

2018

SARE Manipulation: The Hurdles in Single-Asset Real Estate Cases

David R. Hague

St. Mary's University School of Law, dhague@stmarytx.edu

Follow this and additional works at: <https://commons.stmarytx.edu/facarticles>



Part of the [Bankruptcy Law Commons](#)

Recommended Citation

David R. Hague, SARE Manipulation: The Hurdles in Single-Asset Real Estate Cases, 67 Cath. U. L. Rev. 280 (2018).

This Article is brought to you for free and open access by the School of Law Faculty Scholarship at Digital Commons at St. Mary's University. It has been accepted for inclusion in Faculty Articles by an authorized administrator of Digital Commons at St. Mary's University. For more information, please contact sfowler@stmarytx.edu, egoode@stmarytx.edu.

SARE MANIPULATION: THE HURDLES IN SINGLE- ASSET REAL ESTATE CASES

David R. Hague⁺

| | |
|---|-----|
| I. REORGANIZING BUSINESSES | 283 |
| A. <i>The Basics and Benefits of Chapter 11 Reorganization</i> | 283 |
| B. <i>The Concept of a “Plan”</i> | 287 |
| C. <i>Classification of Claims</i> | 289 |
| D. <i>The Accepting Impaired Class</i> | 292 |
| II. THE SARE DEBTOR AND THE HURDLES | 295 |
| A. <i>The SARE Debtor</i> | 295 |
| B. <i>Classification Maneuvering</i> | 297 |
| 1. <i>The Classification Loophole in In re Loop 76, LLC</i> | 298 |
| 2. <i>The Classification Loophole in Non-Recourse Cases</i> | 300 |
| C. <i>Artificial Impairment</i> | 302 |
| III. IMPROPER CLASSIFICATION AND ARTIFICIAL IMPAIRMENT UNDER A GOOD-FAITH APPROACH | 305 |
| A. <i>The Meaning of Good-Faith in Chapter 11</i> | 306 |
| B. <i>Classification and Good Faith</i> | 309 |
| C. <i>Impairment and Good Faith</i> | 313 |
| IV. CONCLUSION | 319 |

Under § 1129(a)(10) of the Bankruptcy Code, a debtor’s plan of reorganization cannot be confirmed unless at least one “impaired class” accepts the plan, excluding acceptance of any insider of the debtor.¹ A class of claims accepts the plan if more than one-half in number and at least two-thirds in amount of claims voting in a class favor the plan.² Thus, a debtor’s composition of its classes clearly has a substantial impact upon its chances of successfully confirming its plan of reorganization over dissenting creditors. Obviously, the debtor would like to have unfettered power and full discretion to group creditors in a way that increases the likelihood that the majority in each class will vote on the plan it proposes.³ This means that the debtor will do whatever is possible to isolate unfriendly and dissenting creditors. In some cases, this classification

⁺ Assistant Professor of Law, St. Mary’s Law School.

1. 11 U.S.C. § 1129(a)(10) (2012).

2. § 1126(c).

3. 7 COLLIER ON BANKRUPTCY ¶ 1100.01 (Alan N. Resnick & Henry J. Sommers eds., 2017) [hereinafter COLLIER ON BANKRUPTCY] (illustrating agreements by which the debtor can increase support for the proposed plan).

treatment is criticized as impermissible gerrymandering in contravention of § 1122 of the Bankruptcy Code.⁴

Section 1122(a) expressly provides that only substantially similar claims *may* be placed in the same class.⁵ It does not, however, expressly *require* that all substantially similar claims be placed in the same class, nor does it expressly prohibit substantially similar claims from being classified separately.⁶ Several courts, nonetheless, hold that “Section 1122 [] must contemplate some limits on classification of claims of similar [rights].”⁷ Other courts disagree.⁸ This creates confusion and unpredictability and courts are yet to agree on a uniform approach to deal with this classification issue.

The additional requirement of § 1129(a)(10) that the accepting class be “impaired” creates further tension amongst courts, scholars and practitioners.⁹ Section 1124 of the Bankruptcy Code states that a creditor’s claim is “impaired” unless its rights are left “unaltered” by the plan.¹⁰ Several cases hold that an alteration intended only to create an impaired class to vote for a plan so that a debtor can confirm it over other dissenting classes is not allowed.¹¹ These cases note that such manipulation – referred to as “artificial impairment” – is contrary to the purpose of § 1129(a)(10), which, these cases suggest, is designed to provide some indicia of support for a plan by truly harmed creditors – i.e., those with a real financial stake in the outcome of the debtor’s case.¹² Other cases, however, hold that the broad language in § 1124 allows any legal, equitable, or contractual alteration of rights to constitute impairment, including the slightest impairment of *de minimis* claims, and that abuses on the part of a plan proponent ought not affect the application of Congress’s definition of impairment.¹³

Although an issue in all Chapter 11 cases, the battle over improper classification and artificial impairment is widely prevalent in Single Asset Real Estate (SARE) cases, where a primary obstacle to confirmation is finding a “plan

4. See *In re Greystone III Joint Venture*, 995 F.2d 1274, 1279 (5th Cir. 1991), *cert. denied*, 506 U.S. 821 (1992) (stating “thou shalt not classify similar claims differently in order to gerrymander an affirmative vote on a reorganization plan”).

5. § 1122(a).

6. See *In re CGE Shattuck, LLC*, Nos. 99–12287–JMD, CM 99–747, 1999 WL 33457789, at *4 (D.N.H. Dec. 20, 1999) (finding that the majority of circuits “hold that separate classification of legally similar claims is not prohibited”).

7. *Greystone III Joint Venture*, 995 F.2d at 1278–79, *see e.g. In re SM 104 Ltd.*, 160 B.R. 202, 216 (Bankr. S.D. Fla. 1993).

8. *CGE Shattuck*, 1999 WL 33457789, at *4.

9. See *In re Combustion Eng’r, Inc.*, 391 F.3d 190, 243–44 (3rd Cir. 2004); *In re Vill. at Camp Bowie I, L.P.*, 710 F.3d 239, 245–46 (5th Cir. 2013); *In re L & J Anaheim Assocs.*, 995 F.2d 940, 943 (9th Cir. 1993); *In re All Land Inv., LLC*, 468 B.R. 676, 689–90 (Bankr. D. Del. 2012).

10. 11 U.S.C. § 1124 (2012).

11. *In re Windsor on the River Assocs.*, 7 F.3d 127, 132 (8th Cir. 1993); *see also infra* note 176 and accompanying text.

12. See *Windsor on the River Assocs.*, 7 F.3d at 131.

13. *L & J Anaheim Assocs.*, 995 F.2d at 943.

[that] is accepted by at least one [creditor] class of impaired claims.”¹⁴ Under the Bankruptcy Code, real property is “single asset real estate” only if it is a single property or project from which the debtor derives substantially all of the debtor’s gross income.¹⁵ This narrow definition means only a few classes of creditors generally exist in a typical SARE case: (1) a secured claim against the real property held by the mortgagee; (2) a rather large unsecured deficiency claim also held by the mortgagee since the real property is usually underwater; and (3) a few general unsecured claims held by trade creditors.¹⁶ In most cases, the mortgagee is unsupportive of the debtor’s plan to reorganize and its sole purpose is to foreclose on the real property securing the loan. As such, it is critical for the SARE debtor to classify the hostile mortgagee’s unsecured deficiency claim separately from the other unsecured claims, since the sheer size of a typical deficiency claim would generally allow the deficiency claimant to block confirmation by controlling the vote of a single unsecured creditor class. Without this separation, there would be no impaired accepting class and the SARE debtor could not confirm its plan – i.e., it would eventually lose its property (and its business) through a foreclosure. In addition to this common classification maneuvering in order to isolate the deficiency claim, the SARE debtor may attempt to minimally alter – that is, “artificially impair” – the friendly, isolated class of trade creditors to secure the needed vote necessary to comply with § 1129(a)(10).¹⁷

Courts, practitioners, and scholars are continuously at odds over the meaning of the code provisions that govern the concepts of classification and impairment. The current approaches for dealing with these sections, particularly in SARE cases, yield confusion and actually make the reorganization process needlessly complex, costly, and unpredictable. Even more problematic is that the muddle surrounding these code provisions results in decisions which are contrary to the congressional intent behind the Chapter 11 reorganization process.¹⁸ But courts do not need to construe these code sections in order to make a determination of the improper classification and artificial impairment issues. Rather, this Article contends that improper classification and artificial impairment should go to a debtor’s good faith in proposing a plan under § 1129(a)(3) of the Bankruptcy Code – i.e., improper classification and artificial impairment should be nothing more than components of the good-faith analysis required by § 1129(a)(3).

14. See *infra* note 93.

15. § 101(51B).

16. See H. Miles Cohn, *Single Asset Chapter 11 Cases*, 26 TULSA L.J. 523, 527–28 (1991).

17. See *In re RYYZ, LLC*, 490 B.R. 29, 43 (Bankr. E.D.N.Y. 2013) (discussing how the debtor can affect the *de minimis* impairment of claims and variety of opinions courts continue to hold).

18. See *In re Vill. at Camp Bowie I, L.P.*, 710 F.3d 239, 246 (5th Cir. 2013) (discussing how the *Windsor* court had imposed requirements contrary to congressional intent).

Section 1129(a)(3) requires the debtor's plan to be "proposed in good faith."¹⁹ Where the plan is proposed with a legitimate and honest purpose to reorganize – a subjective standard – and has a reasonable chance of success – an objective standard – the good faith standard is generally satisfied.²⁰ In this Article, the author suggests that in SARE cases, a presumption should exist that separate classification of deficiency claims from other unsecured claims or impairment of *de minimis* claims for the purpose of achieving confirmation over the objection of a creditor is *per se* bad faith.

Under this proposed framework, the SARE debtor must overcome the presumption of bad faith in its proposed plan of reorganization and justify any separate classification of the deficiency claim or demonstrate that the deficiency claim is dissimilar from other unsecured claims, rather than waiting for the deficiency claimant to object or attack the classification scheme.²¹ If the debtor successfully rebuts the presumption by showing that the deficiency claim was not separately classified to gerrymander a consenting class of impaired claims or that the deficiency claim is, in fact, legally unlike other unsecured claims, the burden shifts to the creditor to demonstrate abuse.²² Likewise, when improper impairment is the issue, the debtor must address § 1129(a)(3) directly in its proposed plan and overcome a presumption that the impairment of the *de minimis* claim was deliberate and for the sole purpose of achieving a forced confirmation over the objection of creditors.²³ Similar to the classification issue, this presumption can be overcome with evidence showing economic justification for such impairment.²⁴ This framework, the author contends, does not operate decisively to block reorganization in SARE cases. Instead, it creates a new hurdle for SARE debtors and operates to curtail abuses of the bankruptcy process that are prevalent in SARE cases.

I. REORGANIZING BUSINESSES

A. *The Basics and Benefits of Chapter 11 Reorganization*

To understand the classification and impairment issue, one must grasp the basics of Chapter 11 reorganization. Elizabeth Warren notes that: "Businesses fail. Sometimes they collapse in a loud crash. Sometimes they drift downward, like a balloon with a slow leak. But fast or slow, noisy or quiet, businesses that

19. § 1129(a)(3).

20. See *In re Koelbl*, 751 F.2d 137, 139 (2d Cir. 1984) ("[D]efining the good faith standard in the bankruptcy context as 'requiring a showing that the plan was proposed 'honestly and good intentions' and with 'a basis for expecting that a reorganization can be effected.'" (quoting *Manati Sugar Co. v. Mock*, 75 F.2d 284, 285 (2d Cir. 1935))).

21. See discussion *infra* Section IV.B.

22. *Id.*

23. See *Vill. at Camp Bowie*, 710 F.3d at 247–48 (analyzing the differences between good faith and bad faith presumptions).

24. See *infra* note 79.

were once fueled by optimism may someday face their demise.”²⁵ Yet, liquidating and selling off a failed business’s assets piecemeal is not always the answer. Salvageable businesses should be rescued or, in some cases, resuscitated. Chapter 11 provides the answer. As the drafters of Chapter 11 put it:

The purpose of a reorganization case, unlike a liquidation case, is to restructure a business’s finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders. The premise of a business reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap. Often, the return on assets that a business can produce is inadequate to compensate those who have invested in the business. Cash flow problems may develop and require creditors of the business, both trade creditors and long-term lenders, to wait for payment of their claims. If the business can extend or reduce its debts, it often can be returned to a viable state. It is more economically efficient to reorganize than to liquidate, because it preserves jobs and assets.²⁶

The beauty of Chapter 11 is that it allows dying businesses to do things that might otherwise be difficult or impossible to achieve outside of Chapter 11. For example, unlike Chapter 7 liquidation, the business debtor in Chapter 11 will continue to operate the business and manage its assets as the “debtor in

25. ELIZABETH WARREN, CHAPTER 11: REORGANIZING BUSINESSES 1 (2008).

26. See H.R. REP. NO. 95-595 (1977). Judge Goldberg of the United States Court of Appeals for the Fifth Circuit described the Chapter 11 process in comical and somewhat mystical terms in *In re Gary Aircraft Corp.*, 698 F.2d 775, 779–80 (5th Cir. 1983):

Bankruptcy serves a role in corporate life eerily similar to that of the doctrine of reincarnation in some eastern religions. Bankruptcy is the belief that the souls of a corporate entity, the equity-holders, do not just vanish when their corporeal form dies. Rather, they learn from the mistakes of a previous incarnation and can once again live on the earth in corporate form. True, they may suffer for the sins of previous incarnations and have trouble raising venture capital, but such is the karmic burden. With luck, someday a corporation may achieve enlightenment and reach a plane of eternal bliss and nirvana—the Fortune 500.

Though the relatives of a departed soul may receive intellectual comfort at the thought of reincarnation, they are often more touched by the pain and immediacy of their personal loss. Just as it is in life, so it is in bankruptcy. The close cousins of the equity-holders, the debt-holders, take little spiritual comfort from the knowledge that the equity-holders may someday be reincorporated. Instead, they are more aware of the anguish of their personal loss, the money they loaned the deceased corporation.

It is at this point that the black robed judge steps in as the saffron robed monk and comforter. Perhaps the corporation has left behind some small amount of worldly goods, some trinkets to remind the debt-holders of their friendship with the departed. Ah, but how to divide the estate so that everyone can have some little item of memorabilia?

