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Understanding The Contents Of A Chapter 11 Plan

Law360, New York (July 30, 2013, 10:31 AM ET) -- In formulating and drafting a Chapter 11 plan, a number of considerations must be taken into account. The debtor must determine whether its business can be reorganized or should be sold while working within the framework of the Bankruptcy Code to achieve confirmation. Further, if the debtor believes a reorganization is achievable, the debtor must determine how to reposition its business for success and make sure that, whatever its ultimate business plan, it can obtain financing to support that plan. After addressing the business issues and developing a business plan (or determining to pursue a sale), the debtor then must turn to developing its Chapter 11 plan.

While the mechanics of structuring a successful plan are many and varied, there are certain provisions required to be included in a plan and certain provisions that the Bankruptcy Code recognizes as being optional. In considering whether to confirm a plan, a court will pay close attention to all provisions to determine whether the plan complies with the applicable provisions of the Bankruptcy Code.

Mandatory Provisions

Section 1123(a) sets forth the following seven provisions that must be included in every Chapter 11 plan other than a plan for an individual.

Designation of Classes of Claims and Interests

Pursuant to Section 1123(a)(1), a plan must designate separate classes of claims and classes of interests subject to Section 1122, which governs the classification of claims and interests. According to Section 1122(a), as a general matter, each class of claims or interests must consist of substantially similar claims or interests, as the case may be.

For example, a plan will typically designate separate classes for: (1) secured claims secured by the same collateral (secured claims are often separated into subclasses according to the debtor’s capital structure); (2) unsecured claims of similar type and priority; and (3) equity interests, among others.

In practice, for a debtor with a simple capital structure, the plan may only have three or four classes: one for the secured lender, one for trade and other unsecured creditors, and one for common stock interests. In a much more complicated capital structure, where there are multiple debtor entities, each with multiple creditors with liens on different assets (and some with a lien on the same assets but in different priorities), multiple unsecured bond issuances (some senior and some subordinate), numerous unsecured creditors, and various equity interests (including multiple series of preferred and common stock), there may be dozens of different classes in a plan.

Moreover, for multiple debtor entities, the plan may be drafted as including multiple “subplans” for each debtor entity, so each class will have multiple subclasses for each debtor. For example, if five of the debtors are obligors under a credit agreement and credit agreement claims are in Class 1 for the main debtor, for the second debtor obligor, those claims will be in Class 1B, the claims will be in Class 1C for the third obligor, and so on.

Parties may object to classifications as improper on any number of grounds. For example, the debtor may place the holder of a hybrid security issued by the debtor in a class of interests, while the holder of the security may object on the basis that it should be classified as a claimholder, and not an interest holder. Conversely, a party, typically an equity holder or subordinated creditor, may argue that the claim of another party should be classified as equity rather than as debt.

Additionally, parties may argue that the claims or interests within a particular class are not substantially similar, as required by Section 1122(a), and therefore should be classified separately. Conversely, parties may argue that claims or interests that are substantially similar are impermissibly separated because the debtor does not have a valid business or financial reason for placing the claims in separate classes. While these objections may be brought because the objector is unhappy with the treatment being provided on account of its claim or interest, they may also be motivated by concerns about voting power or gerrymandering. For example, a particular stakeholder may argue that it should be part of a certain class if it is concerned that such a class will otherwise vote to accept the plan, which may enable the debtor to confirm the plan.

Although a plan must classify claims and interests, a plan is not required to classify three types of priority claims. These priority claims are, generally:

- administrative expenses, including professional fees;
- claims arising between the filing of an involuntary bankruptcy case and the entry of an order granting relief, commonly referred to as “involuntary gap claims;” and
- unsecured claims for certain tax obligations, as set forth in Sections 507(a)(2), 507(a)(3) and 507(a)(8), respectively.

Specification of Unimpaired Classes

Pursuant to Section 1123(a)(2), a plan must specify any classes that are not impaired under the plan. As explained in detail below, a class is not impaired if the plan either: (1) leaves unaltered the legal, equitable and contractual rights of the creditors or interest holders in such class, or (2) cures all defaults (other than those based on the debtor's financial condition, the commencement of the bankruptcy case, or the appointment of a trustee as custodian), reinstates the maturity of the claim or interest, and compensates the holder of such claim or interest for any damages.

