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Creditor and Debtor Burdens When Confirming a Chapter 11

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Creditor and Debtor Burdens When Confirming a Chapter 11 Reorganization Plan

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Introduction

In Chapter 11 bankruptcy, after a debtor has submitted a reorganization plan, the creditor has the right to vote on that plan.[1] However, the right to vote on that plan is grounded in the understanding that the creditor will not vote against a debtor's reorganization plan in bad faith.[2] If a court finds that the creditor rejected the plan in bad faith, the court may "designate" the votes of the creditor that voted against the plan.[3] But the issue of good faith does not solely lie with the creditor's behavior. Reorganization under Chapter 11 also demands that the debtor put forward a plan that is in good faith.[4] Further, the plan must protect creditors by assuring that they will not receive an amount that is less than the amount they would receive under Chapter 7 liquidation.[5]

This article will examine the meaning of good faith on the part of the debtor, good faith on the part of the creditor, and the protection of the debtor's financial investment through the

[1] *See* 11 U.S.C. § 1126(a), "[t] the holder of a claim or interest . . . may accept or reject a plan."
[2] *See id.* at § 1126(e).
[3] *Id.* "Designate" in bankruptcy, means to effectively "set aside" the creditor's votes, rendering them irrelevant to the reorganization plan's approval.
[4] *See* 11 U.S.C. § 1129(a)(3), "court shall confirm a plan only if . . . [t]he plain has been proposed in good faith and not by any means forbidden by law."
[5] *Id.* at § 1129(a)(7).

reorganization. Part I examines what constitutes good faith on the part of a creditor who votes against a reorganization plan, and how far they may go in protecting their interests before a court opts to grant the debtor's request to designate the creditor's vote. Part II examines how a debtor may satisfy its good faith requirement when proposing the plan. Finally, Part III discusses the requirement that the creditor be protected by the maintenance of parity in the recovery of the debt under Chapter 11 reorganization versus Chapter 7 liquidation.

I. Creditor's Good Faith When Voting Against Reorganization

Under title 11 of the United States Code (the "Bankruptcy Code"), creditors have the right to vote for or against a debtor's submitted reorganization plan, and when that vote is not cast in good faith, the courts may disregard these votes in a process known as designation.[6] The task of defining what constitutes good faith (or bad faith), however, has no specific explanation in the statutory language and has been left to case law.[7] The bankruptcy court in *In re Adelphia Communications Corp.*[8] highlighted some instances where bad faith could exist. The *Adelphia* court stated that bad faith can exist where: (1) the claimant used obstructive tactics and hold-up techniques to get better treatment for its claim in comparison to others in the sale class, (2) the holder casts a vote with an ulterior purpose of securing an advantage it would otherwise not have, or (3) the motivation behind the vote is not consistent with a creditor's protection of its

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[6] *See* Figter Ltd. v. Teachers Insurance and Annuity Ass'n of America (*In re* Figter Ltd.), 118 F.3d 635, 638 (9th Cir. 1997) ("[T]he court may designate any entity whose acceptance or rejection of [a] plan was not in good faith, or was not solicited or procured in good faith or in accordance with the provisions of this title.").
[7] *See In re* DBSD North America, Inc., 421 B.R. 133, 137 (Bankr.S.D.N.Y. 2009) (stating that the concept of good faith has been "left to case law"). *See also In re* Landing Assoc. Ltd., 157 B.R. 791, 802 (noting that the term "good faith" was left "intentionally undefined").
[8] 47 B.R. 54 (Bankr. S.D.N.Y. 2006).

own self-interest.[9] On the whole however, courts are generally reluctant to designate the vote of a creditor, even if it appears that the vote was done for purely selfish reasons.