This is a question of great spiritual and temporal import. Fortunately, the sacred writings [of the Bankruptcy Code] can provide guidance and inspiration.

possession.”²⁷ The operation of the debtor’s business may require the use, sale, or lease of property of the debtor’s estate.²⁸ “[A]nd, unless the court orders otherwise, the [debtor in possession] may enter into transactions, including the sale or lease of property of the estate, in the ordinary course of business, without notice [to creditors] or a hearing” before the bankruptcy judge.²⁹

Additionally, the filing of a bankruptcy petition automatically stays – i.e., restrains, prohibits, precludes – any creditor-lender activity or repossessing or foreclosing on the debtor’s property.³⁰ Obtaining the protections of the automatic stay is often the primary reason for filing a bankruptcy petition, particularly for a business that is trying to survive.³¹ Congress, in enacting the Bankruptcy Code, was quite clear as to the purpose of the stay:

The automatic stay is one of the fundamental debtor protections provided by the bankruptcy laws. It gives the debtor a breathing spell from his creditors. It stops all collection efforts, all harassment, and all foreclosure actions. It permits the debtor to attempt a repayment or reorganization plan, or simply to be relieved of the financial pressures that drove him into bankruptcy.³²

The stay is also fundamental to other policies underlying the Bankruptcy Code: equal distribution to creditors of equal priority and orderly administration of the estate.³³ The automatic stay is particularly significant in Chapter 11 bankruptcy cases because it gives the debtor the chance to formulate a plan to present to its creditors for acceptance and approval.

Chapter 11 also enables the debtor to borrow new funds during the bankruptcy case.³⁴ The bankruptcy code “provides certain incentives that a debtor [in

27. 11 U.S.C. § 1107(a) (2012).

28. § 363.

29. § 363(c)(1).

30. § 362(a). The automatic stay is so named because it becomes effective automatically upon the filing of a bankruptcy petition. *Ellis v. Consol. Diesel Elec. Corp.*, 894 F.2d 371, 371 (10th Cir. 1990). The debtor does not have to do anything to make it effective. *Id.* The creditor has the burden of moving to get the stay lifted. *Id.* It is no excuse that the creditor did not have notice of the filing before the action was taken. *Id.* The action will still be set aside as void. *See e.g., id.* (holding summary judgment void where entered prior to lifting automatic stay).

31. *See e.g., id.* (noting filing of a bankruptcy petition triggers to protections of an automatic stay).

32. H.R. REP. NO. 95-595, at 340 (1977).

33. *See e.g., In re Curtis*, 40 B.R. 795, 798–99 (Bankr. D. Utah 1984) (“The stay insures that the debtor’s affairs will be centralized, initially, in a single forum in order to prevent conflicting judgments from different courts and in order to harmonize all of the creditors’ interests with one another.”).

34. § 364; *see* H.R. REP. NO. 95-595 (stating that § 364 “governs all obtaining of credit and incurring of debt by the estate”); 1 COLLIER ON BANKRUPTCY, *supra* note 3, ¶ 364.01, at 1 (“Section 364 now governs all obtaining of credit and incurring of debt by the estate, whether by the trustee... or by the debtor in possession....”); 2 NORTON BANKRUPTCY LAW AND PRACTICE § 39:19 (2011) (“[P]ostpetition financial arrangements are subject to the provisions of Code § 364 concerning obtaining credit.”).

possession] may offer, with court approval, to induce a potential lender” to undertake the risks involved in providing post-petition financing to a bankruptcy estate.³⁵ “These incentives include granting the lender [when necessary under statutorily defined circumstances] an administrative expense priority under § 364(b), a ‘super-priority’ claim under § 364(c)(1), or a lien on unencumbered estate assets under § 364(c)(2) or (3), on account of the *post-petition* credit extended.”³⁶ Further, the Bankruptcy Code provides that, under appropriate circumstances and after notice and a hearing, the court may authorize the obtaining of credit secured by a lien on encumbered property that is senior or equal to any existing lien on the property – often referred to as a “priming lien.”³⁷ Again, the concept of obtaining credit with its associated incentives is unique to the bankruptcy process.

In addition, Chapter 11 gives the debtor-in-possession the right to assume beneficial “executory contracts” and to reject those that might be burdensome, “subject to court approval.”³⁸ Contracts that are executory – i.e., contracts with material obligations owing on either side – could be one of the main reasons a debtor’s business is suffering.³⁹ Take, for example, an energy company that has entered into a coal supply contract. The contract provides that the energy company will purchase coal from the coal provider for the next 10 years at \$50/ton. The energy company entered into the coal supply contract when coal was at \$60/ton, so it was considered a good bargain. Assume, however, that within two years of the contract, coal drops to \$30/ton. Energy company is obligated to keep purchasing coal at what is now an inflated price. This could be detrimental to its business. Bankruptcy would give energy company, now the debtor-in-possession, the power to reject this contract. On the other hand, if coal were now selling for \$75/ton, energy company would want this contract to remain intact, despite the fact that it might be in breach for failure to pay. Chapter 11 would give the energy company power to assume the contract, despite the fact that it had breached.

The “subject to court approval” language was added to the code to “insure that the [debtor-in-possession’s] assumption of the contract] gives the other contracting party the full benefit of his bargain.”⁴⁰ “The bankruptcy court reviews the debtor’s “business judgment” with respect to the proposed assumption or rejection to determine if it would be beneficial or burdensome to assume or reject the executory contract by evaluating whether assumption or rejection would serve the reorganization or whether it would harm other

35. *In re Sun Runner Marine, Inc.*, 945 F.2d 1089, 1092 (9th Cir. 1991).

36. *Id.* at 1092–93.

37. § 364(d).

38. § 365(a).

39. See e.g., *Sun Runner Marine*, 945 F.2d at 1091–92 (finding the business was beginning to fail because of an executory contract).

40. *In re Superior Toy & Mfg. Co.*, 78 F.3d 1169, 1174 (7th Cir. 1996) (quoting S. REP. NO. 98-989, at 59 (1978)).

creditors.”⁴¹ Where a debtor has defaulted on a contract and the debtor-in-possession wants to assume the contract, the bankruptcy code also requires that a debtor-in-possession at the time of assumption (1) “cure[] or provide[] adequate assurance [of] prompt[] cure” of that default; (2) “compensate[] or provide adequate assurance [of] prompt[] compensate[ion]”; and (3) “provide[] adequate assurance of future performance under [the] contract.”⁴² In the Chapter 11 context, the debtor’s plan of reorganization must provide means for “curing or waiving any [outstanding] default[s].”⁴³ At the plan confirmation stage, the bankruptcy court approves those means. At confirmation, the bankruptcy court also approves the plan “provisions for the assumption, rejection, or assignment of any executory contract[s].”⁴⁴

Finally, Chapter 11 enables a debtor to develop a debt-restructuring plan that will bind all creditors, even those who do not accept it.⁴⁵

B. The Concept of a “Plan”

Every debtor that commences a voluntary case under Chapter 11 is presumed to intend to bring about consensual acceptance and court approval of what is called a “plan of reorganization.”⁴⁶ The word “plan” appears in several places in the Bankruptcy Code.⁴⁷ Section 1103(c)(3), for example, states that one of the important duties of a creditor’s committee is to “participate in the formulation of a plan.”⁴⁸ Section 1106(a)(5), moreover, mandates the debtor in possession, as soon as practicable after the commencement of the case, to file “a plan.”⁴⁹ And § 1112(b)(4)(J)–(M) authorize dismissal or conversion of a Chapter 11 case for failure to propose, confirm, or carry out the provisions of “a plan.”⁵⁰ The confirmation of a plan is the prime objective of the Chapter 11 case evidenced by the judge’s wide discretion to dismiss a case if there is an “inability to effectuate a plan.”⁵¹ Nonetheless, the idea of “a plan” and “confirmation” of the plan can be a nebulous concept for those unfamiliar with bankruptcy law.

Simply put, “[a] plan of reorganization is a contract which binds a debtor and its creditors.”⁵² The plan tells the creditors what they will receive on account of their claims and when and how they will receive it. As the Second Circuit observed, “[t]he plan of reorganization determines how much and in what form

41. *In re Orion Pictures Corp.*, 4 F.3d 1095, 1099 (2d Cir. 1993).

42. § 365(b)(1)(A)–(C).

43. § 1123(a)(5)(G).

44. § 1123(b)(2).

45. § 1123(b).

46. § 1123(a).

47. *See generally* § 1106 (using the word “plan” repeatedly).

48. § 1103(c)(3).

49. § 1106(a)(5).

50. § 1112(b)(4)(J)–(M).

51. § 1112.

52. *In re Pettibone Corp.*, 134 B.R. 349, 351–52 (Bankr. N.D. Ill. 1991).

creditors will be paid, whether stockholders will continue to retain any interests, and in what form the business will continue.”⁵³ Generally, a plan must be accepted by creditors and confirmed by the court in order to become effective.⁵⁴ The court held *In re Herron* that “[o]nce a plan is confirmed, the preconfirmation debt is ‘replaced’ with a new indebtedness as provided in the confirmed plan. The new indebtedness is in essence a new and binding contract between the debtor and the creditors.”⁵⁵ Furthermore, a confirmed plan “discharges” a debtor that continues in business from any pre-confirmation debt.⁵⁶ Consider the following example as illustrative:

Assume that a plan provides that holders of unsecured claims will receive 20 cents on the dollar in six monthly installments in satisfaction of their claims. An unsecured creditor with an allowed claim of \$10,000, therefore, would only be entitled to \$2,000 under the plan, spread out over six months (i.e., \$333.33/month). The debtor’s remaining liability – the \$8,000 deficiency – to the creditor is discharged pursuant to Section 1141(d)(1). Also assume the newly reorganized debtor paid the first installment, but defaulted on the second. Could the newly reorganized debtor file suit to recover on the original \$10,000 claim? The answer is: no. The creditor would be relegated to the \$2,000 reorganized debt and could bring an action only to recover the balance owing on the new \$2,000 debt. Thus, unlike the common law theories of contract dealing with accord and satisfaction, whereby a creditor agrees to accept in full satisfaction something less than the amounts of the original claim *only* when performance is rendered, a confirmed plan permanently modifies the debtor’s obligations, notwithstanding a subsequent default.⁵⁷

Confirmation of the plan is clearly the goal of every debtor in possession. The requirements for confirmation of a proposed Chapter 11 plan are listed in 11 U.S.C. § 1129.⁵⁸ The proponent of the plan bears the burden of establishing the plan’s compliance with each of these requirements, including the first requirement found in § 1129(a)(1), which states that “[t]he plan complies with the applicable provisions of this title.”⁵⁹ The phrase “applicable provisions” is not defined. The legislative history of § 1129(a)(1), however, explains that this provision incorporates the requirements of § 1122 and § 1123, which govern

53. *In re Lionel Corp.*, 722 F.2d 1063, 1070 (2d Cir. 1983).

54. *See* § 1129(a).

55. *In re Herron*, 60 B.R. 82, 84 (Bankr. W.D. La. 1986); *see also In re Ernst*, 45 B.R. 700, 702 (Bankr. D. Minn. 1985) (“The plan is essentially a new and binding contract, sanctioned by the Court, between the debtor and his preconfirmation creditors.”).

56. § 1141(d)(1)(a).

57. *Id.*

58. *Id.*

59. § 1129(a)(1).

classification of claims and interests and the contents of a plan of reorganization.⁶⁰

C. Classification of Claims

Section 1123(a)(1) and (a)(4) mandate, in pertinent part, that “a plan shall – designate, subject to [§] 1122 of this title, *classes of claims*,” and 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.”⁶¹ The importance of classification of claims is not explicitly set out in the Bankruptcy Code, but the purpose is simple: creditors vote for a proposed plan of reorganization by class – not in their individual capacity – and the debtor only needs one class to accept its plan as a condition to confirmation. Classification of claims, therefore, plays a central role in the formation and confirmation of the Chapter 11 plan.⁶²

Section 1126(c) states that a class is deemed to have accepted a plan if creditors constituting more than one-half of the members of the class and representing at least two-thirds of the amount of debt owed to that class have voted in favor of the plan.⁶³ Because of the importance of voting by classes, the debtor and its creditors often fight about the composition of the classes.⁶⁴ Obviously, the debtor would like to have unfettered power and full discretion to group creditors in a way that increases the likelihood that the majority in each class will vote on the plan it proposes.⁶⁵ This means that the debtor will do whatever is possible to isolate unfriendly and dissenting creditors. These creditors, not surprisingly, object to this classification treatment, often referring to the debtor’s actions as improper gerrymandering.⁶⁶

Section 1122 of the Bankruptcy Code governs classification of claims.⁶⁷ Section 1122(a) requires that a plan “place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class.”⁶⁸ “Substantially similar” generally means similar in

60. H.R. REP. NO. 95-595, at 412 (1977); S. REP. NO. 95-989, at 126 (1978); *see Kane v. Johns-Manville Corp.*, 843 F.2d 636, 648–49 (2d Cir. 1988); *In re Toy & Sports Warehouse, Inc.*, 37 B.R. 141, 149 (Bankr. S.D.N.Y. 1984).

61. § 1123(a)(1), (4).

62. *See* § 1123(a)(1)–(4).

63. § 1126(c).

64. 7 COLLIER ON BANKRUPTCY, *supra* note 3, ¶ 1100.01 (discussing the motivations for creditor classifications).

65. *Id.*

66. *See e.g., In re Boston Post Road Ltd. P’ship*, 21 F.3d 477, 479 (2d Cir. 1994), *cert. denied*, 513 U.S. 1109 (1995); *In re Greystone III Joint Venture*, 995 F.2d 1274, 1279 (5th Cir. 1991), *cert. denied*, 506 U.S. 821 (1992).

67. § 1122.