In order to leave unaltered the legal, equitable and contractual rights of the holders in a class, the plan must not provide for any change in treatment of the claims or interests of those holders. For example, if the relevant agreement provides that certain claims are to be paid in cash on a certain date, the plan must provide that the claims will be paid, in accordance with the agreement, in cash on that date. The plan may not change any contractual provision or encumber any right that such a holder may have against the debtor. A more detailed discussion regarding this topic can be found in the subsection titled Impairment of Claims or Interests in the Optional Provisions section of this article.

An unimpaired class is conclusively presumed to have accepted the plan pursuant to Section 1126(f). The plan proponent, therefore, does not have to solicit votes from an unimpaired class.

Specification of Treatment of Impaired Classes

Pursuant to Section 1123(a)(3), a plan must prescribe treatment of the impaired classes of claims or interests.

Treatment refers to the way in which the Chapter 11 plan will handle and affect an impaired class of claims or interests. A plan can treat an impaired class in any number of ways. For example, the plan may provide for:

- the payment of claims in full over time;
- the partial payment of the claims;
- the conversion of claims to equity;
- the exchange of one kind of security of the debtor for another kind of security of the debtor;
- the exchange of a security of the debtor for a security of a new entity;
- the cancellation of unsecured claims or interests; or
- full or partial payment in kind of claims or interests (i.e., payment in a medium other than cash).

Many varying factors unique to each debtor and bankruptcy case, including the company's balance sheet, business plan, workforce, financeability and industry, will affect which classes will be impaired under a plan. Impairment may depend on, for example, the value of the estate, the debtor's ability to service debt, the amount of cash on hand, the nature and type of the debtor's business and its particular assets and liabilities, the importance of a quick exit from Chapter 11, and the debtor's need to maintain a good relationship with the stakeholders in a particular class, such as a class of customers or trade vendors.

If the plan does not provide for the payment in full of all creditors, and a class votes to or is deemed to reject the plan, the debtor may have to use the cramdown provisions of the Bankruptcy Code to achieve confirmation. In such instances, the debtor attempts to confirm the plan over the objection of stakeholders that are entitled to receive less than full payment, or nothing, under the plan. Such stakeholders may oppose the cramdown on the basis that the estate assets are undervalued, and, pursuant to an accurate valuation, they are entitled to receive more payment than the plan provides.

If a creditor seeks to exert greater control over the process or to affect its ultimate treatment, a creditor or interest holder may buy a blocking position of claims in its class in order to control the vote of the class and to obtain leverage in negotiations with the debtor. The success of a blocking position depends on a number of factors, including the size of the class, the amount of the claims in the class, whether the stakeholder has the support of the relevant committee, and where the class falls in the plan's distribution scheme.

In order for this method to be effective, the stakeholder should buy into a class of claims that would be entitled to a distribution in the Chapter 11 case, but that the debtors would not be able to leave unimpaired, otherwise known as a "fulcrum class." To counteract this tactic, the debtor can attempt to preemptively place such a creditor in a class with other claims so as to dilute the creditor's relative holdings and, accordingly, power. The debtor, however, may not gerrymander the class for this purpose and needs to have a legitimate basis to classify the creditor's claim together with other claims or separate from other claims. Also, a blocking position does not eliminate the possibility of a cramdown, but would give such creditors a better chance at participating in the negotiations with respect to the restructuring.

Equality of Treatment of Each Claim or Interest within Class

Pursuant to Section 1123(a)(4), a plan must provide the same treatment for each claim or interest within a particular class. Treatment of claims may be found to be unequal when, for example, one creditor or interest holder is asked to relinquish certain rights that other members of the class are not. Thus, for example, a plan cannot provide that holders within a class that vote to accept the plan receive a greater distribution than holders within the class that reject the plan. A holder of a particular claim or interest may, however, agree to a less favorable treatment of its claim or interest than that of the other members of its class.

In practice, a holder would not agree to accept worse treatment than other similarly situated stakeholders absent unusual circumstances, such as the treatment being part of a settlement of other issues, the stakeholder is an insider of the debtor, or the stakeholder wants to preserve a business relationship with the debtor. Additionally, in certain circumstances, a stakeholder may prefer to receive stock in the reorganized debtor rather than accept, for example, a percentage of its claim in cash because the holder believes that the equity will ultimately yield more value than the amount of the cash it would receive.

