Block Shim Development Co. – Irving*, 939 F.2d 289, 282 (5<sup>th</sup> Cir. 1991); *In re Madison Hotel Associates*, 749 F.2d 410, 425 (7<sup>th</sup> Cir. 1984); *In re Coastal Cable T.V., Inc.*, 709 F.2d 762, 764-65 (1<sup>st</sup> Cir. 1983). In making such determination, the court focuses on the plan itself, and the totality of the

circumstances surrounding the plan. *McCormick*, 49 F.3d at 1526; *Block Shim*, 939 F.2d at 292; *Madison Hotel Assoc.*, 749 F.2d at 425; *see also Pikes Peak*, 779 F.2d at 1460.

The principal purpose of a Chapter 11 reorganization is to maximize the value of the estate for the benefit of creditors first, and owners second. *See Toibb v. Radloff*, 501 U.S. 157 (1991); *see also In re Bonner Mall Partnership*, 2 F.3d 899, 916 (9<sup>th</sup> Cir. 1993). Plans which maximize the estate and distributions to creditors have been found to have been proposed in good faith. *See, e.g., In re Transworld Airlines, Inc.*, 185 B.R. 302, 314 (Bankr. E.D. Mo. 1995). The Courts also review the proposed plan for a fundamental fairness in dealing with creditors. *Madison Hotel Assocs.*, 749 F.2d at 425.

C. Bankruptcy Code § 1129(a)(7).

Bankruptcy Code § 1129(a)(7) contains the so-called best interest of creditors test, mandating that a plan distribute at least the liquidation value of the debtor as a minimum requirement for confirmation. The distribution amount is determined as though the debtor were liquidated through a Chapter 7 proceeding. In a solvent debtor case, interest could be required to satisfy the best interests test because Bankruptcy Code § 726(a)(5) requires interest to be paid on claims before the residual of a Chapter 7 estate's assets are distributed to the debtor. Bankruptcy Code § 726(a)(5); *In re Schoenberg*, 156 B.R. 963, 969-73 (Bankr. W.D. Tx. 1993). This is one of only a few instances when post-petition interest is allowable. *See generally Vanston Bondholders Protective Committee v. Green*, 329 U.S. 156 (1946). Courts split on the rate of interest that should apply, federal judgment rate or the contract rate. *See, e.g., In re Dow Corning Corp.*, 270 B.R. 393, 403-06 (Bankr. E.D. Mich. 2001); *Schoenberg*, 156 B.R. at 969-73; *In re Oak Park Calabasas Condominium Association*, 302 B.R. 682, 686 (Bankr. C.D. Ca. 2003); *see also In re Cook*, 322 B.R. 336, 339-340 (Bankr. N.D. Ohio 2005) (Chapter 13).

D. Bankruptcy Code § 1129(a)(9)((C)).

Prior to the 2005 Amendment, priority tax claims (claims qualifying for treatment under § 507(a)(8)) could be paid over six (6) years from the date of assessment, and routinely were. The 2005 change in allowed treatment of priority tax claims will cause new considerations. Now payment terms of priority tax claims must be no worse than the best-treated unsecured class and may be paid over five (5) years from the petition date. Bankruptcy Code § 1129(a)(9)(C)(iii).

E. Bankruptcy Code § 1129(a)(11).

A plan may not be confirmed if it is likely to be followed by liquidation. Bankruptcy Code § 1129(a)(11). "Feasibility" bars confirmation of speculative and visionary plans which the proponent cannot realistically hope to fulfill. *Travelers Ins. Co. v. Pikes Peak Water Co. (In re Pikes Peak Water Co.)*, 779 F.2d 1456, 1460 (10<sup>th</sup> Cir. 1985) (citation omitted). It is the debtor's burden to prove feasibility, to establish "reasonable assurance that the plan can be effectuated." *In re Ames*, 973 F.2d 849, 851 (10<sup>th</sup> Cir.1992).

Courts often determine feasibility by looking to: (a) the adequacy of the capital structure; (b) earning power of the reorganized business; (c) current economic conditions; (d) the competency, and ability of the debtor's management; and (e) any other relevant matter relating to the prospects for a successful operation of the business after confirmation. *In re Monnier Bros.*, 755 F.2d 1336, 1341 (8<sup>th</sup> Cir. 1985) (quotation omitted). "To demonstrate feasibility, the Debtor must show by concrete evidence that it will have sufficient cash to fund the plan and maintain operations proposed by it. The test is whether the things which are to be done after confirmation can be done as a practical matter under the facts." *In re Walker*, 165 B.R. 994, 1005 (E.D. Va. 1994).

A recurring issue in real estate cases toggles between the interest rate to be accorded a secured claim in order to satisfy cramdown and feasibility, with feasibility becoming questionable if a higher interest rate is given to a secured creditor in order to satisfy the requirements of § 1129(b). This is an important consideration in formulating and prosecuting a plan through the confirmation process.