Insider’s Acquisition of Claims to Create Accepting Impaired Class Constitutes Impermissible Gerrymandering

July/August 2007

Mark G. Douglas

The strategic importance of classifying claims and interests under a chapter 11 plan is sometimes an invitation for creative machinations designed to muster adequate support for confirmation of the plan. Although the Bankruptcy Code unequivocally states that only “substantially similar” claims or interests can be classified together, it neither defines “substantial similarity” nor requires that all claims or interests fitting the description be classified together. It has been left to the courts to develop hard-and-fast rules on classification, and the results have occasionally been inconsistent or controversial. An enduringly prominent bone of contention in the ongoing plan-classification dispute concerns the legitimacy of separately classifying similar, but arguably distinct, kinds of claims in an effort to create an accepting impaired class. Sometimes referred to as class “gerrymandering,” this practice was the subject of a ruling recently handed down by the Third Circuit Court of Appeals. In *In re Machne Menachem, Inc.*, the court upheld an order vacating confirmation of a chapter 11 plan because an insider of the debtor purchased unsecured claims during the case to ensure that an impaired unsecured class would vote in favor of the plan.

Voting and Plan Confirmation in Chapter 11

A fundamental precept underpinning the chapter 11 process is that stakeholders involved in the bankruptcy case have the right to vote for or against confirmation of a chapter 11 plan that specifies how their respective claims or interests are to be treated going forward. Confirmation of a plan is possible under two circumstances: (i) the requisite majorities of creditors and equity interest holders in every “class” (explained below) vote in favor of the plan (or are deemed to do

so by reason of being “unimpaired”); or (ii) despite the absence of acceptance by all classes, the plan meets certain minimum standards of fairness spelled out in the nonconsensual confirmation, or “cramdown,” provisions of the Bankruptcy Code.

Voting in chapter 11 is conducted by classes, rather than individual creditors or shareholders. This means that a dissenting individual creditor or shareholder can be outvoted if the remaining class members hold enough of the claims or interests in the class to achieve the voting majorities specified in the Bankruptcy Code for class acceptance. As such, how a claim or interest is classified can have a significant impact on the debtor’s prospects for confirming a chapter 11 plan — a creditor, for example, whose claim is substantial enough to give it voting control of a class may be able to block confirmation.

Confirmation is possible only if at least one “impaired” class of creditors or shareholders in the plan votes to accept it (without counting insider votes). This requirement, which appears in section 1129(a)(10) of the Bankruptcy Code, operates as a statutory gatekeeper to cramdown. Cramdown is a powerful remedy — it imposes a binding reorganization (or liquidation) scheme upon a body of dissenting creditors and other stakeholders predicated upon sometimes complicated judicial determinations concerning asset and claim valuation, feasibility and other important issues. Section 1129(a)(10) is premised on the policy that, before compelling stakeholders to bear the risks of error necessarily associated with cramdown, at least one class whose members are not being paid in full (or whose claims or interests are otherwise “impaired”) is willing to go along with the chapter 11 plan.

Classification of Claims and Interests Under a Plan

Section 1122 of the Bankruptcy Code provides that, except with respect to a class of "administrative convenience" claims (*i.e.*, relatively small unsecured claims, such as trade claims below a certain dollar amount), a plan may place a claim or interest in a particular class only "if such claim or interest is substantially similar to the claims or interests of such class." The statute, however, does not define "substantially similar." This was left to the courts, relying upon past practice under the former Bankruptcy Act and lawmakers' statements in connection with the enactment of the Bankruptcy Code indicating that the term should be construed to mean similar in legal character or effect as a claim against the debtor's assets or as an interest in the debtor. Thus, interests, such as stock, may not be classified together with claims, such as trade or bond debt, because the relationship between the debtor and its creditors, who assume credit risk but not enterprise risk, is fundamentally different from the relationship between the debtor and its stockholders, who do shoulder that risk as investors.