By agreeing to take "less favorable" treatment in the form of equity, while the rest of the class is cashed out, the stakeholder can receive a greater percentage of equity. Of course, if other stakeholders in the class are also interested in receiving equity, such stakeholders may dispute the fact that receiving equity is less favorable than the cash distribution.

Adequate Means for Implementation

Pursuant to Section 1123(a)(5), a plan must provide adequate means for the plan's implementation. Although typically referred to as a plan of reorganization, a Chapter 11 plan may provide anything from a complex, comprehensive restructuring of a debtor's business and its related obligations to a simple liquidation of its assets and distribution of the proceeds. The Bankruptcy Code provides the following 10 nonexclusive illustrations of provisions that may be used, whether in concert or independently, to provide adequate means of implementation:

- The plan may provide that the debtor will retain all or any part of the estate's property;
- The plan may provide for the transfer of all or any part of the estate's property to one or more entities, whether organized before or after the confirmation of the plan;
- The plan may provide for the merger or consolidation of the debtor with one or more persons;
- The plan may provide for the sale of all or any part of the estate's property, either subject to or free of any lien, or the distribution of all or any part of the estate's property among those having an interest in such property;
- The plan may provide for the satisfaction or modification of any lien;
- The plan may provide for the cancellation or modification of any indenture or similar instrument;
- The plan may provide for the cure or waiver of any default;
- The plan may provide for the extension of a maturity date or a change in an interest rate or other term of outstanding securities;
- The plan may provide for the amendment of the debtor's charter; and
- The plan may provide for the issuance of securities of the debtor or of any entity to which property is transferred or with which the debtor is merged or consolidated, for cash, for property, for existing securities, in exchange for claims or interests, or for any other appropriate purpose.

In structuring a Chapter 11 plan, there are numerous other ways that a debtor can provide value to certain constituencies, particularly those that may be "out of the money" and thus, not entitled to a distribution. For example, the plan may provide for the issuance of warrants to junior stakeholders that provide the stakeholders with the right to buy shares at a given price within a fixed period of time. The price is often a discounted price, but the price may be any price set in the plan.

If, for example, a class of equity that is entitled to receive nothing under the plan based on the debtor's valuation disputes that valuation as too low, the plan proponent may provide that class with warrants struck at a price that pays all of the creditors in full. If the reorganized debtor appreciates in value while the warrants are outstanding such that the warrants become "in the money," the warrant holders get to share in that value.

Another implementation tool to obtain liquidity and that may also provide a mechanism for out-of-the-money constituents to receive a recovery is the inclusion of a rights offering in the plan. Pursuant to a rights offering, the debtor issues to a specified class (or classes) rights to subscribe for (i.e., purchase) the reorganized debtor's equity at a certain price. If the constituents believe the debtor's value is low, then the rights offering allows those constituents to purchase the equity at a discount and thus benefit from the rise in value. Rights offerings are typically "backstopped," meaning that certain parties agree to purchase all of the shares to the extent that they are not subscribed by the stakeholders to whom the rights are issued.

As mentioned in the list above, while a Chapter 11 plan may provide for a reorganization of the debtor, it may provide for a sale of all or a portion of the debtor's assets to a purchaser (referred to as a "plan sale"). The plan may exercise a variety of methods to effectuate such a sale. For example, the plan may incorporate bid procedures that dictate that the assets will be sold to the highest bidder at an auction. Similarly, the plan may provide that the assets will be sold to an existing creditor or to a third party unless another party emerges with a higher and better offer.

Although a debtor may determine to sell its assets under Section 363 prior to the plan process and then have a Chapter 11 plan for the purpose of distributing the proceeds, a debtor may want to employ a plan sale for a number of reasons, including the greater flexibility concerning the types of consideration offered by the purchaser for the purchased assets. For example, a purchaser may use noncash consideration, such as equity securities, to acquire the assets of the debtor.

A plan sale may also be more attractive to purchasers because Section 1141(a) provides a greater binding effect on all creditors than a sale under Section 363, and Section 1141(c) provides clearer statutory language concerning the protection of purchasers from liabilities of the business than a sale under Section 363. Furthermore, a plan sale results in resolution of all of the outstanding issues in the bankruptcy case, and even perhaps leaves behind a mechanism to administer outstanding issues or claims.