For example, in *In re Monticello Realty Investments, Inc.*,[10] the bankruptcy court held that a bank did not act in bad faith when it purchased a class of unsecured debt from another creditor in order to have the votes necessary to veto the debtor's reorganization plan.[11] The debtor, a realty investor, and the bank debated the inclusion of new loan documents that the bank claimed were "standard."[12] In order to ensure that the debtor's plan would not be able to acquire the requisite amount of votes to be confirmed, the bank bought the unsecured claim from a credit card company.[13] The bank's manager explained that had the plan been approved without the new loan documents being included, the FDIC would negatively rate the debt.[14] The debtor moved to have the bank's ballots designated (disregarded) pursuant to 11 U.S.C. § 1126(e), stating that the bank exhibited bad faith because it wanted to dictate the terms of the new loan documents, ceased negotiation over the new terms before the court ordered expiration deadline, and purchased other claims in order to have the requisite number of votes.[15] The court disagreed, however, finding that because the execution of the new loan agreements was a crucial element to

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[9] *See id.* at 60.
[10] 526 B.R. 902 (Bankr. M.D. Fla. 2015).
[11] *Id.* at 910. The bank in this case was a secured creditor, and opted to foreclose on the property in lieu of negotiating a new payment plan. *Id* at 906.
[12] *Id.* at 908. The bank's manager testified that the terms "[had] to be supported by loan documents which protected [the bank's] collateral and provided customary rights and remedies."
[13] *Id.*
[14] *See id.* at 908. The bank's manager explained that this negative rating would stem from a lack of cross default from the nonpayment of taxes, along with the debtor's history of failing to pay taxes in the past. This would then have to be reported to shareholders.
[15] Monticello, 526 B.R. at 910.

the bank, the purchase of other claims to ensure the plan would not succeed was not in bad faith.[16]

Although this may seem to fall within the "ulterior purpose" classification laid out by section 1126(e), courts have noted that simply being selfish does not equate to an ulterior motive. In *In re Federal Support Co.*,[17] the 4th Circuit explicitly stated that "[o]ne's self interest . . . does not provide an ulterior motive."[18] In that case the creditor voted against a reorganization plan in order to protect itself from the potential harm that it could suffer because of a pending antitrust suit.[19] The court classified this action as simply being in self interest, defining ulterior motives as "pure malice, strikes, blackmail and to destroy an enterprise in order to advance a competing business."[20] Thus, while the act was one of self interest, it was not bad faith, and was therefore a legitimate use of a creditor's voting power.[21] Likewise, in *In re Figter*,[22] the Ninth Circuit held that no bad faith existed when a bank purchased 21 unsecured claims to ensure that the debtor would not have enough votes to pass its reorganization plan.[23] Although the court noted that the reorganization plan seemed feasible, the Ninth Circuit noted that it "would not condemn mere enlightened self interest, even if it appears selfish to those who do not benefit from it."[24] That selfishness is tolerated as long as the "interest being served is that of a creditor as creditor."[25] The courts, on the whole, are simply reluctant to designate a creditor's right to vote on a

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[16] *Id.*
[17] 859 F.2d 17, 19 (4th Cir. 1988).
[18] *Id.* at 20.
[19] *Id.* at 18.
[20] *Id.* at 19.
[21] *Id.* at 20 ("Insinger is entitled to cast its vote in accordance with its perception of self-interest, and nothing suggests that Insinger was motivated by any other interest or purpose.").
[22] 118 F.3d 635 (9th Cir. 1997).
[23] *Id.* at 637.
[24] *Id.* at 639.
[25] *In re* DSBD, 421 B.R. at 139 (quoting Collier on Bankruptcy, 7 *Collier on Bankruptcy* ¶1126.06[2] (15th Ed. Rev. 2009).

reorganization plan. It is cited as the exception rather than the rule, because it is considered a "drastic remedy."[26]

While the case law does appear to favor the creditor when considering whether designation is the appropriate course of action, there is case law to the contrary. For example, the court in *In re DSBD* examined a situation where a creditor – who was not an original creditor – bought claims in order to have the debtor's reorganization plan fail, in order to be in a position where the debtor could be acquired.[27] The court noted that the ulterior motive was confirmed by the internal memos of that creditor, and that the ulterior motive could have been determined by the fact that the new creditor bought the debt at par value.[28] According to the Southern District of New York, this was more than "most other creditors could only hope [for]."[29]