In passing on the propriety of a plan's claims-classification scheme, courts generally examine the nature of the claim (*e.g.*, senior or subordinated, secured or unsecured) and the relationship of the claim to the debtor's property. For example, secured claims must be classified separately from unsecured claims, and priority claims should not be placed in the same class as general unsecured claims.

A Classification Controversy: Gerrymandering

Although the Bankruptcy Code provides that only substantially similar claims may be classified together, it does not *require* that all such claims be placed into a single class. Substantially similar claims may be divided into separate classes if separate classification is reasonable. The

proponent of a chapter 11 plan has wide latitude in determining whether similar claims may be classified separately. Thus, for example, separate classification of substantially similar unsecured claims has been approved where: (i) certain unsecured creditors, such as unionized employees or vendors, will continue to have a relationship with the debtor after confirmation of a plan; (ii) separate classification is necessary to preserve the debtor's ability to leave unimpaired low-interest long-term bond debt by reinstating the maturity of the obligation; (iii) separate classification of unsecured debt is necessary to enforce the terms of a pre-bankruptcy subordination agreement; or (iv) the unique nature of "future claims" in mass tort cases (particularly asbestos claims that will be paid from a trust created under section 524(g) of the Bankruptcy Code) makes it appropriate to classify such claims apart from general unsecured claims that are matured, liquidated and noncontingent.

As a general rule, shared interest in voting for or against a plan is a prerequisite to jointly classifying claims or interests. This ensures that dissenting creditors or shareholders can be outvoted in their class only by creditors or shareholders with similar economic interests with respect to the debtor and/or its assets. When claims of the same nature are classified separately, the classification must be a reasonable means of achieving the goals of the Bankruptcy Code. For example, although trade and unsecured institutional creditors should not be classified separately in most cases, separate classification of such claims may be appropriate if institutional lenders are willing to accept debt or stock under a plan, while trade creditors would prefer a pro rata cash payment.

A classification scheme designed to fabricate an accepting impaired class under section 1129(a)(10) is sometimes referred to as class "gerrymandering." The practice can involve, among other things: (i) joint classification of claims whose holders are favorable to a plan with the claims of creditors who are not, with the expectation that supporting claims will sufficiently outnumber dissenting claims to ensure acceptance of the plan by the class as a whole; or (ii) separately classifying the claims of dissenting creditors from the claims of creditors favorable to the plan to ensure that the dissenting creditors cannot defeat cramdown confirmation. The latter form of gerrymandering has arisen almost exclusively in single-asset real estate cases, where the plan proponent attempts to classify the mortgagee's unsecured deficiency claim apart from the claims of other unsecured creditors. The practice has been invalidated by a majority of the circuit courts of appeal that have faced the issue, including the Fifth Circuit in *In re Greystone III Joint Venture* and the Fourth Circuit in *In re Bryson Properties, XVIII*. A slightly different form of class gerrymandering was the subject of the Third Circuit's unpublished ruling in *Machne Menachem*.

Machne Menachem

Machne Menachem, Inc. ("Machne"), a nonprofit company that operated a summer camp for Orthodox Jewish boys, filed for chapter 11 protection in 2001 in Pennsylvania. Machne proposed a third amended plan of reorganization in 2003 under which there were two classes of unsecured creditors — Class 4, containing general unsecured claims, and Class 5, containing insider unsecured claims. Prior to seeking confirmation of the plan in 2004, the son of one of Machne's directors, apparently at the debtor's bidding, purchased the claims of four of the 17 unsecured creditors in Class 4, after which the claims were reassigned to Class 5. Two of the

claims were purchased at face value, while the other two claims were purchased at roughly half of face value.

Class 4 was impaired — the claims in the class were to be paid in full within 45 days of the plan's effective date with cash generated from postconfirmation operations. The class accepted the plan because seven of its members (holding approximately $34,500 in claims) voted in favor of the plan, only four creditors (holding approximately $13,230 in claims) in the class rejected it, and two creditors (holding approximately $17,800 in claims) did not timely submit their ballots. Class 5 was also impaired by the plan and voted to reject it.