Lastly, certain sales (including sales of real estate in certain jurisdictions) may generate significant transfer taxes. In such cases, a sale pursuant to a plan may be the preferred course of action because the estate can benefit from the transfer tax exception in Section 1146.

Notwithstanding the benefits of a plan sale, there are notable disadvantages when compared to a sale under Section 363. The process for a plan sale tends to be more protracted and complex. For the sale to take place, among other things, all requirements for a plan confirmation must be satisfied.

A buyer in a plan sale will have to endure the process of the debtor seeking approval of the disclosure statement, soliciting acceptances of the plan from the debtor's stakeholders and obtaining confirmation of the plan, all in addition to effectuating the sale transaction itself. Also, in a plan sale, the buyer will likely be involved in all stages and negotiations between and among the debtor and its various stakeholders regarding the debtor's restructuring, the sale transaction and the recoveries provided under the plan. These negotiations may be contentious and may have the effect of increasing the price paid for the assets.

If a party-in-interest believes that the plan fails to provide adequate means for implementation, it may object on the basis that the plan is unconfirmable because it does not meet the requirements of Section 1123(a)(5). For example, a party may object on the basis that the financing is illusory or that the plan does not identify who will manage the reorganized entity or the process by which such managers will be selected. A party may also object to the adequacy of the plan's means of implementation if the plan provides for the sale of assets to a purchaser that has yet to be identified or that has failed to sell in the past.

Voting Powers

If the debtor is a corporation, Section 1123(a)(6) requires the plan to provide that the charter of the reorganized debtor or its successor will prohibit the issuance of nonvoting equity securities. This requirement prevents the plan from distributing nonvoting stock to creditors on account of their claims. Accordingly, it is often necessary to amend or modify the debtor's charter on the effective date of the plan to include this prohibition.

While Section 1123(a)(6) prevents the issuance of nonvoting stock under a plan, a Chapter 11 plan may, and many often do, issue various classes of securities, some of which may have very limited voting power. For example, a debtor may create a voting trust or issue preferred stock with limited voting rights and remain in compliance with Section 1123(a)(6). See Richard L. Epling, Fun with Nonvoting Stock, 10 BANKR. DEV. J. 17, 23 (1994).

Section 1123(a)(6) imposes an additional requirement in situations where the debtor has multiple classes of securities with voting power. In those situations, the plan must ensure an appropriate distribution of voting power among the various classes. In the case where one class of securities has a preference over another class of securities with respect to dividends, the plan must provide adequate provisions for the election of directors representing such preferred securities in the event of default in the payment of dividends.

Provisions Consistent with Public Policy

Pursuant to Section 1123(a)(7), the plan must contain only provisions that are consistent with the interests of creditors and equity security holders and with public policy with respect to the manner of selection of any officer, director and trustee under the plan and any successor to such officer, director and trustee. Courts have held that, in order to be consistent with public policy, such provisions must be consistent with a state's constitution, laws and judicial decisions. See, for e.g., In re Machne Menachem Inc., 304 B.R. 140, 143 (Bankr. M.D. Pa. 2003) (holding that provisions regarding the composition of the debtor's board of directors were inconsistent with state corporate law and, accordingly, did not satisfy the public policy provision of Section 1123(a)(7)).

For example, assume a state law requires a not-for-profit corporation's board to be appointed by a vote of the membership, a vote of the directors, or an action of the state attorney general. A plan that provides that a creditor and two other individuals appointed by the creditor will replace the current board violates Section 1123(a)(7) because the plan's provision is not consistent with the state law. See id. at 143. Such a plan must comply with state law and provide that the board will be appointed by a vote of the membership, a vote of the directors or an action of the state attorney general.

Optional Provisions

The Bankruptcy Code gives broad discretion as to the types of provisions that may be included in a plan after ensuring that the mandatory provisions are present, as long as such provisions are not inconsistent with the Bankruptcy Code. Section 1123(b) provides the following nonexclusive list of optional provisions that may be included in a Chapter 11 plan.

Impairment of Claims or Interests

Among the types of optional provisions listed in Section 1123(b) is the choice to either impair or leave unimpaired any class of claims, whether secured or unsecured, or any class of interests.

The debtor's decision whether to impair or leave unimpaired each class of claims and interests largely depends on the individual needs and circumstances of that debtor, including the valuation of the debtor and its assets, the debtor's ability to obtain financing, the terms of that financing, the debtor's ability to service debt, and how many classes will necessarily fall outside of the range of distribution.