68. § 1122(a).

legal nature, character, or effect.⁶⁹ Thus, when a debtor seeks to confirm a plan of reorganization, it must submit to the court that the plan's classification of claims and interest is appropriate under Section 1122.⁷⁰

Section 1122(a) speaks only to the types of claims that can be classified together, but it does not address the question of whether substantially similar claims may be classified separately.⁷¹ Nonetheless, § 1122(a) mandates that dissimilar claims cannot be placed into the same class. Thus, "[t]he threshold question for [a] bankruptcy court when applying [§] 1122(a) is to determine whether the claims are 'substantially similar.'"⁷² The Bankruptcy Code, however, is silent on how to ascertain whether claims are "substantially similar." Accordingly, the meaning of "substantially similar" is left to the courts. Courts, however, vary in this meaning and there is a "paucity of case law defining what constitutes either similarity or substantial similarity of claims."⁷³ The Ninth Circuit, for example, has determined that "bankruptcy court judges must evaluate the nature of each claim, i.e., the kind, species, or character of each category of claims."⁷⁴ The Fifth Circuit holds that "'substantially similar claims' [are] those which share common priority and rights against the debtor's estate."⁷⁵ The First Circuit announced a general principle that "all creditors of equal rank with claims against the same property should be placed in the same class."⁷⁶ And the Senate Committee on the Judiciary stated:

This [§ 1122] codifies current case law surrounding classification of claim and equity securities. It requires classification based on the nature of the claims or interests classified, and permits inclusion of claims or interests in a particular class only if the claim or interest being included is substantially similar to the other claims or interests of the class.⁷⁷

Despite the lack of a generally accepted definition of the phrase "substantially similar," § 1122(a) clearly mandates that dissimilar claims may not be placed into the same class.⁷⁸ Thus, if the bankruptcy court determines that the claims are not substantially similar, the analysis should end there – the claims must be

69. 7 COLLIER ON BANKRUPTCY, *supra* note 3, ¶ 1122.03[3]; *see also In re Johnston*, 21 F.3d 323, 327 (9th Cir. 1994).

70. § 1123.

71. *In re U.S. Truck Co.*, 800 F.2d 581, 585 (6th Cir. 1986).

72. *In re Loop 76, LLC*, 465 B.R. 525, 536 (B.A.P. 9th Cir. 2012).

73. *In re Loop 76, LLC*, 442 B.R. 713, 716 (Bankr. D. Ariz. 2010).

74. *Johnston*, 21 F.3d at 327.

75. *In re Save Our Springs (S.O.S.) Alliance, Inc.*, 632 F.3d 168, 174 (5th Cir. 2011).

76. *Granada Wines, Inc. v. New Eng. Teamsters & Trucking Indus. Pension Fund*, 748 F.2d 42, 46 (1st Cir. 1984).

77. S. REP. NO. 95-989, at 118 (1978); *see also* CHAPTER 11 THEORY AND PRACTICE: A GUIDE TO REORGANIZATION § 30.16 (James F. Queenan, Jr. et al eds., 1994) (stating that "[t]hese committee reports, like the statute itself, expressly encompass only the requirement of homogeneity of claims placed within the same class.").

78. 11 U.S.C. § 1122(a) (2012).

separately classified. If, however, the court finds that the claims are substantially similar and the debtor seeks to classify them separately, a few approaches have emerged to determine whether this separate classification is appropriate.

A majority of courts say that the plan may place these substantially similar claims in different classes if the debtor can show a business or economic justification for doing so.⁷⁹ But absent a business or economic justification, it is not enough to justify separate classification of substantially similar claims. Indeed, when objections to classification under § 1122(a) arise, courts are oftentimes presented with allegations that the plan proponent separately classified similar claims only to ensure acceptance by at least one class of impaired claims required by § 1129(a)(10), as discussed below.⁸⁰ Such manipulation is viewed as an abuse of Chapter 11. Indeed, the Fifth Circuit has held that “one clear rule [has] emerge[d] from [the] otherwise muddled case law on § 1122 claims: [T]hou shalt not classify similar claims differently in order to gerrymander an affirmative vote on a reorganization plan.”⁸¹ Thus, when the debtor separately classifies legally similar claims, but can demonstrate “business or economic reasons independent of the debtor’s need to secure the acceptance of a plan by an impaired accepting class of creditors for purposes of confirmation,” the majority approach would allow it.⁸²

The other approach does not consider a business or economic justification for placing substantially similar claims in separate classes. This approach – referred to as the so-called “strict approach” derived from pre-Code Chapter X cases – requires all creditors of equal rank with claims against the same property to be placed in the same class, regardless of business or economic issues.⁸³ Thus, “[s]eparate classification for unsecured creditors, [for example, is] only justified where the legal character of their claims is such as to accord them a status *different* from the other unsecured creditors.”⁸⁴

79. See *Barakt v. Life Ins. Co. of Va. (In re Barakat)*, 99 F.3d 1520, 1526 (9th Cir. 1996). “Courts of Appeals for the Second, Third, Fourth, Fifth, Eighth, and Ninth Circuits have held that a debtor proposing a cramdown plan must show a reason for separately classifying unsecured claims other than the need to secure the vote of an impaired class of claims.” *In re CGE Shattuck, LLC*, Nos. 99–12287–JMD, CM 99–747, 1999 WL 33457789, at *4 (D.N.H. 1999) (citing *In re Boston Post Road Ltd. P’ship*, 21 F.3d 477, 481–83 (2d Cir. 1994), *cert. denied*, 513 U.S. 1109 (1995)); see *John Hancock Mut. Life Ins. Co. v. Route 37 Bus. Park Assocs.*, 987 F.2d 154, 159 (3rd Cir. 1993); *In re Bryson Props. XVIII*, 961 F.2d 496, 502 (4th Cir. 1992), *cert. denied*, 506 U.S. 866 (1992); *In re Lumber Exchange Bldg. Ltd. P’ship*, 968 F.2d 647, 649 (8th Cir. 1992); *In re Greystone III Joint Venture*, 995 F.2d 1274, 1279–80 (5th Cir. 1991), *cert. denied*, 506 U.S. 821 (1992); *In re Barakat*, 99 F.3d 1520, 1526 (9th Cir. 1996), *cert. denied*, 520 U.S. 1143 (1997).

80. *Greystone III Joint Venture*, 995 F.2d at 1278, 1280.

81. *Phoenix Mut. Life Ins. Co. v. Greystone III Joint Venture*, 995 F.2d 1274, 1279 (5th Cir. 1991).

82. *CGE Shattuck*, 1999 WL 33457789, at *4.

83. See *In re Barney & Carey Co.*, 170 B.R. 17, 22 (Bankr. D. Mass. 1994).

84. *Id.* (emphasis added) (quoting *Granada Wines, Inc. v. New Eng. Teamsters & Trucking Indus. Pension Fund*, 748 F.2d 42, 46 (1st Cir. 1984)).

Clearly, these two approaches are at odds with each other. Debtors who file Chapter 11 bankruptcy petitions in circuits that have adopted the flexible business/economic justification approach have a much easier path to confirmation. Debtors who file in circuits adopting the strict approach, on the other hand, will be required to demonstrate that each class of claims in its plan is materially different – i.e., that the legal character or nature of the claims are simply not the same.⁸⁵

In addition to properly organizing its claims into classes, part of plan confirmation requires the debtor to “specify any class of claims or interests that is *not impaired*, . . . [and] specify the treatment of any class of claims or interests that *is impaired* under the plan.”⁸⁶ Understanding the meaning and import of “impairment” is crucial to the development of a confirmable plan of reorganization.

D. The Accepting Impaired Class

There are two ways in which a plan of reorganization may be confirmed. One way is that the plan may be agreed to by the affirmative vote of *all* impaired classes – i.e., a consensual plan.⁸⁷ “This consensual means of plan negotiation and confirmation is among the paramount goals of Chapter 11.”⁸⁸ However,

[S]hould an impaired class vote against confirmation, all hope is not lost, for a plan can be confirmed [– that is, “crammed down” –] over the vote of dissenting classes of claims under the cramdown provisions of 11 U.S.C. § 1129(b) if all the requirements of subsection (a) of section 1129 are satisfied, excluding (a)(8) [(which requires all impaired classes to accept the plan),] and the bankruptcy court is satisfied that the plan does not discriminate unfairly and is fair and equitable with respect to each class of impaired claims that has not accepted the plan [– i.e., a nonconsensual plan].⁸⁹

“But the requirement of approval by at least one impaired accepting class (not counting the votes of insiders) must be met.”⁹⁰ Thus, the concept of class “impairment” is paramount to confirmation – a debtor always needs an accepting impaired class.⁹¹

Section 1124 of the Bankruptcy Code defines “impairment” in the negative.⁹² Under § 1124, “a class of claims or interests is ‘impaired’ under a plan of reorganization, unless, with respect to each claim or interest [in the] class, the

85. *See id.*

86. 11 U.S.C. § 1123(a) (2012) (emphasis added).

87. § 1129(a)(8).

88. *In re* 500 Fifth Ave. Assocs., 148 B.R. 1010, 1017 (S.D.N.Y. 1993).

89. *Id.*

90. *Id.*

91. *Id.*

92. § 1124.

plan leaves unaltered the legal, equitable, and contractual rights to which such claim or interest entitles the holder of such claim or interest,” or cures a default and leaves such legal, equitable, and contractual rights otherwise unaltered.⁹³ Thus, by negative implication from the statute’s language, *any* alteration of the pre-petition legal or equitable rights of a creditor, positive or negative, is an impairment.⁹⁴

“The concept of ‘impairment’ was engrafted into § 1129(a)(10) in 1984 in an attempt to engender in the reorganization process a greater degree of consensus by mandating the affirmative vote by a class of claimants whose rights were altered under a plan of reorganization.”⁹⁵ This mandatory requirement for plan confirmation where at least one accepting class is impaired – that is, that will not receive the full value of its claims – has created much controversy.

Section 1129(a)(10) provides that “[i]f a class of claims is impaired under the plan, at least one class of claims that is impaired under the plan has accepted the plan, determined without including any acceptance of the plan by any insider.”⁹⁶ This section, therefore, is designed to prevent a plan from being confirmed unless a class of creditors impaired by such plan support it.⁹⁷ The Eighth Circuit has stated that “[t]he purpose of [Bankruptcy Code § 1129(a)(10)] ‘is to provide some indicia of support [for a plan] by affected creditors and prevent confirmation where such support is lacking.’”⁹⁸ “As such, [§] 1129(a)(10) requires that a plan of reorganization pass muster in the opinion of creditors whose rights to repayment from the debtor are implicated by the reorganization.”⁹⁹ Indeed, “[b]y providing impaired creditors the right to vote on confirmation, the Bankruptcy Code ensures the terms of the reorganization are monitored by those who have a financial stake in its outcome.”¹⁰⁰

The author believes that two basic principles underlie § 1129(a)(10): fairness and judicial efficiency. The fairness component focuses on what is fair to the creditors. Indeed, “before embarking upon the tortuous path of cram down and compelling the target of cram down to shoulder the risks of error necessarily associated with a forced confirmation, there must be some other properly

93. *Id.*

94. See *In re U.S. Truck Co., Inc.*, 47 B.R. 932, 940 n.23 (Bankr. E.D. Mich. 1985), *aff’d*, 800 F.2d 581 (6th Cir. 1986) (explaining that “a creditor is unimpaired only if the plan restores the creditor to its pre-petition position”); see also *In re Elecs. & Metals Indus., Inc.*, 153 B.R. 36, 38 (Bankr. W.D. Tex. 1992); see also *In re Valley Park Group, Inc.*, 96 B.R. 16, 22 (Bankr. N.D.N.Y. 1989).

95. John R. Clemancy & Nancy J. March, *Artificial Impairment and the Elusive Accepting Impaired Class in Single Asset Chapter 11 Bankruptcies*, 12 AM. BANKR. INST. J. 21 (1993).

96. § 1129(a)(10).

97. *Id.*

98. *In re Windsor on the River Assoc., Ltd.*, 7 F.3d 127, 131 (8th Cir. 1993) (quoting *In re Lettick Typographic, Inc.*, 103 B.R. 32, 38 (Bankr. D. Conn. 1989)).

99. *In re Combustion Eng’g., Inc.*, 391 F.3d 190, 244 (3rd Cir. 2004).

100. *Id.*

classified group that is also hurt and nonetheless favors the plan.”¹⁰¹ Indeed, § 1129(a)(10) clearly ensures “there must be someone other than the debtor, other than the insiders, and other than the target of the cram down, who cares enough about the reorganization and whose rights must also be considered to invoke the equitable grounds that justify resort to cram down.”¹⁰² If fairness were not a consideration, § 1129(a)(10) would not expressly exclude the votes of insiders. Section 1129(a)(10) mandates that the votes of insiders be omitted from calculating plan acceptances, even if the result is an unconfirmable plan.¹⁰³ While the impact of this requirement may appear harsh,

“[t]he exclusion recognizes that where a creditor is under the debtor’s proverbial thumb due to the parties’ affinity of interests, that creditor is less likely, perhaps even incapable, of casting a vote formed on an independent judgment of what will best serve his interests, much less those of his fellow class members.”¹⁰⁴

Section 1129(a)(10) also preserves judicial resources: if the debtor fails to attain the requisite acceptance from an impaired, non-insider class, then the court need consider the plan no further.¹⁰⁵ Indeed, “[i]f cramdown is not available, it is pointless to further consider a plan which requires cramdown for its success.”¹⁰⁶ Courts across the board recognize that “a threshold and potentially dispositive issue is the . . . hurdle present in 11 U.S.C. § 1129(a)(10)”¹⁰⁷

Because § 1129(a)(10) essentially functions as a gatekeeper to confirmation by excluding unfair plans with no creditor support, its application is not without controversy.

The seemingly straightforward construction of § 1129(a)(10) belies the obstacle it can present in the confirmation of a plan of reorganization. Indeed, the generality of § 1129(a)(10) has caused bankruptcy courts and federal circuits alike to come to diametrically opposed conclusions about the ability of § 1129(a)(10) to scuttle plan confirmation.¹⁰⁸

The § 1129(a)(10) battle is even more prevalent in SARE Cases, where a primary obstacle to confirmation is simply finding a creditor that favors the plan.

101. *In re* 266 Wash. Assocs., 141 B.R. 275, 287 (Bankr. E.D.N.Y. 1992).

102. *In re* Anderson Oaks (Phase I) Ltd. P’ship., 77 B.R. 108, 112–13 (Bankr. W.D. Tex. 1987).

103. 11 U.S.C. § 1129(a)(10) (2012).

104. *In re* Gilbert, 104 B.R. 206, 210 (Bankr. W.D. Mo. 1989).

105. § 1129(a)(10).

106. *Anderson Oaks*, 77 B.R. at 113.

107. *In re* Duval Manor Assoc., 191 B.R. 622, 626 (Bankr. E.D. Pa. 1996).

108. Carson T. H. Emmons, *Construction and Application of 11 U.S.C.A. § 1129(a)(10), Requiring at Least One Impaired Class to Accept Plan for Confirmation*, 4 A.L.R. FED. 3D ART. 3 (2015).