A former director of Machne who had filed a competing chapter 11 plan objected to confirmation of Machne's plan, claiming that, because of the claims acquisition and subsequent reclassification, the plan violated section 1129(a)(3) of the Bankruptcy Code, which mandates that a plan have been "proposed in good faith and not by any means forbidden by law." The bankruptcy court confirmed Machne's chapter 11 plan on June 23, 2004, concluding that "the mere fact that the debtor purchased a creditor's interest for the purpose of securing approval or rejection of a plan did not necessarily amount to bad faith."

The district court vacated the confirmation order on appeal, ruling that the claims purchase and subsequent reclassification made Machne's plan unconfirmable. In doing so, the court explained that the voting in Class 4, which was the only accepting impaired class, was manipulated because, if the class had contained the four acquired claims that were reassigned to Class 5, Class 4 might have voted to reject the plan. Without any basis for determining whether Class 4 would have

accepted the plan in the absence of the debtor's manipulation, the district court concluded that the purchase and reclassification of claims effectively "gerrymandered" Class 4 to secure confirmation.

The court rejected Machne's contention that the claims acquisition was motivated by its desire to maintain good relations with food vendors. The evidence indicated that only one of the four purchased claims was held by a food vendor, and Machne had moved to disallow the claims of all the other food vendors. The district court also ruled that the payment of creditors "outside of a plan of reorganization" constituted bad faith under section 1129(a)(3). Finally, because two of the claims purchased from Class 4 were bought for less than face value, while Class 4 creditors were to be paid in full over time under the plan, the court held that the plan violated section 1129(a)(4) of the Bankruptcy Code, which requires "the same treatment for each claim or interest of a particular class."

Machne fared no better with the Third Circuit on appeal. In affirming the district court's ruling, the court of appeals emphasized that vote manipulation by the gerrymandering of classes "seriously undermines" the "critical confirmation requirements set out in Section 1129(a)(8) (acceptance by all impaired classes) and Section 1129(a)(10) (acceptance by at least one impaired class in the event of a 'cramdown')." By orchestrating the acceptance of Class 4 through reducing the number of votes necessary to achieve acceptance by the class, the Third Circuit explained, Machne engaged in impermissible gerrymandering.

Analysis

As a general rule, acquiring claims for the purpose of facilitating or blocking confirmation of a plan does not amount to bad faith under section 1129(a)(3). However, buying claims with an ulterior motive (*i.e.*, intent other than to protect a legitimate interest as a creditor) is generally deemed to be objectionable. In *Machne Menachem*, the Third Circuit adopted the approach taken by other courts that have found the existence of bad faith in cases involving a debtor that arranges for an insider or affiliate to purchase claims for the purpose of blocking or confirming a chapter 11 plan.

The circumstances involved in *Machne Menachem*, including the timing of the claims acquisitions, the impact they had on the class composition, and the debtor's inability to come up with a plausible explanation for buying the claims in question, made a strong case for vote manipulation and class gerrymandering. The manipulation was so transparent that, upon becoming aware of the pending claims acquisitions, the competing plan proponent (unsuccessfully) sought to enjoin the transfers. Attempts to influence or manipulate voting in other cases may be less obvious.

In re Machne Menachem, Inc., 2007 WL 1157015 (3d Cir. Apr. 19, 2007).

Phoenix Mut. Life Ins. Co. v. Greystone III Joint Venture (In re Greystone III Joint Venture), 995 F.2d 1274 (5th Cir. 1991).

Travellers Ins. Co. v. Bryson Props., XVIII (In re Bryson Props., XVIII), 961 F.2d 496 (4th Cir. 1992).

In re Figter Ltd., 118 F.3d 635 (9th Cir. 1997).

In re Holly Knoll Partnership, 167 B.R. 381 (Bankr. E.D. Pa. 1994).

In re Applegate Property, Ltd., 133 B.R. 827 (Bankr. W.D. Tex. 1991).