For example, a debtor may strategically decide to allocate its assets in a way that will impair a class of bondholders by extending the maturity date of the bonds or by providing to its bondholders payment of interest in kind, and leaving unimpaired all other creditors and interest holders. If the debtor seeks to fully restructure its debt and equity, the debtor may, for example, leave secured creditors unimpaired and impair some or all unsecured creditors and all interest holders.

While a debtor will make decisions regarding impairment based on the facts and circumstances, the debtor must be cautious of artificial impairment, which may not always be permissible. Artificial impairment occurs when, in order to secure the approval of an impaired class and satisfy the requirement of Section 1129(a)(10), the debtor slightly impairs a class that would otherwise be unimpaired.

For example, artificial impairment would occur where a plan provides that a particular class, which could otherwise be paid in full in cash on the effective date, given the debtor's cash position, will receive 97 percent of its claims in cash on the effective date and receive the remaining 3 percent of its claims in cash two months after the effective date for no reason other than gaining the acceptance of an impaired class.

Currently, circuits are split as to whether to permit artificial impairment. The Eighth Circuit prohibits artificial impairment when an analysis of the impairment reveals that it "arises solely from the debtor's exercise of discretion" with the purpose of ensuring compliance with Section 1129(a)(10). Windsor on the River Associates Ltd. v. Balcor Real Estate Finance Inc. (In re Windsor on the River Associates Ltd.). 7 F.3d 127, 132 (8th Cir. 1993).

The Fifth and Ninth Circuits, however, permit artificial impairment as a valid and strategic method of securing the support necessary to accomplish a cramdown of a plan and reject any inquiry into the motive of the plan proponent. See W. Real Estate Equities LLC v. Village at Camp Bowie I LP (In re Village at Camp Bowie I LP), (5th Cir. Feb. 26, 2013) (holding that Section 1129(a)(10) does not distinguish between artificial and economically driven impairment); L & J Anaheim Associates v. Kawasaki Leasing International Inc. (In re L & J Anaheim Associates), 995 F.2d 940, 943 (9th Cir. 1993) (holding that the court's inquiry with regard to impairment is limited to determining whether or not the claimant's legal, equitable or contractual rights are changed by a plan and does not extend to the nature or degree of change).

Assumption or Rejection of Executory Contracts

Pursuant to Section 1123(b)(2), a plan may, but does not have to, provide for the assumption, rejection or assignment of an executory contract or unexpired lease that the debtor has not previously assumed, rejected or assigned, in accordance with Section 365, which governs the assignment, rejection and assumption of executory contracts and unexpired leases.

In a case where a debtor has numerous executory contracts or unexpired leases, it is often most efficient to address them within the context of a plan rather than by separate motions as required by Section 365 (unless the time for assumption or rejection of real property leases will expire prior to the effective date of the plan). In the event that such a provision is included in a plan, the debtor will still need to satisfy all requirements of Section 365 with respect to notice and adequate assurance of future performance.

Often, a plan will employ a catch-all provision providing that all leases and executory contracts that have not previously been assumed or rejected are either assumed or rejected on the effective date. In the event that it is more important to a debtor to ensure that it will be assuming or assigning all relevant executory contracts and unexpired leases, the plan may provide that all executory contracts and unexpired leases will be assumed or assigned except for those listed on an attached schedule, which will be rejected.

Conversely, if a debtor's main objective is to ensure that it is rejecting all relevant executory contracts and unexpired leases in order to relieve itself from their burdensome liabilities and liquidate their claims within the context of the bankruptcy case, then the plan may provide that all executory contracts and unexpired leases will be rejected except for those listed on an attached schedule, which will be assumed or assigned.

There are several considerations when a plan assumes, assigns or rejects executory contracts or unexpired leases. If the plan provides for the assumption of any executory contracts or unexpired leases, the plan must provide that the plan proponent will file, within a certain period of time from the confirmation date, a list of cure amounts for all of the executory contracts and unexpired leases to be assumed.

A cure amount is the amount of money that the debtor must pay in order to cure all defaults on each executory contract and unexpired lease before the debtor can assume the executory contract or unexpired lease. The plan must contemplate these cure amounts, which may be quite significant. Conversely, if the plan provides for the rejection of any executory contracts or unexpired leases, the plan must contend with the claims that will arise from the rejection of the executory contracts and unexpired leases.