II. THE SARE DEBTOR AND THE HURDLES

A. *The SARE Debtor*

When the Bankruptcy Code was enacted in 1978, there was no express mention of single asset real estate.¹⁰⁹ As such, there was no specific limitation on the relief afforded a debtor with a case entirely dependent on one piece of real estate. Congress, however, found a need to curb abusive filings and protect secured creditors who were being strung out for long periods of time, having no remuneration and no real hope of reorganization by the debtor.¹¹⁰ Accordingly, the Bankruptcy Reform Act of 1994 added provisions to create special treatment for debtors with assets constituting “single asset real estate.”¹¹¹ The Bankruptcy Code defines “single asset real estate” as:

[R]eal property constituting a single property or project, other than residential real property with fewer than 4 residential units, which generates substantially all of the gross income of a debtor who is not a family farmer and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental thereto.¹¹²

Classification of a SARE case is relevant in several respects, particularly because of its effect on the operation of the automatic stay of § 362. If a creditor has secured claims in “single asset real estate,” it can obtain relief from the

109. Cohn, *supra* note 16, at 525. The Bankruptcy Reform Act of 1994 did not introduce the phrase “single asset real estate” into bankruptcy cognizance. It is a common term in bankruptcy and has been used for many years in the bankruptcy area:

Single asset Chapter 11 cases have been filed in rapidly increasing numbers in recent years. Hit by real estate recessions in the mid-1970's and mid-1980's, innumerable single asset partnerships and corporations, formed only to acquire and manage their one investment asset, have sought the protection of the bankruptcy court. Often filed with little purpose but to postpone foreclosure, and with no serious hope of reorganization, single asset cases have met harsh reactions from many courts.

* * * * *

Single asset bankruptcy cases are not new. They first blossomed under Chapter XII of the Bankruptcy Act of 1898, which was enacted as a part of the Chandler Act in 1938. Chapter XII, entitled “Real Property Arrangements by Persons Other Than Corporations,” was precipitated by the then-common situation in which an individual or partnership owned real estate for which it was obligated on bond issues secured by trust indentures and owned by large numbers of individual holders. Although Chapter XII was not limited to “single asset” cases, most debtors who sought its protection owned a single parcel of real estate, typically a developed property such as an apartment house or office building. Increasing numbers of such individuals and partnerships found themselves unable to pay their bond issues during the depression years of the 1930's, particularly in Chicago and in some northeastern cities. Chapter XII was designed for these individual and partnership debtors.

Id. at 523–24.

110. See 3 COLLIER ON BANKRUPTCY, *supra* note 3, ¶ 362.07[5].

111. *Id.*

112. 11 U.S.C. § 101(51B) (2012).

automatic stay to foreclose on the real estate if the debtor fails to file a plan within a shortened amount of time or make specified monthly payments under § 362(d)(3).¹¹³ “The purpose that § 362(d)(3) serves is, where there is a single asset real estate Chapter 11 case, to impose an expedited time frame for filing a plan.”¹¹⁴ The plan in such a case must be filed within ninety days after the filing of the case.¹¹⁵ This requirement is significant in two respects. “First, it sets a time for filing a plan in this species of Chapter 11 case.”¹¹⁶ In fact, “[t]here is no time requirement in the Bankruptcy Code for the filing of a plan for any other kind of Chapter 11 case.”¹¹⁷ “Second, the consequence of not meeting that requirement is that the automatic stay of § 362 may be lifted without ado.”¹¹⁸

Using the Bankruptcy Code definition, courts have adopted three requirements necessary for characterizing a debtor’s case as a SARE case:

- (1) The debtor must have real property constituting a single property or project (other than residential real property with fewer than 4 residential units), (2) which generates substantially all of the gross income of the debtor, and (3) on which no substantial business is conducted other than the business of operating real property and activities incidental thereto.¹¹⁹

“If a debtor fails to meet *any* prong, it is not a [single asset real estate debtor].”¹²⁰

SARE cases share a few other commonalities: “(1) There is usually ‘a single secured creditor, which is at war with the debtor and which will not go along with any proposal made by the debtor,’ (2) foreclosure on the real property is imminent (SARE cases are usually filed on the eve of foreclosure), (3) there exists a handful of trade creditors with nominal claims, (4) there is likely ‘a year or two of unpaid real property taxes,’ and (5) ‘the secured debt dwarfs the value of the real property,’ leaving the secured creditor with a large, unsecured deficiency claim.”¹²¹

Because of these commonalities – particularly the large looming deficiency claim – the SARE debtor has a critical need to isolate the secured creditor’s deficiency claim from the other creditors and then work towards “impairing” its friendly class of claims and soliciting their affirmative vote in favor of its plan.¹²²

113. § 362(d)(3).

114. *In re Kkemko, Inc.*, 181 B.R. 47, 49 (Bankr. S.D. Ohio 1995).

115. *Id.*

116. *Id.*

117. *Id.*

118. *Id.*

119. *In re Scotia Pacific Co., LLC*, 508 F.3d 214, 220 (5th Cir. 2007) (quoting § 101(51B)).

120. *Id.* (emphasis added).

121. *Clemancy & Marsh, supra* note 95, at 21.

122. *See id.*

B. Classification Maneuvering

Because a class of claims accepts a plan if more than one-half in number and at least two-thirds in amount of claims voting in a class favor the plan,¹²³ a debtor's composition of its classes clearly has a substantial impact upon its chances of successfully cramming down a plan. In SARE cases, it almost always behooves the debtor to separately classify the mortgagees' deficiency claims from the other unsecured claims, since the sheer size of a typical deficiency claim would generally allow the deficiency claimant to block confirmation by controlling the vote of a single unsecured creditor class.¹²⁴ Under this common scenario, there would be no impaired accepting class under § 1129(a)(10) and the SARE debtor would be barred from confirming its plan. Consider the following example:

Big Bank (Bank) makes a \$6 million loan to D&M Developments, LLC (D&M), secured by a first mortgage on an office complex, which is D&M's sole asset. The office complex generates all of D&M's income. D&M is unable to service the debt and defaults under the loan. Bank schedules a foreclosure sale. On the eve of the scheduled sale, D&M files for bankruptcy under Chapter 11 of the Bankruptcy Code, and designates its filing as a SARE case. At that time, general unsecured trade creditors are owed \$100,000. D&M paid down the loan by \$1 million before it defaulted, so the principal balance at filing was \$5 million. D&M (now the debtor-in-possession) wants to file a plan of reorganization where it will retain the property, pay general unsecured trade creditors 90% of their claims on the effective date of the plan, without interest, and restructure the \$5 million balance into a new note with more favorable terms. But the \$5 million secured claim really might not be a fully secured claim under bankruptcy law, which will affect how the debtor structures its plan.

Assume the value of the property is \$3 million. Under § 506(a) of the Bankruptcy Code, this gives Bank a bifurcated claim in D&M's bankruptcy case, since a lender's secured claim is limited to the value of its collateral and any difference between the amount of the debt and the value of the collateral, that is, the deficiency, is deemed an unsecured claim. Thus, in this example, Bank's claim against the estate would be treated as follows: (1) a secured claim of \$3 million (i.e., the value of the property) and (2) an unsecured claim of \$2 million (i.e., the deficiency). Under the Bankruptcy Code, these are considered separate claims and will be placed in separate classes because they are in no way substantially similar.¹²⁵ D&M has two options for classification:

123. § 1126(c).

124. James Lawnczak, *Separate Classification of Deficiency Claims in Chapter 11 Plans*, LEXISNEXIS (Oct. 31, 2012), <https://www.lexisnexis.com/legalnewsroom/bankruptcy/b/bankruptcy-law-blog/archive/2012/10/31/separate-classification-of-deficiency-claims-in-chapter-11-plans.aspx>.

125. See *In re Loop 76, LLC*, 465 B.R. 525, 536 (B.A.P. 9th Cir. 2012).

*Option 1:*¹²⁶

Class 1: Bank's Secured Claim: \$3 million

Class 2: Unsecured Claims: \$2,100,000 (i.e., \$2 million deficiency + \$100,000 trade)

*Option 2:*¹²⁷

Class 1: Bank's Secured Claim: \$3 million

Class 2: Bank's Unsecured Claim: \$2 million

Class 3: Trade Creditors: \$100,000

D&M will never go with Option 1 if the Bank makes it known that it will vote against its plan both in its capacity as a secured creditor and as an unsecured creditor. D&M will also not find Option 1 attractive if it promised to pay that class 90% of their claims, since it will be required to provide the Bank's deficiency claim with the same treatment as the other claims in that class.¹²⁸ More importantly, however, is that under Option 1, the Bank's unsecured deficiency claim will swamp Class 2, making it impossible for Class 2 to meet the one-half in number and at least two-thirds in amount requirement for an accepting class. Thus, Option 2 is really the only option available for D&M.

Under Option 2, however, Class 1 and Class 2 can reject the plan, but now Class 3 can accept it. Class 3 is likely to accept the plan since they are being paid nearly in full. If this separate classification is proper, the trade creditors will constitute the needed impaired accepting class necessary to satisfy § 1129(a)(10) of the Bankruptcy Code. In other words, the class representing 2% of D&M debt will determine whether the plan gets confirmed.

Based on this simple example, it is not surprising that the SARE debtor searches for ways to flexibly classify the deficiency claim, a flexibility which is vital to the effort to reorganize. The following cases are illustrative:

1. The Classification Loophole in In re Loop 76, LLC

In *Wells Fargo Bank, N.A. v. Loop 76, LLC (In re Loop 76, LLC)*,¹²⁹ the Ninth Circuit Bankruptcy Appellate Panel held that a bankruptcy court may consider a third-party source (a guarantor) for recovery on a creditor's unsecured deficiency claim when determining whether claims are "substantially similar" under § 1122(a) of the Bankruptcy Code, thus justifying a debtor's classification of the deficiency claim separate from the claims of other unsecured creditors.¹³⁰

126. See James Lawniczak, *Separate Classification of Deficiency Claims in Chapter 11 Plans*, LEXISNEXIS (Oct. 31, 2012, 1:23 PM), <https://www.lexisnexis.com/legalnewsroom/bankruptcy/b/bankruptcy-law-blog/archive/2012/10/31/separate-classification-of-deficiency-claims-in-chapter-11-plans.aspx>.

127. See *id.*

128. See § 1123(a)(4).

129. *Loop 76, LLC*, 465 B.R. at 525.

130. *Id.* at 528.

The facts of *In re Loop* are rather simple. *In re Loop* was a SARE case that involved an undersecured lender. Loop 66's sole asset was an office/retail complex.¹³¹ Wells Fargo had provided Loop 66 with a \$23 million construction loan, which was secured by the office complex, and which was also personally guaranteed by Loop 66's members.¹³² For voting purposes, Wells Fargo and the debtor stipulated that the value of the office complex was \$17 million, giving Wells Fargo a bifurcated claim against the estate pursuant to § 506(a): (1) a secured claim for \$17 million and (2) an unsecured deficiency claim for \$6 million.¹³³

The debtor's plan placed Wells Fargo's secured claim in Class 2, and its deficiency claim in Class 8(B).¹³⁴ All of the other unsecured claims were placed in Class 8(A).¹³⁵ This separate classification allowed the debtor to obtain the requisite impaired accepting class pursuant to § 1129(a)(10).¹³⁶ If Wells Fargo's deficiency claim had been placed in Class 8(A) along with all other general unsecured claims, it would have prevented the debtor's plan from being confirmed.

Wells Fargo objected to the separate classification of its deficiency claim, arguing that its claim was "substantially similar" to all other general unsecured claims pursuant to § 1122(a) and, therefore, separate classification was impermissible.¹³⁷ The debtor, on the other hand, argued that Wells Fargo's deficiency claim was dissimilar because it had potential recovery against third-party guarantors.¹³⁸ This, the debtor argued, rendered Wells Fargo's unsecured claim different in legal character as compared to Class 8(A) general unsecured claims, allowing for separate classification.¹³⁹

The bankruptcy court agreed with the debtor.¹⁴⁰ It held that "a claimant with a third-party source of repayment for its claim is dissimilar from a claimant who lacks such [an] alternative source[] of [recovery]."¹⁴¹ Accordingly, the bankruptcy court overruled Wells Fargo's objection and confirmed the plan.¹⁴²

The Bankruptcy Appellate Panel for the Ninth Circuit affirmed the bankruptcy court's ruling.¹⁴³ It agreed that possessing a separate course of recovery is something different and distinct from other unsecured creditors with no similar

131. *Id.* at 529.

132. *Id.*

133. *Id.* at 529–30.

134. *Id.*

135. *Id.*

136. *Id.* at 531–32.

137. *Id.*

138. *Id.* at 531.

139. *See id.*

140. *Id.* at 533–34.

141. *Id.* at 533–34.

142. *Id.* at 535.

143. *Id.* at 541.

source.¹⁴⁴ Under its ruling, the court stated that bankruptcy courts should not be limited to determining the “nature” of a claim’s relation to the “assets of the debtor,” but that considering third-party sources of recovery is an appropriate way to analyze the similarity of claims.¹⁴⁵ Wells Fargo’s pending lawsuit against the guarantors, opined the court, rendered its unsecured deficiency claims distinct from the debtor’s other unsecured claims.¹⁴⁶

The Bankruptcy Appellate Panel’s decision in *In re Loop* is at odds with other cases, which hold that “the existence of a third-party guarantee does not change the nature of a claim with respect to the debtor’s estate.”¹⁴⁷ Creditors should be aware that, depending on the jurisdiction, plans with similar classification schemes may have substantially dissimilar outcomes. A debtor’s ability to classify claims separately based on a third-party guaranty is arguably a loophole which Congress did not intend to create.

If a guarantor is absent in the debtor’s case or the debtor is otherwise unable to use the guarantor argument as way to manufacture its classes, it has another classification loophole to explore. This loophole necessitates examination of § 506(a) and § 1111(b).

2. *The Classification Loophole in Non-Recourse Cases*

In the example above involving D&M, it is obvious, given the size of Bank’s deficiency claim relative to the other unsecured claims and its opposition to D&M’s plan, why D&M needs to separately classify the Bank’s deficiency claim: it must satisfy the requirements of § 1129(a)(10) and get at least one impaired class to accept the plan.¹⁴⁸ In this example, a finding by a court that joint classification is necessary would be the death knell for D&M’s plan because it could not satisfy the requirements of § 1129(a)(10) and because Bank refuses to accept its plan. But assume that the loan the Bank made to D&M is nonrecourse – i.e., its recovery for default is limited to the real property pledged by D&M. Does this fact provide D&M with an additional loophole to argue separate classification is appropriate? The answer is: yes.