Likewise, in *In re Quigley Co*.,[30] the court designated the votes for a reorganization plan, because the confirmation of the plan was based on settlement agreements with the creditors. [31] There, the debtor was a manufacturer of asbestos related products, and became involved in litigation related to its asbestos products.[32] The creditor then entered into settlement agreements with various creditors, but made the agreements subject to the confirmation of its reorganization plan.[33] In designating the votes cast in favor of the reorganization plan, the court stated that "a

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[26] *In re* Adelphia, 47 B.R. at 60.
[27] *In re* DSBD, 421 B.R. at 141.
[28] *See id.* at 112 n. 18.
[29] *Id.* at 135. The court relied on the ruling *In re* Allengheny Int'l, Inc., 118 B.R. 282 (Bankr. W.D. Pa. 1990). Bankruptcy court found fraud where the creditor purchased claims in order to gain a favorable position where it could acquire its competitor.
[30] 437 B.R. 102, 131-32 (Bankr. S.D.N.Y. 2010).
[31] *Id.*at 131-32.
[32] *See id.* at 112.
[33] *Id.* at 131 (stating that the debtor "paid cash to the Settling Claimants . . . and promised a second payment if any . . . plan was confirmed.")

plan based on [an] agreement that secures an advantage for the insiders at the expense of [other] creditors is not one proposed in good faith."[34]

The unusual cases noted above involving a latecomer creditor, and conspirators, are extreme examples of what constitutes bad faith, however. Absent similarly unusual circumstances, a court is simply unlikely to grant any request to designate the creditor's vote, even if ostensibly for selfish purposes. However, debtors must also satisfy requirements in order to have the reorganization plan supported by a court.

II. Debtor's Good Faith When Proposing A Reorganization Plan

Section 1129(a)(3) notes that a court can confirm a plan if it has been "proposed in good faith and not by any means forbidden by law."[35] Like the good faith standard laid out for the creditor's vote, a debtor's good faith is also left undefined. The *Monticello* court defined the debtor's good faith as being a consideration of "the totality of the circumstances."[36] The court stated that the totality of the circumstances is determined by "focus[ing] on the plan and the plan's ability to achieve the objectives of the Bankruptcy Code."[37]

In *Monticello*, the bank argued that the plan was proposed in bad faith because the debtor wanted to avoid a significant tax liability if the property were liquidated.[38] The court rejected this however, finding that good faith indeed existed, because the debtor increased the occupancy of the property at issue from 56% to 83% in two years.[39] The court viewed this factor as

[34] *Id.* Although the court used the term "insiders," the context appears to mean "conspirators."
[35] *See* 11 U.S.C. § 1129(a)(3).
[36] *See In re* Monticello, 526 B.R. at 914.
[37] *See id.* at 914.
[38] *Id.*
[39] *Id.*

dispositive, stating that the increase demonstrated the debtor's "desire to remain open and continue to operate."[40]

Conversely, actions that are intended to conceal the debtor's true intentions are almost considered *per se* bad faith. For example, in *In re Proud Mary Marina Corp.*,[41] the court found that the debtor, an operator of a mobile home park, exhibited bad faith in the proposal of its reorganization plan.[42] There, the principals of the debtor executed a handwritten contract to sell the property, knowing that the sale of the property while in bankruptcy would require the Bankruptcy Court's approval.[43] However, the agreement was never disclosed.[44] In its decision finding bad faith, the court noted that "[t]he single, most important factor in determining that the Plan was not proposed in good faith is the Debtor's knowing concealment from the Court of the contract to sell substantially all of its assets."[45] This plan was "intended to abuse the juridical process and the purpose of the reorganizations provisions and was therefore not in good faith."[46]

III. Protection of the Creditor's Financial Standing in a Plan

Not only must the debtor's proposal be proffered in good faith, it must also financially protect the creditor. Under section 1129(a)(7), the debtor, in offering their plan, must prove that the creditor "will receive or retain under the plan . . .property of a value . . . that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under Chapter 7."[47] Effectively, this means that the debtor's plan must pay out an equivalent amount in

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[40] *Id.*
[41] 338 B.R. 114 (Bankr. M.D. Fla. 2006).
[42] *Id.* at 124.
[43] *Id.*
[44] *Id.*
[45] *Id.*
[46] *Id.* at 123 (quoting *In re* Bravo Enterprises, 331 B.R. 459, 472 (Bankr. M.D. Fla. 2005)).
[47] *See* 11 U.S.C. § 1129(a)(7).