If the debtor assumes an executory contract or unexpired lease through the plan, the counterparty to the contract or lease may object to the plan confirmation on the basis that the debtor's proposed cure amount is insufficient. If the debtor assigns an executory contract or unexpired lease through the plan, the counterparty may object to the plan confirmation on the basis of lack of adequate assurance that the assignee will be able to perform under the executory contract or unexpired lease. If the debtor rejects an executory contract or unexpired lease through the plan, the debtor and the counterparty may disagree over the amount of the damages due to the rejection.

Appointment of Representative

One of the optional provisions listed in the Bankruptcy Code is the ability to provide for the settlement or adjustment of any claim or interest belonging to the debtor or to the estate. In structuring a plan, such claims or interests often are valuable assets of the debtor's estate and may be important components of the debtor's restructuring. Section 1123(b)(3), therefore, also clarifies that as part of any plan, such claims or interests may either be retained or enforced by the debtor, the trustee or a representative of the estate appointed for such retention or enforcement. The plan may provide for a variety of methods to appoint such a representative, such as providing that the creditors' committee in the bankruptcy case will appoint the trustee or representative.

The responsibilities of such a representative will vary according to the type of entity the plan creates to retain or enforce the debtor's assets and will depend upon how large, substantial or complex the litigations or claims may be. By way of example, the responsibilities of a representative may include:

- claims resolution, estimation, objection and ultimate settlement;
- preference analysis, negotiation, settlement and, if necessary, litigation;
- liquidation of remaining assets of the estate;
- management of employee-related issues, such as 401(k), pension, profit-sharing, plan wind-downs, distributions to plan participants and filing of necessary statutory forms;
- filing of final tax returns;
- collection of other assets or funds of the estate, including closing escrows or receiving refunds owed to the debtor's estate; and
- administering various environmental concerns.

Because of its role as a fiduciary of the estate, often a representative (or the party who is given the right to appoint the representative, such as the creditors' committee) will have input drafting the plan, and as a result, will have certain consents or review rights included in the plan.

A plan may also employ this provision to transfer the debtor's claims or causes of action to a trust or other entity with authority to settle the claims or causes of action. Such a trust, typically called a "liquidation trust" or a "litigation trust," may serve a variety of purposes.

The plan may provide for transfer of all the estate's assets to a liquidation trust and provide the relevant creditors and/or interest holders with interests, typically in the form of shares or certificates, in the trust. The trustee will first liquidate the assets and then distribute the proceeds to claim and interest holders. If the plan employs a litigation trust, the plan may provide, for example, for the transfer of all claims against third parties to the litigation trust and give the trustee the authority to act as the debtor/plaintiff to commence or continue adversary proceedings to recover estate assets for the benefit of the holders of claims or interests.

As another example, a plan may provide for the transfer of all claims against the debtor to a litigation trust and give the trustee the authority to litigate and resolve the claims and make distributions under the plan.

Such an entity can speed the debtor's emergence from Chapter 11 by allowing the debtor's operating assets to emerge from bankruptcy prior to the full resolution of the liquidation or resolution of all or certain claims and causes of action, and, as a consequence, reduce the expenses of the bankruptcy case.

Classification of Claims and Interests

Pursuant to Section 1123(a)(1), a plan must designate classes of claims, except certain priority claims, and classes of interests for purposes of voting on the plan. In formulating classes of claims and interests, the objective is to facilitate confirmation of the plan by ensuring that each class will either vote in favor of the plan or that the plan may be confirmed over a dissenting class' objection. Plan proponents have some discretion in classifying claims and interests subject to certain requirements.

Typically, secured creditors are placed into their own classes, unless two or more secured creditors have identical rights to the same collateral. In classifying unsecured claims, the debtor should consider whether to classify all unsecured claims in one class or whether such unsecured claims should be separated in distinct classes. Often, for example, a debtor will classify all trade creditors in one class, while classifying bondholders in a separate class. Equity interests are typically separated into classes based on the type of interest, such as a class for preferred equity interests and a class for common equity interests.

General Rules

As an initial matter, all claims or interests within a particular class must be substantially similar to the other claims or interests within the class. However, claims or interests that are substantially similar may be placed in separate classes if there is a valid business or financial reason for doing so.