Because a claim in bankruptcy is secured only to the extent of the judicially determined value of the collateral, § 506(a), in effect, bifurcates an otherwise secured claim into a secured claim up to the value of the collateral and an

144. *Id.* at 539–40.

145. *Id.* at 540.

146. *Id.* at 540–41.

147. Dana Hall, *One of These Things is Not Like the Other; 9th Circuit B.A.P. Holds that Bankruptcy Court May Consider the Existence of a Third-Party Source of Recovery When Determining Whether Unsecured Claims are “Substantially Similar”*, WEIL BANKRUPTCY (March 15, 2012), <https://business-finance-restructuring.weil.com/claims/one-of-these-things-is-not-like-the-other-9th-circuit-b-a-p-holds-that-bankruptcy-court-may-consider-the-existence-of-a-third-party-source-of-recovery-when-determining-whether-unsecured-claims-are/>; see also *In re Quigley Co., Inc.*, 437 B.R. 102, 144 (Bankr. S.D.N.Y. 2010).

148. 11 U.S.C. § 1129(a)(10) (2012).

unsecured claim for any deficiency, even if under state law the creditor's claim is nonrecourse.¹⁴⁹ "Under [§] 1111(b)(1)(A), non-recourse claims secured by liens on property of the estate . . . are treated as though they were recourse claims, with the claimant having an unsecured claim against the debtor to the extent of a deficiency."¹⁵⁰ The class holding such claims is given an option: it may retain this recourse treatment or make the § 1111(b)(2) election pursuant to which each claim in the class is considered fully secured, despite the value of the collateral being less than the claim.¹⁵¹

Assume Bank chooses to bifurcate its claim. The classification scheme will be identical to that discussed previously, despite the fact that it is a nonrecourse loan. It will have a secured claim of \$3 million (i.e., the value of the property) and (2) an unsecured claim of \$2 million (i.e., the deficiency). But now D&M has a new quiver in its arrow – one, in fact, that it would not have if the loan were recourse – to help it classify the bank's deficiency claim separately.

Debtor will argue that unsecured deficiency claims created by § 1111(b) are not substantially similar to general unsecured claims and, therefore, separate classification is mandatory. Courts that support this argument contend that "the most obvious difference between a general unsecured claim and an unsecured [deficiency] claim created by § 1111(b) is that the former exists regardless of what chapter of the Bankruptcy Code the case is in, while the latter exists only so long as the case remains in Chapter 11."¹⁵² In the abstract, this is true. If the Chapter 11 case is converted to Chapter 7, the nonrecourse lender is confined to its collateral for recovery and has no deficiency claim against the Chapter 7 estate.¹⁵³ This is also true if the bankruptcy case is dismissed. But is this difference material enough to make these claims dissimilar? Another argument courts make in favor of this position is "that [a creditor's] secured claim may drive the manner in which it casts its unsecured deficiency claim ([perhaps causing] it to cast its unsecured vote in a manner that has nothing to do with its best interest as an unsecured creditor)" and, therefore, separate classification is proper.¹⁵⁴

Other courts do not agree with this approach, holding that unsecured claims and deficiency claims – regardless of their nonrecourse character – are substantially similar.¹⁵⁵ "Since these are creditors of equal rank with equal rights within chapter 11, . . . they should be classified together."¹⁵⁶ Moreover, courts reject the voting-motive theory since it "focuses on the motives and agenda of

149. § 506(a).

150. *In re* 266 Washington Assoc., 141 B.R. 275, 283 (Bankr. E.D.N.Y. 1992).

151. *Id.* at 283–84.

152. *In re* SM 104 Ltd., 160 B.R. 202, 219 (Bankr. S.D. Fla. 1993); *In re* Matter of Woodbrook Assocs., 19 F.3d 312, 318 (7th Cir. 1994).

153. § 502(b)(1).

154. *In re* 500 Fifth Ave. Assocs., 148 B.R. 1010, 1019 (Bankr. S.D.N.Y. 1993).

155. *Id.*

156. *Id.*

the claim holder rather than on the nature of the underlying claim.”¹⁵⁷ Notwithstanding, this classification loophole has created a split of authority and creditors should be aware that, depending on the jurisdiction, plans with similar classification schemes may have substantially dissimilar outcomes.¹⁵⁸

C. Artificial Impairment

Inventive and manipulative classification is not the only loophole SARE debtors are utilizing to confirm plans. Even if classification is proper – i.e., even if the debtor is allowed to classify separately the lender’s deficiency claim from other general unsecured claims – the debtor still must have at least one “impaired” class accepting the plan pursuant to § 1129(a)(10).¹⁵⁹ This condition to confirmation requires further creativity for the SARE debtor.

In the D&M hypothetical, assume that D&M is allowed to separately classify Bank’s deficiency claim of \$2 million from the trade creditors’ claims of \$100,000. On the effective date of the plan, the debtor proposes to pay trade creditors’ 90% of their claims – i.e., \$90,000 – and without interest. Why would D&M not pay the trade creditors \$100,000 with interest? The answer is simple. If D&M offered full payment with interest, the trade creditor class would not be “impaired” and, therefore, the § 1129(a)(10) requirement would not be met. Assume D&M has sufficient funds to pay trade creditors in full on the effective date, but has deliberately chosen the 10% haircut to obtain its impaired accepting class for confirmation. Is this scheme allowed? Several courts, practitioners, and scholars refer to this impairment manipulation as “artificial impairment” and are split on whether it runs afoul of § 1129(a)(10).¹⁶⁰

The Bankruptcy Code presumes that a class of claims is “impaired” under a plan unless a specific exception applies.¹⁶¹ One exception to the presumption of impairment arises where the plan “leaves unaltered the legal, equitable, and contractual rights to which such claim or interest entitles the holder of such claim or interest.”¹⁶² Several courts have found that “Congress defined impairment in the broadest possible terms.”¹⁶³ The bankruptcy court found “impairment

157. *500 Fifth Ave. Assoc.*, 148 B.R. at 1019–20 (citing 5 COLLIER ON BANKRUPTCY, *supra* note 3, ¶ 1122.03[1][b]) (“The focus on a particular claim should not be on the claim holder but rather on the legal nature of the claim.”).

158. *See id.* at 1020–21.

159. 11 U.S.C. § 1129(a)(10) (2012).

160. To date, the term “artificial impairment” shows up in 109 federal cases.

161. § 1124.

162. § 1124(1); *Bank of Am. Nat’l Trust & Sav. Ass’n v. 203 N. LaSalle St. P’ship.*, 526 U.S. 434, 441 n.14 (“Claims are unimpaired if they retain all of their prepetition legal, equitable, and contractual rights against the debtor.”); *United States v. Graham*, 59 Fed. Appx. 660, 664 (6th Cir. 2003).

163. *In re Madison Hotel Assocs.*, 749 F.2d 410, 418 (7th Cir.1984) (quoting *Di Pierro v. Taddeo*, 685 F.2d 24, 28 (2d Cir.1982)); *L & J Anaheim Assoc. v. Kawasaki Leasing Int’l, Inc.*, 995 F.2d 940, 942 (9th Cir.1993); *see also* 7 COLLIER ON BANKRUPTCY, *supra* note 3, ¶ 1124.03, at 1124–27.

apparently can be of nominal financial significance, since Congress rejected the Commission's recommendation that impairment be deemed to exist only if the class is material and adversely affected."¹⁶⁴

Artificial impairment generally refers to "[t]he manipulation of classes of claims in order to artificially create an accepting class of impaired claims."¹⁶⁵ Courts, scholars and practitioners oftentimes confuse artificial impairment with what is described above as "artificial classification" – i.e., a debtor's attempt to separate classes of claims/creditors who otherwise could have been grouped into one class, purely for the purpose of creating an accepting class to support the Chapter 11 plan.¹⁶⁶ But the proper use of the term "artificial impairment" refers to a scenario "where a debtor deliberately 'impairs a *de minimis* claim' solely for the purpose of achieving a forced confirmation over the objection of a creditor."¹⁶⁷

One of the leading cases criticizing artificial impairment is *Windsor on the River Associates v. Balcors Real Estate Finance*.¹⁶⁸ In that case, the debtor owned an apartment complex that secured a \$9.35 million mortgage and note held by Balcors, the only secured creditor.¹⁶⁹ The debtor also owed debts to one individual amounting to approximately \$59,000 in addition to \$13,000 owed to 34 trade creditors.¹⁷⁰ When the debtor filed its plan, these became Classes 1, 2, and 3, respectively.¹⁷¹ Class 1 was impaired because the plan extended the term of the note from four to ten years, with a cash payment of \$500,000 on the plan's effective date.¹⁷² Classes 2 and 3 were allegedly impaired because these classes would not be paid in full until 60 days after the plan's effective date.¹⁷³ Despite Balcors holding over 99% of the money value of the creditors' claims, the District Court approved the plan because Class 3 (as the "impaired" non-insider class) accepted the plan.¹⁷⁴

On appeal, the Eighth Circuit held that "a claim is not impaired [for purposes of the 1129(a)(10) requirement] if the alteration of the rights in question arises solely from the debtor's exercise of discretion."¹⁷⁵ Under the Eighth Circuit's

164. *In re* 28th Legislative Dist. Cmty. Dev. Corp., No. 10-14804, 2011 WL 5509140, at *32 (Bankr. E.D. Tenn. Nov. 10, 2011) (quoting 6 NORTON BANKRUPTCY LAW AND PRACTICE § 113:5 (2011)).

165. *In re* Griswold Bldg., LLC, 420 B.R. 666, 707 (Bankr. E.D. Mich. 2009); *see also In re* Trenton Ridge Investors, LLC, 461 B.R. 440, 464-65 (Banks. S.D. Ohio 2011).

166. *See* Clemency & Marsh, *supra* note 95, at 21.

167. *In re* Swartville, LLC, No. 11-08676-8-SWH, 2012 WL 3564171, at *2 (quoting *In re* Dunes Hotel Assocs., 188 B.R. 174, 184 (Bankr. S.C. 1995)).

168. *In re* Windsor on the River Assoc., Ltd., 7 F.3d 127, 131-32 (8th Cir. 1993).

169. *Id.* at 129.

170. *Id.*

171. *Id.*

172. *Id.* at 129-30.

173. *Id.* at 129.

174. *Id.* at 130.

175. *Id.* at 132.

approach, § 1129(a)(10) recognizes impairment only to the extent it is driven by some economic “need.”¹⁷⁶

Several courts have followed *Windsor on the River* – although not necessarily adopting its reasoning – and have denied confirmation of Chapter 11 plans impairing *de minimis* claims of some creditors for the purpose of contriving a class to accept the plan.¹⁷⁷ These courts reasoned that allowing this kind of manipulation undermines the policy of consensual reorganization expressed in § 1129(a)(10).¹⁷⁸ Indeed, the Eighth Circuit stated “[t]he purpose of [§ 1129(a)(10)] ‘is to provide some indicia of support [for a plan] by affected creditors and prevent confirmation where such support is lacking.’”¹⁷⁹

Other courts, however, including the Ninth Circuit, have concluded that artificial impairment does not “run afoul” of § 1129(a)(10).¹⁸⁰ In *In re L & J Anaheim Associates*,¹⁸¹ the Ninth Circuit held that § 1129(a)(10) does not distinguish between discretionary and economically driven impairment, observing that “the plain language of [§] 1124 says that a creditor’s claim is ‘impaired’ unless its rights are left ‘unaltered’ by the [p]lan,” and that “[t]here is no suggestion here that only alternations of a particular kind or degree can constitute impairment.”¹⁸²

Likewise, the Fifth Circuit, in *In re Village at Camp Bowie I, L.P.*,¹⁸³ “expressly reject[ed] *Windsor* and join[ed] the Ninth Circuit in holding that [§] 1129(a)(10) does not distinguish between discretionary and economically driven impairment.”¹⁸⁴ It held that “[b]y shoehorning a motive inquiry and materiality requirement into § 1129(a)(10), *Windsor* warps the text of the Code, requiring a court to “deem” a claim unimpaired for purposes of § 1129(a)(10) even though

176. *Id.* at 132–33.

177. *In re Combustion Eng’g.*, 391 F.3d 190, 243–44 (3d Cir. 2004); *In re All Land Investments, LLC*, 468 B.R. 676, 689–90 (Bankr. D. Del. 2012); *In re Daly*, 167 B.R. 734, 736–37 (Bankr. D. Mass. 1994); *In re N. Wash. Ctr. Ltd. P’ship.*, 165 B.R. 805, 810 (Bankr. D. Md. 1994); *Willows Convalescent Ctrs. Ltd. P’ship v. UNUM Life Ins. Co.*, 151 B.R. 220, 222 (D. Minn. 1991); *In re Lettick Typographic, Inc.*, 103 B.R. 32, 39 (Bankr. D. Conn. 1989); *In re Club Assocs.*, 107 B.R. 385, 398 (Bankr. N.D. Ga. 1989).

178. *E.g.*, *Windsor on the River*, 7 F.3d at 131–32.

179. *Id.* at 131 (internal citation omitted).

180. *See L & J Anaheim Assocs.*, 995 F.2d at 943 (holding that § 1124 does not differentiate between artificial and actual impairment of claims); *Conn. Gen. Life Ins. Co. v. Hotel Assocs. of Tucson*, 165 B.R. 470, 475 (B.A.P. 9th Cir. 1994); *In re Greate Bay Hotel & Casino, Inc.*, 251 B.R. 213, 240 (Bankr. D.N.J. 2000) (holding that “[u]nder the statutory scheme for the classification and treatment of claims, a plan proponent may impair a class of claims”); *In re Duval Manor Assocs.*, 191 B.R. 622, 628 (Bankr. E.D. Pa. 1996) (stating that “artificial impairment, while perhaps not philosophically the better view, is nevertheless clearly permitted under the plain meaning of the statute”); *In re The Beare Co.*, 177 B.R. 886, 889 (Bankr. W.D. Tenn. 1994).

181. *L & J Anaheim Assocs.*, 995 F.2d at 942–43.

182. *Id.*

183. *In re Vill. at Camp Bowie I, L.P.*, 710 F.3d 239, 245 (5th Cir. 2013).