Chapter 11 bankruptcy that the creditor would have received under liquidation through Chapter 7.

According to the court in *In re Smith*, proof that the reorganization plan is in the best interests of the creditor requires that the debtor perform a liquidation analysis of the estate.[48] There, the debtors failed to conduct a liquidation analysis, and the court rejected the plan for a lack of proof of its feasibility.[49] For example, the court noted that there was no proof given that the 10% dividend proposed by the debtor matched what the unsecured creditors would have received had there been a liquidation analysis.[50] Therefore, because this key factor was missing, the plan was effectively dead on arrival.

But even the presence of a liquidation analysis is no guarantee of a plan being granted. The *Monticello* court rejected the liquidation analysis done by the debtor.[51] To prove that the plan would work, the court stated that a debtor would have to prove "by a preponderance of the evidence . . . that the bank would receive or retain property that is of value not less than . . . what the bank would receive under Chapter 7."[52] The debtor in that case agreed with the bank's valuation of the property at $1.4 million, but stated that a Chapter 7 liquidation would only recover a "fraction" of the property value, and put the bank and other creditors at risk of only partial payment or no payment at all.[53] The court found that the valuation was done via an "off the cuff estimation," which it found was not a sufficient method of analysis.[54] Furthermore, the

[48] 357 B.R. 60, 67 (Bankr. M.D. N.C. 2006) (citing *In re* MCorp Fin., Inc., 137 B.R. 219, 228-29 (Bankr. S.D. Tex 1992).
[49] *Id.*
[50] *Id.*
[51] 526 B.R. at 915.
[52] *Id.*
[53] *Id.*
[54] *Id.* (quoting *In re* Smith, 357 B.R. at 67 ("there must be a liquidation analysis of some type that is based on evidence and not mere assumptions or assertions.")).

court noted that the debtor's plan did not propose to pay the secured creditors, nor the unsecured creditors in full.[55] Therefore, the plan was denied.

While it is true that the debtor has the burden of proving that the Chapter 11 plan will provide the creditor with property of a value that is not less than what they would receive under Chapter 7, this prong is not a hindrance to the debtor. In *Matter of Briscoe Enterprises, Ltd.*, the debtor easily met its burden when it showed that the section 1129(a)(7) factor was satisfied.[56] There, under the reorganization plan, the creditors were to receive $8.2 million, and the liquidation assessment conducted by the Bankruptcy Court found that the property would have had a value of $8.2 million.[57] Furthermore, the payout under the reorganization plan also included interest payments for the delay in payment.[58] Thus, the reorganization plan was effectively the better option for the creditor.[59]

Implications

The well-settled case law for reorganization plans does not break any new ground, but rather shows that the debtor carries the greater burden when trying to get that plan approved by a court. A creditor who does not support the reorganization plan is effectively allowed to act in an extremely selfish manner (absent extraordinary circumstances), even if the debtor has proposed the plan in good faith and the creditor stands to do just as well as it would if the property were liquidated. This has the possibility of allowing creditors to act in bad faith, while objectively appearing only "selfish."

Conclusion

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[55] *Id.*
[56] 994 F.2d 1160, 1168 (5th Cir. 1993).
[57] *See id.*
[58] *Id.*
[59] *Id.* at 1168 ("[The debtor] may wish to cut its losses now rather than wait and see if it may eventually receive more . . .").

The statute does not instruct the courts on how to balance these factors, but greater weight should be given to plans which effectively give the creditor the same amount that it would have gotten under Chapter 7 liquidation. It stands to reason that if the creditor—secured or unsecured—will receive the money owed to it, and an enterprise is saved in the process, then it is an economic win for both parties.