A plan may, for example, designate a separate class of claims consisting of every unsecured claim that is less than, or reduced to, an amount that the court approves as reasonable and necessary for administrative convenience. Creating such a class, typically called a "convenience class," is a useful method for taking care of smaller claims without putting those claims through a complicated resolution process.

A plan may not, however, separately classify substantially similar claims for the sole purpose of gerrymandering or organizing the classes so as to secure acceptance of the plan. A more detailed discussion regarding this topic can be found in the section of this article titled Specification of Treatment of Impaired Classes.

As an illustrative example, consider a debtor with one secured creditor and 100 unsecured creditors. Assume the secured creditor has a claim for $1 million, but the collateral is worth only $800,000. Pursuant to Section 506(a)(1), the secured creditor holds a secured claim to the extent of the value of the collateral, and an unsecured claim to the extent that the claim exceeds the value of the collateral, commonly called "claim bifurcation." As a result, the secured creditor has a secured claim for $800,000 and an unsecured claim (referred to as the "deficiency claim") for $200,000.

Assume the unsecured creditors are all trade vendors, with claims totaling $50,000. The debtor could put the unsecured claim of the secured creditor in the same class as the trade vendors because the claims, as unsecured claims, are substantially similar. Then, if the secured creditor votes its unsecured deficiency claim to reject the plan, the trade venders of the unsecured class would not have enough votes to be able to accept the plan. The secured creditor would, therefore, control both the vote of the secured class as well as the class of general unsecured creditors.

On the other hand, the debtor could put the secured creditor's deficiency claim in its own class, separate from the class of the trade vendors. A debtor, however, must always have a business or financial justification when separating similarly situated claims and interests; the debtor may not separate substantially similar claims solely for voting purposes. In this example, the debtor may try to justify the separation by citing the need to maintain a good relationship with the trade vendors so that the reorganized debtor can continue to do business with them. If the debtor, however, could not show that it had a legitimate business reason for the separate classification, the debtor would not be able to separate the dissenting secured creditor from the accepting trade vendors simply to gain the support of one impaired class.

In practical terms, to determine whether particular claims or interests are substantially similar and may, therefore, be classified together, the debtor should consider whether the nature of the claims or interests entitle the holders to the same rights and remedies against the debtor. For example, if two secured creditors have equal rights to the same collateral, they are likely to be similarly situated. Likewise, if two stakeholders have the same contractual rights vis-à-vis the debtor, they are likely to be similarly situated. As another example, a group of judicial creditors, whose claims arise from the same litigation, are likely to be similarly situated.

Unsecured Claims

All unsecured claims that are pari passu, excluding priority claims outstanding as of the commencement of the case, may generally be classified as one class of general unsecured claims. Alternatively, such claims may be divided into separate classes of claims if there is a legitimate business or financial reason for doing so. For example, as discussed above, a Chapter 11 plan may:

- create a separate class of creditors holding small claims for administrative convenience;
- create a separate class for contractually subordinated creditors; and/or
- create a separate class for a group of creditors that will receive the benefit of a payover provision.

The separation of different types of unsecured claims allows a Chapter 11 plan to tailor the plan provisions to accommodate each particular class. For example, bondholders often want to receive equity in the reorganized debtor, while trade creditors typically prefer cash. Separate classification of the trade creditors and the bondholders may allow the debtor to accommodate those preferences. A plan proponent must consider the ramifications of such separation on the potential class acceptances or rejections of the plan.

It is important to note that, while they are interrelated, treatment and classification are two different concepts. Two groups of claims or interests that will be treated differently must be classified separately. Two separate classes of claims or interests may also, however, receive the same treatment from the debtor. For example, there may be two unsecured creditors that are pari passu vis-à-vis the debtor, but, due to contractual subordination between the creditors, one of the two secured creditors will receive the benefit of a pay-over provision. In such a situation, the debtor may separately classify the two creditors, even though the creditors have the same rights against the debtor.

Secured Claims

Pursuant to Section 506(a)(1), the general rule is that an allowed claim of a creditor that is secured by a lien on property in which the estate has an interest is a secured claim to the extent of the value of the creditor's interest in the estate's interest in the property. A creditor, therefore, will typically hold a secured claim for an amount equal to the value of the collateral. If the creditor's claim is greater than the value of the collateral, the creditor will hold an unsecured claim for the difference between the allowed amount of the claim and the value of the collateral.