184. *Id.*

it plainly qualifies as impaired under § 1124.”¹⁸⁵ The court further held that “*Windsor*’s motive inquiry is also inconsistent with § 1123(b)(1), which provides that a plan proponent ‘may impair or leave unimpaired any class of claim,’ and does not contain any indication that impairment must be driven by economic motives.”¹⁸⁶ Regarding *Windsor*’s pronouncement that “Congress enacted [§] 1129(a)(10) . . . to provide some indicia of support [for a cramdown plan] by affected creditors” and that “interpreting [§] 1124 literally would vitiate this congressional purpose”, the Fifth Circuit stated that “the Bankruptcy Code *must* be read literally, and congressional intent is relevant only when the statutory language is ambiguous.”¹⁸⁷ In support of this position, it stated that even if it were to consider congressional intent in divining the meaning of § 1129(a)(10) and § 1124, “the scant legislative history on § 1129(a)(10) provides virtually no insight as to the provision’s intended role, and the Congress that passed § 1124 considered and rejected precisely the sort of materiality requirement that *Windsor* has imposed by judicial fiat.”¹⁸⁸ The last critique offered by the Fifth Circuit is that *Windsor* “ignores the determinative role § 1129(a)(10) plays in the typical single-asset bankruptcy, in which the debtor has a negative equity and the secured creditor receives a deficiency claim that allows it to control the vote of the unsecured class.”¹⁸⁹

In short, much like the classification issue, courts split on the role that § 1129(a)(10) and the impairment requirement play in Chapter 11 cases.¹⁹⁰ A uniform approach to this issue is wanted.

III. IMPROPER CLASSIFICATION AND ARTIFICIAL IMPAIRMENT UNDER A GOOD-FAITH APPROACH

Improper classification and artificial impairment are often most apparent in single asset real estate cases. Courts, practitioners, and scholars are continuously at odds over the meaning of the code provisions that govern the concepts of classification and impairment. The current approaches for dealing with these sections, particularly in single asset real estate cases, yield confusion and actually make the reorganization process needlessly complex, costly, and unpredictable. Even more problematic is that the muddle surrounding these code provisions is resulting in decisions which are contrary to the congressional intent behind the Chapter 11 reorganization process.¹⁹¹ But courts do not need to construe these code sections in order to make a determination of the improper

185. *Id.*

186. *Id.* at 245–46 (quoting 11 U.S.C. § 1123(b)(1) (2012)).

187. *Id.*

188. *Id.* at 246 (noting that Congress rejected proposed legislation that would have required a creditor to be “materially and adversely affected” in order to gain the right to vote on a reorganization under § 1124); *see also id.* at n.27.

189. *Id.* at 246.

190. *See supra* note 9.

191. *See Vill. at Camp Bowie*, 710 F.3d at 246.

classification and artificial impairment issues. Rather, improper classification and artificial impairment should go to a debtor's good faith in proposing a plan under § 1129(a)(3) of the Bankruptcy Code – i.e., improper classification and artificial impairment should be nothing more than subdivisions of the good-faith requirement mandated by the Bankruptcy Code.

A. *The Meaning of Good-Faith in Chapter 11*

Pursuant to § 1129(a)(3), the party seeking confirmation must show that “[t]he plan has been proposed in good faith and not by any means forbidden by law.”¹⁹² “Good faith” is not defined in the Bankruptcy Code; however, as explained by the Seventh Circuit:

Though the term “good faith,” as used in [§] 1129(a)(3), is not defined in the Bankruptcy Code, the term is generally interpreted to mean that there exists “a reasonable likelihood that the plan will achieve a result consistent with the objectives and purposes of the Bankruptcy Code.” . . . Thus, for purposes of determining good faith under [§] 1129(a)(3) . . . the important point of inquiry is the plan itself and whether such plan will fairly achieve a result consistent with the objectives and purposes of the Bankruptcy Code.¹⁹³

The good faith standard found in “[§] 1129(a)(3) speaks more to the process of plan development than to the content of the plan.”¹⁹⁴ When considering the good faith intentions of a Chapter 11 plan, the court looks to the circumstances surrounding the plan's development including the debtor's pre-filing conduct.¹⁹⁵ The review of a plan's development allows “a court considerable discretion in finding good faith.”¹⁹⁶ Moreover, “the bankruptcy court[s] [are] in the best position to [ascertain] the good faith of the parties' proposals.”¹⁹⁷ Notwithstanding, “the fact that a debtor proposes a plan in which it avails itself of an applicable Code provision does not constitute evidence of bad faith.”¹⁹⁸

In short, “the important point of inquiry is the plan itself and whether such plan will fairly achieve a result consistent with the objectives and purposes of

192. 11 U.S.C. § 1129(a)(3) (2012).

193. *In re Madison Hotel Assocs.*, 749 F.2d 410, 424–25 (7th Cir. 1984) (internal citations omitted); see also *Kane v. Johns-Manville Corp.*, 843 F.2d 636, 649 (2d Cir. 1988) (stating that “[t]he good-faith test means that the plan was proposed with ‘honesty and good intentions’ and with ‘a basis for expecting that a reorganization can be effected’”) (quoting *In re Koelbl*, 751 F.2d 137, 139 (2d Cir. 1984)).

194. *In re Bush Industries, Inc.*, 315 B.R. 292, 304 (Bankr. W.D.N.Y. 2004).

195. See *In re Madison Hotel Assocs.*, 749 F.2d 410, 425 (7th Cir. 1984); *In re Jasik*, 727 F.2d 1379, 1383 (5th Cir. 1984); *In re WorldCom, Inc.*, No. 02–13533, 2003 WL 23861928, at *51 (S.D.N.Y. Oct. 31, 2003); *In re Leslie Fay Cos.*, 207 B.R. 764, 781 (Bankr. S.D.N.Y. 1997); *In re Resorts Int'l, Inc.*, 145 B.R. 412, 469 (Bankr. D.N.J. 1990); *In re Toy & Sports Warehouse, Inc.*, 37 B.R. 141, 149 (Bankr. S.D.N.Y. 1984).

196. *In re Coram Healthcare Corp.*, 271 B.R. 228, 234 (Bankr. D. Del. 2001).

197. *In re Matter of Sound Radio, Inc.*, 93 B.R. 849, 853 (Bankr. D.N.J. 1998).

198. *In re PPL Enters., Inc.*, 228 B.R. 339, 347 (Bankr. D. Del. 1998).

the Bankruptcy Code.”¹⁹⁹ The additional factors courts have considered in determining a debtor’s good faith include whether “the plan has been proposed with honesty and good intentions and with a basis for expecting that reorganization can be effected, and [exhibits a] fundamental fairness in dealing with the creditors.”²⁰⁰

Regarding the first factor, the United States Supreme Court has specifically identified “preserving going concerns and maximizing property available to satisfy creditors” as “the two recognized policies underlying Chapter 11.”²⁰¹

The second factor requires that the plan have been proposed with honesty and good intentions, and that it have “a reasonable hope of success.”²⁰² The Third Circuit has provided guidance on this point, stating that, “[a]t its most fundamental level, the good faith requirement ensures that the Bankruptcy Code’s careful balancing of interests is not undermined by petitioners whose aims are antithetical to the basic purposes of bankruptcy.”²⁰³ In analyzing whether a debtor’s plan has been proposed for honest and good reasons, courts regularly consider “whether the debtor intended to abuse the judicial process,” whether the plan was proposed for ulterior motives, or if “no realistic possibility for effective reorganization exists.”²⁰⁴

The third and final factor courts consider when considering a debtor’s good faith is if the debtor exhibited a fundamental unfairness when dealing with its creditors. In order to comply with this requirement, the plan “must treat all interested parties fairly and . . . efforts used to confirm the plan must comport with due process.”²⁰⁵

For SARE cases, the Eleventh Circuit has enumerated the following factors as indicative of bad faith:

- (1) The debtor has only one asset, the Property, in which it does not hold legal title;
- (2) The debtor has few unsecured creditors whose claims are small in relation to the claims of the Secured Creditors;
- (3) The Debtor has few employees;
- (4) The Property is the subject of a foreclosure action as a result of arrearages on the debt;

199. *Madison Hotel Assocs.*, 749 F.2d at 425.

200. *In re Genesis Health Ventures, Inc.*, 266 B.R. 591, 609 (Bankr. D. Del. 2001).

201. *Bank of Am. Nat’l Trust & Sav. Ass’n v. 203 N. LaSalle St. P’Ship.*, 526 U.S. 434, 453 (1999).

202. *In re Sun Cty. Dev., Inc.*, 764 F.2d 406, 408 (5th Cir. 1985).

203. *In re Integrated Telecom Express, Inc.*, 383 F.3d 108, 119 (3d Cir. 2004).

204. *Matter of Sound Radio, Inc.*, 93 B.R. 849, 853 (Bankr. D. N.J. 1988) (The court stated “[t]o find a lack of ‘good faith’ courts have examined whether the debtor intended to abuse the judicial process and the purposes of reorganization provisions”).

205. *In re Mount Carbon Metro. Dist.*, 242 B.R. 18, 39 (Bankr. D. Colo. 1999).

(5) The Debtor's financial problems involve essentially a dispute between the Debtor and the Secured Creditors which can be resolved in the pending State Court Action [if any]; and

(6) The timing of the Debtor's filing evidences an intent to delay or frustrate the legitimate efforts of the Debtor's secured creditors to enforce their rights.²⁰⁶

The above factors are not exhaustive, and no single factor is determinative.²⁰⁷ A Bankruptcy Court in the Northern District of Georgia has proposed a more extensive list of factors to consider in determining whether a petition was filed in good faith:

- (1) Whether the debtor has few or no unsecured creditors;
- (2) Whether there has been a previous bankruptcy petition by the debtor or a related entity;
- (3) Whether the pre-petition conduct of the debtor has been improper;
- (4) Whether the petition effectively allows the debtor to evade court orders;
- (5) Whether there are few debts to non-moving creditors;
- (6) Whether the petition was filed on the eve of foreclosure;
- (7) Whether the foreclosed property is the sole or major asset of the debtor;
- (8) Whether the debtor has no ongoing business or employees;
- (9) Whether there is no possibility of reorganization;
- (10) Whether the debtor's income is not sufficient to operate;
- (11) Whether there was no pressure from non-moving creditors;
- (12) Whether reorganization essentially involves the resolution of a two-party dispute;
- (13) Whether a corporate debtor was formed and received title to its major assets immediately before the petition; and
- (14) Whether the debtor filed solely to create the automatic stay.²⁰⁸

Many of these factors will be present in SARE cases. A majority of SARE cases have only a few unsecured creditors whose claims are small in relation to the claims of the secured creditor (i.e., the mortgagee).²⁰⁹ Most SARE debtors only have a few employees. SARE debtors often file cases days before the mortgagee's scheduled foreclosure on the real property. These factors will likely taint the reorganization proposal of a SARE debtor and may be enough to cause the proposed plan to fail the good faith requirement of § 1129(a)(3).

206. *In re Phoenix Piccadilly Ltd.*, 849 F.2d 1393, 1394–95 (11th Cir. 1998).

207. *Id.* at 1394.

208. *Nw. Place, Ltd. v. Cooper*, 73 B.R. 978, 981 (Bankr. N.D. Ga. 1987).

209. Cohn, *supra* note 16, at 527.

When it comes to classification and impairment issues, particularly in SARE cases, courts should focus their attention on the good-faith requirement set forth in the Bankruptcy Code.

B. Classification and Good Faith

Section 1122(a) expressly provides that only substantially similar claims may be placed in the same class.²¹⁰ It does not, however, expressly require that all substantially similar claims be placed in the same class, nor does it expressly prohibit substantially similar claims from being classified separately. Several courts, however, hold that § 1122 “must contemplate some limits on classification of claims of similar [rights].”²¹¹ This creates complexity and unpredictability.

Courts should consider avoiding the statutory construction of section 1122, and instead turn more towards notions of basic fairness and good faith. Most courts agree that separate classification of substantially similar claims is usually done to ensure that at least one impaired class of creditors accepts the plan.²¹² When this occurs, this manipulation should be viewed as an abuse of Chapter 11, thereby invoking the good-faith analysis of § 1129(a)(3), not an analysis and construction of § 1122. Under a good-faith approach, for example, separate classification of an unsecured deficiency claim created by § 1111(b) from general unsecured claims solely to create an accepting creditor class would likely be impermissible under § 1129(a)(3), but arguably not under 1122(a). Indeed, several courts have held that unsecured deficiency claims created by § 1111(b) are substantially similar to general unsecured claims, while other courts reject this conclusion and have held that these claims are not substantially similar to other unsecured claims, and thus separate classification of those claims is not only permissible, but mandatory.²¹³

Sorting out the validity of the various lines of reasoning for separation of substantially similar claims is futile because § 1122 is not ambiguous. As one judge observed: “[§] 1122 allows a claim or interest to be placed in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class. It does not require that similar classes be grouped together but merely that any group be homogenous.”²¹⁴ The legislative history of § 1122 arguably creates confusion about creative or manipulative

210. 11 U.S.C. § 1122(a) (2012).

211. *In re Greystone III Joint Venture*, 995 F.2d 1274, 1278–79 (5th Cir. 1991), *cert. denied*, 506 U.S. 821 (1992); *see also In re SM 104 Ltd.*, 160 B.R. 202, 216 (Bankr. S.D. Fla. 1993).

212. *See Emmons*, *supra* note 108, § 2.

213. *See e.g., SM 104 Ltd.* 160 B.R. at 221 (holding that deficiency claims created by § 1111(b) were required to be classified separately under § 1122(a)); *Greystone III Joint Venture*, 995 F.2d at 1280 (noting the high likelihood of detrimental effect on parties making deficiency claims); *In re Woodbrook Associates*, 19 F.3d 312, 318 (7th Cir. 1994) (discussing the different interpretations among the circuit courts).

214. *In re AG Consultants Grain Div., Inc.*, 77 B.R. 665, 674 (Bankr. N.D. Ind. 1987).

classification because § 1122 purported to be a codification of existing case law and pre-code case law was inconsistent. However, a straightforward reading of § 1122 should settle any debate. Some judges agree:

“[A] plan proponent under § 1122:

(1) may have the flexibility to place claims of a similar nature in different classes; and

(2) may not place claims of a dissimilar nature in the same class.”²¹⁵

The author agrees with this reasoning simply because the statute is unambiguous. The real issue, in the author’s opinion, always becomes one of good faith – i.e., has the debtor demonstrated that the separate classification of substantially similar claims is in good faith. These created classes should be heavily scrutinized to prevent abuse. But to be clear: creation of separate classes of substantially similar claims is not an abuse of the classification systems under section 1122. Rather, it goes to the heart of the good-faith analysis under § 1129(a)(3).

If a creditor objects to the classification scheme on gerrymandering grounds, most courts require the plan proponent to justify the classification.²¹⁶ The author agrees the plan proponent should justify the classification, but thinks the order prescribed by courts is backwards, particularly in SARE cases. Why is the onus on the creditor to point out the debtor’s improper classification attempt? The author believes courts should require SARE debtors to articulate in their proposed plans why deficiency claimants are not being grouped with other unsecured creditors. In other words, the author would push for a presumption in SARE cases that when a SARE debtor separately classifies unsecured deficiency claims – whether created by § 1111(b) or otherwise – it is not exhibiting a fundamental fairness in dealing with creditors as required by § 1129(a)(3). Under this approach, the SARE debtor must overcome the presumption of bad faith and justify any separate classification of deficiency

215. *Id.*; see also *In re City of Colo. Springs Spring Creek General Imp. Dist.*, 187 B.R. 683, 687 (Bankr. D. Colo. 1995).

The express language of § 1122 imposes only one requirement—that claims in a given class be substantially similar to each other. There is no requirement that all substantially similar claims be placed in the same class nor is there a prohibition against classifying substantially similar claims separately. Almost all courts interpreting § 1122(a) recognize that it does not prohibit separate classification of similar claims, yet many courts . . . have augmented § 1122(a) to impose restrictions on a plan proponent’s ability to separate similar claims.).

Id.

216. See *Dean*, 166 B.R. 949, 952 (Bankr. D.N.M. 1994) (debtor must demonstrate reasons apart from gerrymandering to separately classify); *In re Barakat*, 99 F.3d 1520, 1526 (9th Cir. 1996), cert. denied, 520 U.S. 1143 (1997) (business or economic justification required); *In re Tucson Self-Storage, Inc.*, 166 B.R. 892, 898 (9th Cir. 1994) (placed justification burden on debtor); *In re Heritage Org., LLC*, 375 B.R. 230, 303–04 (Bankr. N.D. Tex. 2007) (discussing when separate classification justified); see also *City of Colo. Spring Creek*, 187 B.R. at 688, n. 4 (collecting cases).

claims from unsecured claims. If the debtor rebuts the presumption by showing either (i) that the claims are *not* substantially similar, or (ii) even if they are substantially similar claims, that they were not separately classified to gerrymander a consenting class of impaired claims, the burden shifts to the creditor to show abuse. Analyzing separate classification issues in this way protects creditors from gerrymandering and other improper classification attempts, while avoiding the squabbling over the meaning of the text of § 1122(a). It also makes the confirmation process more efficient. In most cases, if the debtor separately classifies the deficiency claim from other unsecured claims, the deficiency claimant is going to file a motion objecting to the classification scheme.²¹⁷ This motion will be followed by the debtor's opposition brief. And the opposition brief will be followed by the deficiency claimant's reply brief. Requiring the debtor to rationalize the separate classification of the deficiency claim in the plan may avoid additional filings and hearings on the matters.

Of course, justifying separate classification of deficiency claims from general unsecured claims or proving that such claims are dissimilar is not an easy task. This Article does not suggest a uniform approach for scrutinizing the debtor's explanations or rationales for separate classification. It simply suggests that good faith is the proper inquiry and a presumption of bad faith should exist in SARE cases where the debtor separates deficiency claims from general unsecured claims. However, in determining whether separate classification is proper, courts could consider a few justifications or theories that the debtor would be required to set forth in its plan.

First, a court may consider whether a "legitimate business reason" exists for separately classifying the deficiency claim.²¹⁸ For example, a SARE debtor may have a strong reason to place a contentious deficiency claimant in one class separate from trade creditors. The routine extension of monthly services and supplies by a group of trade creditors might be essential to the debtor's reorganization efforts and ultimately to the survival and continuation of the debtor's business. Trade creditors may also benefit from a continuing relationship with the debtor. The same may not be true for an unsecured deficiency claimant. In *In re Richard Buick, Inc.*,²¹⁹ a car dealership's plan proposed to pay its dealer-trader claims in full while its other general unsecured claims would receive a five percent distribution on their claims. The court found that there was sufficient justification to segregate the dealer claims and offer them superior treatment:

[The witnesses] testified without rebuttal that full payment of dealer-trade claims was absolutely necessary to the future success of the

217. *Dean*, 166 B.R. at 952; see e.g., *Tucson Self-Storage, Inc.*, 166 B.R. at 895 (Merabank/RTC filed an objection to the classification plan).

218. *Barakat*, 99 F.3d at 1525.

219. *In re Richard Buick, Inc.*, 126 B.R. 840, 851 (Bankr. E.D. Pa. 1991).

Debtor's business. Not only was it needed to re-establish a good relationship with other dealers whose trades would supply a large percentage of the vehicles sold, but also this treatment was needed because both of the franchisees willing to resume a relationship with the Debtor, *i.e.*, Buick and Volvo, had made full payment of dealer-trade claims a prerequisite of their continuing respective future relationships with the Debtor. Therefore, the Debtor had good reason for allowing the degree of favorable treatment allotted to these parties.²²⁰

In *In re Georgetown Ltd. Partnership*,²²¹ the court concluded that the separate classification of an undersecured lender's deficiency claim from the claims of trade creditors was appropriate because it was a significantly larger claim and would have to be repaid over a longer period of time.²²² Additionally, the court found that the debtor intended to have a continuing relationship with its trade creditors but not the lender.²²³

Second, the debtor may be able to point to differing interests in the plan. Some creditors, such as deficiency claimants, may have different interests in plans from other unsecured creditors. This type of interest has been referred to as "non-creditor interests" and a number of courts allow for separate classification.²²⁴ Indeed, "[a] non-creditor interest can justify separate classification if it gives [the creditor] a different stake in the future viability of [the debtor] that may cause it to vote for reasons other than its economic interest in the claim."²²⁵

Lastly, the debtor could attempt to articulate why the deficiency claim is legally dissimilar from general unsecured claims – *i.e.*, why the Bankruptcy Code mandates their separateness. This approach, however, is highly unpredictable given the strong split amongst the courts.²²⁶ If the SARE debtor files its Chapter 11 case in the Ninth Circuit, for example, and the mortgagee has a third-party source of recovery for its claim (*i.e.*, from a guarantor), the SARE debtor may be able to overcome the presumption by simply articulating in its plan, and citing to *In re Loop*, that such claims are dissimilar.²²⁷ This, alone, could rebut the bad-faith presumption, as the Bankruptcy Appellate Panel

220. *Id.* at 852.

221. *In re Geo. Ltd. P'ship.*, 209 B.R. 763, 771–72 (Bankr. M.D. Ga. 1997).

222. *Id.* at 772.

223. *Id.* at 772.

224. *Id.* at 771–72.

225. *In re Tex. Star Refreshments, LLC.*, 494 B.R. 684, 696 (Bankr. N.D. Tex. 2013); *see also In re Lightsquared, Inc.*, 513 B.R. 56, 83 (Bankr. S.D.N.Y. 2014) (separate classification is justified where claimant is a competitor of the debtor); *In re Premiere Network Servs., Inc.*, 333 B.R. 130, 133 (Bankr. N.D.Tex. 2005) (a non-creditor interest in the reorganized debtor meets the "good business reason" and justifies separate classification of the creditor's claim).

226. *See Barakat*, 99 F.3d at 1524–26.

227. *In re Loop 76, LLC.*, 465 B.R. 525, 541 (B.A.P. 9th Cir. 2012).

for the Ninth Circuit holds that possessing a separate course of recovery is something different and distinct from other unsecured creditors with no similar source.²²⁸ Thus, in the Ninth Circuit, there would be no hurdle to overcome regarding separate classification of substantially similar claims, since these deficiency claimants with third-party sources of recovery are, by judicial precedent, legally dissimilar. Without a guarantor in the mix, however, the debtor would be required to articulate a legitimate business reason or non-creditor interest rationale for the separate classification.²²⁹

Similarly, where the unsecured deficiency claim was created by § 1111(b) (i.e., a non-recourse deficiency claim), a SARE debtor may be able to overcome the bad-faith presumption by arguing that unsecured deficiency claims created by § 1111(b) are not substantially similar to general unsecured claims and, therefore, separate classification is mandatory.²³⁰ Some courts agree with this line of reasoning, while other courts hold that unsecured claims and deficiency claims – regardless of their nonrecourse character – are substantially similar and should be classified together.²³¹ Like the third-party source argument, the § 1111(b) rationale for separate classification is jurisdictional and the outcomes are unpredictable. Notwithstanding, the good-faith examination puts a justified burden on the SARE debtor to articulate why deficiency claims are dissimilar from general unsecured claims or why separate classification is justified. This requirement should curb abuse in SARE cases and make confirmation more efficient and less costly for creditors.

C. Impairment and Good Faith

Like the classification issue, courts do not need to construe § 1124 and § 1129(a)(10) in order to make a determination of the artificial impairment issue. The issue comes down to the debtor's good faith in proposing such a plan.²³² Indeed, an artificial impairment analysis requires an inquiry into the debtor's motives and courts are finding this argument more persuasive than simply attacking the language and meaning of § 1129(a)(10).²³³

In *In re 203 N. LaSalle St. Partnership*,²³⁴ for example, the debtor proposed a plan in which the trade claims were not paid in full. Bank of America argued, in part, that the only reason for not paying the trade creditors in full was to create an impaired class that would vote to accept the plan. The Seventh Circuit stated:

228. *See id.* at 540–41.

229. *Id.* at 538.

230. *Id.* at 529–30.

231. *In re 500 Fifth Ave. Assoc.*, 148 B.R. 1010, 1019 (Bankr. S.D.N.Y. 1993).

232. *In re 203 N. LaSalle St. P'ship.*, 126 F.3d 955, 968–69 (7th Cir. 1997), *rev'd sub nom.*, *Bank of Am. Nat. Tr. & Sav. Ass'n v. 203 N. LaSalle St. P'ship.*, 526 U.S. 434 (1999).

233. *Id.* at 968.

234. *Id.* at 959, 963–64.

Although we have never before adopted the Eighth Circuit's "artificial impairment" test, we believe that, even assuming that the Eighth Circuit's interpretation of § 1129(a)(10) is the appropriate standard, the bankruptcy court did not err in its application here. We have noted, in discussing *In re Windsor*, that "[a] finding of 'artificial impairment' requires an inquiry into the purposes of the debtor." *In re Windsor* recognizes that the question of motivation is one for the bankruptcy court, whose resolution of the question is entitled to deference The bankruptcy court found that there were *legitimate reasons* for impairing the trade claims class. Impairing these claims allowed more money to be dedicated to the successful reorganization of the debtor. The court distinguished this situation from the one at issue in *In re Windsor* in which the only impairment was to wait 60 days to pay the "artificially impaired" class in full, and the debtor's only purpose for doing so . . . was to create an impaired class to approve the plan. In short, the bankruptcy court explicitly found that there was no lack of good faith by LaSalle's failure to pay the trade claims in full. We are not left with the definite and firm conviction that the bankruptcy court has made a mistake with respect to this issue.²³⁵

Another case in the Seventh Circuit addressed artificial impairment under § 1129(a)(10), but focused on good faith and the debtor's motivations.²³⁶ In *In re Greenwood Point, LP*,²³⁷ the debtor separately classified a secured tax claim, and proposed deferred interest payments of \$12,442.80 on the claim over two months after the effective date of the plan, despite having sufficient funds to pay the amount on the effective date.²³⁸ A creditor objected on the basis that the claim was artificially impaired for the sole purpose of obtaining acceptance by at least one impaired class pursuant to § 1129(a)(10).²³⁹ The court first found that "[i]f motivation of the debtor was to alter treatment of a class solely to obtain plan approval by at least one impaired class, and for no legitimate business purpose, the class is artificially impaired and its acceptance cannot be used to satisfy Section 1129(a)(10)."²⁴⁰ The court further found that "nothing in the Bankruptcy Code prevents a debtor from negotiating a plan in order to gain acceptance, including impairment of claims."²⁴¹ "[A] plan proponent may impair a class of claims" and "[i]f the impaired class accepts the plan, the requirement of [§] 1129(a)(10) is satisfied."²⁴²

235. *Id.* at 968.

236. *In re Greenwood Point, LP*, 445 B.R. 885, 907–08, 912 (Bankr. S.D. Ind. 2011).

237. *Id.* at 892.

238. *Id.*

239. *Id.* at 907–08.

240. *Id.* at 908.

241. *Id.*

242. *Id.*

Like classification, the author believes impairment of claims should be subject to the good faith requirement under § 1129(a)(3). Courts continue to take different views on *de minimis* impairment of claims under § 1129(a)(10). Engaging in a good faith analysis and focusing on the debtor's motives is consistent with the objectives of the Bankruptcy Code and avoids the disorder created by focusing on the language of § 1124 and § 1129(a)(10).²⁴³

The author does not necessarily contend that artificial impairment constitutes bad faith as a matter of law, but argues that, like the classification issue, a presumption of bad faith should exist in SARE cases when artificial impairment is present. The author suggests a SARE debtor can overcome this presumption by demonstrating, in its proposed plan of reorganization, that the proposed impairment is necessary for economical reasons and not just to achieve a cram down over the objecting creditor. This presumption and burden require the debtor to provide evidence in its plan concerning a valid, economical reason concerning the impairment of the class.²⁴⁴ Several recent cases seem to support this position.²⁴⁵

In a 2016 case, *Village Green I, GP v. Fannie Mae (In re Village Green I, GP)*,²⁴⁶ the debtor owed its former lawyer and accountant a total of less than \$2,400. The debtor created a separate class for those two creditors and impaired the class by proposing to pay the claims in full over sixty days rather than up front.²⁴⁷ The Debtor argued that the impairment was justified by the debtor's need to "ration every dollar."²⁴⁸ The court found the debtor's reasoning "dubious," and held that the separate classification of the claims violated § 1129(a)(3)'s good faith requirement.²⁴⁹ The only other creditor in *Village Green* was Fannie Mae, a secured creditor that was owed \$8.6 million.²⁵⁰ There were no other unsecured creditors. Furthermore, the debtor's expected monthly net income after confirmation was \$71,400, which the court found was more than enough to pay *de minimis* claims of \$2400.²⁵¹

In *In re RYYZ, LLC*,²⁵² the court discussed indicia of impermissible artificial impairment, which, again, would go to the issue of good faith. In *RYYZ*, the court found that "based on the [d]ebtor's current projections and/or the purported

243. *Id.* at 913.

244. See *KCB Bank N.V. v. Capitol Lakes, Inc.*, Nos. 16-cv-266-wmc, 16-cv-468-wmc, 2016 WL 5394767, at *18–19 (W.D. Wis. 2016); *In re RAMZ Real Estate Co., LLC*, 510 B.R. 712, 717 (Bankr. S.D.N.Y. 2014).

245. See *KCB Bank N.V.*, 2016 WL 5394767, *18–19; *RAMZ Real Estate Co., LLC*, 510 B.R. at 717.

246. *In re Vill. Green I, GP*, 811 F.3d 816 (6th Cir. 2016).

247. *Id.* at 818.

248. *Id.* at 819.

249. *Id.*

250. *Id.* at 818.

251. *Id.* at 819.

252. *In re RYYZ, LLC*, 490 B.R. 29 (Bankr. E.D.N.Y. 2013).

ability of the [d]ebtor's principles to contribute \$250,000, it would appear that the debtor" could quite easily pay the impaired amount of the claim at issue.²⁵³ In other words, proof that a debtor can "pay a higher claim if necessary was 'fatal to [the debtor's] argument that a valid business reason motivated the proposed' impairment of a lesser claim."²⁵⁴ The court further noted that the "impaired" claim "is a mere 1.7 percent of" of the objecting creditor's total claim.²⁵⁵ The court also found that "[u]nder these circumstances allowing [the *de minimis* class] to be used to cramdown [the] plan over [the objecting creditor] was 'simply inconsistent with the principles underlying the Bankruptcy Code.'²⁵⁶

In *In re Swartville*,²⁵⁷ the court denied confirmation of the debtor's Chapter 11 plan upon finding that it failed to satisfy the good faith requirement of § 1129(a)(3).²⁵⁸ In that case, with the exception of the objecting large secured creditor, "the debtor [scheduled] only four non-insider unsecured creditors... [with] claims total[ing] \$8,901."²⁵⁹ Only one ballot was cast in that class, an acceptance from a creditor with a claim of \$1,170, failing which, the debtor would not have been able to effectuate a cramdown of the secured creditor.²⁶⁰ Moreover, the original amount of the loan was \$1,615,000 and the secured creditor's claim totaled \$1,624,530, suggesting that very few payments had been made prior to filing the bankruptcy petition.²⁶¹ Lastly, and of great significance to the court, the plan provided for payment of the unsecured claims within 60 days of the plan's effective date by the guarantors; however, one of the guarantors testified that he could pay those claims immediately, and actually offered to do so during the hearing.²⁶² The evidence in that case strongly supported a finding of bad faith, resulting in denial of confirmation.

In another case also decided in 2016, a debtor's plan was not confirmable both because of improper classification and artificial impairment.²⁶³ In *In re Auttersson*, one of the creditors, Sherman & Howard, was allegedly owed \$10,000.²⁶⁴ In a surprisingly common situation, "Sherman & Howard never filed a proof of claim against the [d]ebtor", yet the debtor listed it on its schedules as an undisputed debt "of exactly \$10,000 – 'not a penny more, not a penny

253. *Id.* at 43.

254. *Id.*

255. *Id.*

256. *Id.*

257. *In re Swartville, LLC.*, No. 11-08676-8-SWH, 2012 WL 3564171 (Bankr. E.D.N.C. Aug. 17, 2012).

258. *Id.* at *4.

259. *Id.* at *5.

260. *Id.*

261. *Id.* at *1.

262. *Id.* at *1, *6.

263. *In re Auttersson*, 547 B.R. 372, 379 (Bankr. D. Colo. 2016).

264. *Id.* at 380.

less.”²⁶⁵ Sherman & Howard had also represented the debtor in several matters.²⁶⁶ The debtor placed Sherman & Howard in an “administrative convenience” class separate from other unsecured claims and “proposed to pay [it] 80% of [its] claim (i.e., only \$8,000 instead of \$10,000)”.²⁶⁷

The court held that “the [d]ebtor’s plan [was] unconfirmable because the obvious purpose of the improper classification was to manipulate and gerrymander acceptance of the plan.”²⁶⁸ In fact, the court stated that “the [d]ebtor created a bogus and artificially impaired administrative convenience class to gerrymander consent.”²⁶⁹ The court noted that small administrative expense classes are normal in bankruptcy cases because it allows a plan to reduce the number of creditors eligible to vote.²⁷⁰ “This result”, the court stated, “is accomplished by offering creditors holding small claims of perhaps a few hundred dollars each a 100% payment and thus providing that they are not impaired.”²⁷¹ The court found that “[b]y doing so, the debtor avoids the cost of sending disclosure statements, soliciting votes from the *de minimis* creditors, and making fractional distributions.”²⁷² But that is not what the debtor did in *Auttersen*. It “did the opposite.”²⁷³ It “decided to pay [its law firm] only 80% (instead of 100%) of the [] claim in order to create an impaired class that could vote in favor [of its plan].”²⁷⁴ The court noted that “there may be legitimate reasons not to propose full payment in some proceedings” but “the debtor offered no evidence or explanation to justify creating the separate administrative convenience class and then impairing it.”²⁷⁵ Thus, “the court easily conclude[d] that the [d]ebtor artificially impaired” that class of claims.²⁷⁶

Based on the foregoing, the author offers two conclusions when impairment of *de minimis* claims exist in SARE cases. First, the issue of artificial impairment goes to § 1129(a)(3). Second, economic justification for impairment should be the sole factor in the good faith determination. Some courts appear to be following this good-faith analysis with economic considerations. For example, in a case focusing on good faith and inquiring into the motives of the debtor for creating and impairing a small class, the Bankruptcy Court for the Central District of California stated that “this smells . . . like a device to create

265. *Id.* at 395.

266. *Id.* at 394.

267. *Id.* at 395–97.

268. *Id.* at 396.

269. *Id.*

270. *Id.* at 397 (citing *In re Mastercraft Record Plating, Inc.*, 32 B.R. 106, 108 (Bankr. S.D.N.Y. 1983)).

271. *Id.* at 397.

272. *Id.*

273. *Id.*

274. *Id.*

275. *Id.*

276. *Id.*

an impaired consenting class.²⁷⁷ The court noted that “a doctrine has emerged that that ‘artificial impairment’ is a form of gerrymandering and when abusively used is held to be *antithetical to the good faith* which must be at the center of any reorganization effort.”²⁷⁸ As such, the court held that “the plan’s proposal in ‘good faith’ necessary under § 1129(a)(3) is consequently also left very much in doubt. Debtor bears the burden on this and that burden is not carried.”²⁷⁹ The Bankruptcy Appellate Panel for the First Circuit similarly stated that,

[w]here the plan contemplates the debtor’s continuation in business and the reasonable cash needs of that business – to meet accrued and foreseeable expenses and to make reasonable provision for contingencies – require some or all of the cash on hand that might otherwise be paid to plan creditors on confirmation, that need justifies the plan’s deferment of payment to the plan creditors.²⁸⁰

Case law clearly supports the proposition that impairment of *de minimis* claims without economic justification is relevant to the good-faith inquiry and, indeed, antithetical to Chapter 11 reorganization.²⁸¹ The issue in these types of

277. *In re NNN Parkway 400 26, LLC*, 506 B.R. 277, 285 (Bankr. C.D. Ca. 2014).

278. *Id.* (emphasis added).

279. *Id.*

280. *Poncebank v. Mem’l Prods. Co., Inc.*, 212 B.R. 178, 184 (B.A.P. 1st Cir. 1997).

281. When a court makes findings of bad faith under § 1129(a)(3) for improper classification or artificial impairment, the analysis should not necessarily end. Findings of bad faith under § 1129(a)(3) may also support the conclusion that the votes associated with the impaired class should be designated. Section 1126(e) provides:

On request of a party in interest, and after notice and a hearing, the court may designate any entity whose acceptance or rejection of such plan was not in good faith, or was not solicited or procured in good faith or in accordance with the provisions of this title.

11 U.S.C. § 1126(e) (1984).

The provision “grants the bankruptcy court discretion to sanction any conduct that taints the voting process, whether it violates a specific provision or is in ‘bad faith.’” *Century Glove, Inc. v. First Am. Bank of New York*, 860 F.2d 94, 97 (3d Cir. 1988). Like “good faith,” “bad faith” is also not defined and its meaning has been left for development under the case law. The cases have generally recognized two types of bad faith: (1) “where a claimholder attempts to . . . extort a personal advantage not available to other creditors,” or (2) “where the [claimholder] acts in furtherance of an ‘ulterior motive.’” *In re DBSD N. Am., Inc.*, 421 B.R. 133, 138 (Bankr. S.D.N.Y. 2009); see *In re Dune Deck Owners Corp.*, 175 B.R. 839, 844 (Bankr. S.D.N.Y. 1995). Although the decisions generally focus on the voting creditor’s motive, § 1126(e) is much broader: “it provides a basis to designate, without regard to the creditor’s motive, where the vote is ‘solicited or procured’ in bad faith.” *In re Quigley Co., Inc.*, 437 B.R. 102, 130–31 (Bankr. S.D.N.Y. 2010).

Black’s Law Dictionary defines “procurement,” as “[t]he act of getting or obtaining something or bringing something about.” BLACK’S LAW DICTIONARY 1327 (9th ed. 2009). Webster’s has defined it similarly to mean “to get possession of,” “to cause to happen or be done: bring about,” and “to prevail upon to do something indicated.” WEBSTER’S THIRD NEW INTERNATIONAL DICTIONARY 1809 (1981).

Does § 1126(e) give creditors an additional vehicle to thwart single-asset real estate cases by “designating” votes “procured” or otherwise tainted by improper classification and artificial impairment? The author argues it does. The consequence of a designation under § 1126(e) is that the vote is disregarded in the counting of votes to determine whether a class has accepted or rejected

cases is not whether the claims are impaired, as the Code defines them, but whether the debtor impaired them without justification. Arguments about the Code's definition of impairment and the proper construction of the statutory text is ineffective and results in inconsistent case law.²⁸² When improper impairment is the issue, the debtor must address § 1129(a)(3).²⁸³ As stated by the Fifth Circuit, "though we reject the concept of artificial impairment as developed in *Windsor*, we do not suggest that a debtor's methods for achieving literal compliance with § 1129(a)(10) enjoy a free pass from scrutiny under § 1129(a)(3)."²⁸⁴ Indeed, "a plan proponent's motives and methods for achieving compliance with the voting requirement of § 1129(a)(10) *must* be scrutinized, if at all, under the rubric of § 1129(a)(3)."²⁸⁵ This level of scrutiny should be heightened in SARE cases with a presumption of bad faith when impairment of *de minimis* claims exists. This presumption can be overcome with evidence showing economic justification for such impairment. This framework does not operate decisively to block reorganization in SARE cases, but it should operate to curtail abuses of the bankruptcy process.

IV. CONCLUSION

The conflict over improper classification and artificial impairment is widely prevalent in SARE cases.²⁸⁶ The current approaches developed by the courts yield confusion and make the reorganization process in SARE cases needlessly complex, costly, and unpredictable.²⁸⁷ Courts can avoid these problems by analyzing improper classification and artificial impairment issues under the good-faith requirement found in § 1129(a)(3) of the Bankruptcy Code, which must be satisfied for the confirmation of any proposed plan of reorganization.²⁸⁸

Because there is a strong likelihood in SARE cases that isolation of deficiency claims and impairment of friendly *de minimis* claims is being utilized for the

the plan. *In re Save Our Springs Alliance, Inc.*, 388 B.R. 202, 230 (Bankr. W.D. Tex. 2008). This paper recognizes courts may have issues with this argument. Section 1126(e) does not specifically refer to a bad faith creation of a claim as a basis to designate a vote. On a strict reading, it only applies to bad faith in the solicitation or procurement of the vote, not to the creation of the claim on which the vote is cast. Notwithstanding, the author believes procurement should be read broadly and could stretch to implicate situations where the debtor purposefully creates a class an accepting impaired class through improper classification or artificial impairment.

282. See *supra* notes 164–89 and accompanying text.

283. *In re Village at Camp Bowie I, L.P.*, 710 F.3d 239, 247–48 (5th Cir. 2013); see generally *supra* notes 189–204.

284. *Village at Camp Bowie*, 710 F.3d at 239.

285. *Id.* at 247.

286. See *supra* Part IV (discussing improper classification and artificial impairment issues in SARE cases).

287. See *supra* Part IV (noting that classification issues in SARE cases result in numerous challenges to successful reorganization).

288. *In re Village Green I, GP*, 811 F.3d 816, 819 (6th Cir. 2016) (discussing the general requirement that reorganization plans pass review under the § 1129(a)(3) good faith standard).

sole purpose of achieving a forced confirmation over the objection of a truly harmed creditor, a presumption should exist that the SARE debtor is not exhibiting a fundamental fairness in dealing with its creditors as required by § 1129(a)(3).²⁸⁹ With no explanation or justification, courts have been placing the burden on creditors to prove that the debtor has not proposed its plan in good faith, after which the burden shifts to the debtor to demonstrate the existence of good faith in its proposal of its plan.²⁹⁰ This burden-shifting scheme – particularly in SARE cases – is backwards and prejudicial to creditors. It should be the debtor that shoulders the initial burden.

When it comes to separate classification of deficiency claims, the SARE debtor may overcome the bad-faith presumption by showing that the deficiency claim is either (1) not substantially similar to other unsecured claims or (ii) that it is not being separately classified to gerrymander a consenting class of impaired claims.²⁹¹ Similarly, *de minimis* impairment of claims under § 1129(a)(10) would require the SARE debtor to provide evidence in its plan concerning a valid, economical reason concerning the impairment of the class.²⁹² Case law supports this proposition and the abuse found in SARE cases warrants a change and some uniformity.²⁹³

289. See generally *supra* Part IV (analyzing how a new bad faith presumption would interact with the current framework of Chapter 11 reorganization).

290. See *supra* note 215; see also *In re Dean*, 166 B.R. 949, 952 (Bankr. D.N.M. 1994); *In re Barakat*, 99 F.3d 1520, 1523 (9th Cir.1996), *cert. denied*, 520 U.S. 1143 (1997) (illustrating generally the burden on creditors to challenge improper classifications).

291. See generally *supra* Part IV.

292. *In re Tucson Self-Storage, Inc.*, 166 B.R. 892, 898 (B.A.P. 9th Cir. 1994) (discussing the importance of a valid business or economic justification for a separate classification structure in a reorganizing plan).

293. *Id.*