Typically, each secured creditor is placed in a separate class unless another secured creditor has an identical and equal right to the same property. Likewise, if there are holders of a first lien and holders of a second lien on the same assets, the first lien holders will be in one class and the second lien holders will be in another.

Subordination Provisions

Pursuant to Section 510(a), a subordination agreement is enforceable in a bankruptcy case to the same extent that the agreement is enforceable under nonbankruptcy law. Thus, notwithstanding the priority scheme set forth in Section 507(a), creditors may agree on their respective priorities of recovery from the debtor. Under a subordination agreement, one creditor (or a group of creditors) agrees to subordinate its right to payment to another creditor (or group of creditors) and frequently agrees that if the more senior creditor has not been paid in full, the junior creditor will "pay over" to the senior creditor any distributions received by the junior creditor.

Because subordination agreements are intercreditor agreements, from the debtor's perspective, the creditors' claims are pari passu. Pursuant to Section 510(a), a plan may give effect to a pay-over provision by providing that the distribution that would have been paid on account of the subordinated claim be paid to the senior claimholder until the senior claim is paid in full. Any remaining amount would then be distributed to the subordinated claimholder.

For example, assume a debtor has three classes of unsecured claims, each having $1,000 worth of claims: (1) trade claims, (2) senior bonds and (3) subordinated bonds. The senior bonds and the subordinated bonds have entered into a subordination agreement, pursuant to which the subordinated bonds agreed that the senior bonds will be paid in full before the subordinated bonds receive a distribution.

Further assume that the debtor has enough funds to pay unsecured claims 50 percent of their claims. Without considering the subordination agreement, each of the classes would be entitled to receive a distribution of $500 because, vis-à-vis the debtor, each of the three classes is equal in priority. Pursuant to a pay-over provision, however, the debtor would pay $500 to the trade claims, $1,000 to the senior bonds, and nothing to the subordinated bonds. The senior bonds will receive their $500 distribution, as well as the $500 distribution otherwise due to the subordinated bonds.

In the situation where a subordinated creditor will receive a partial or no recovery after effect is given to the subordination agreement, the subordinated creditor may seek to negotiate or litigate with the debtor (and perhaps other parties) in an effort to maximize the company's enterprise value and, as a result, that creditor's recovery, under the plan. Such a subordinated creditor may be involved in every aspect of the bankruptcy case linked to valuation of the company and to the determination of amounts to be distributed under the plan.

In such a situation, a debtor has several strategies that it can use to obtain consent, including issuing to out-of-the-money classes warrants or rights to buy into the equity of the reorganized debtor and potentially realize a return in the future. A more detailed discussion regarding this topic can be found in the subsection titled Adequate Means for Implementation in the Mandatory Provisions section above.

Treatment of Claims and Interests

A Chapter 11 plan must specify the treatment of claims and interests under the plan. Treatment generally refers to whether a particular class of claims or interests will be unimpaired or impaired under the Chapter 11 plan and, if the class is impaired, what, if anything, the class will receive on account of its claims or interests. The treatment of a claim or interest will depend on a number of factors, including the nature of the claim or interest, the value of the debtor, and the value available for distribution to stakeholders. For example, the treatment of a claim may differ depending upon whether claim is secured or unsecured and whether it is entitled to priority or not.

In General

A plan may treat a class of secured claims, unsecured claims or interests in one of three ways:

- leave the class unimpaired and, thus, conclusively presume to have accepted the plan;
- impair the class and obtain the class's acceptance of the plan; or
- impair the class and confirm the plan over the objection of the class by satisfying Section 1129(b), an alternative to consensual confirmation that is commonly called "cramdown."

Nonrecourse Claims

Outside of bankruptcy, a nonrecourse loan is a secured loan, which, in the event of default, entitles the lender to look solely to the property securing the loan as the only recourse. A recourse loan, on the other hand, permits a lender to obtain a deficiency judgment against the borrower if the collateral value is insufficient to pay the lender in full.

However, under Section 1111(b)(1), a nonrecourse secured claim is treated as a recourse claim except where the collateral is sold or going to be sold under a plan, or the class of such claims elects to be treated as fully secured under Section 1111(b)(2). Treating a nonrecourse secured claim as a recourse claim can be particularly useful in the context of, for example, commercial mortgages, which are generally nonrecourse mortgages. If the nonrecourse claim were treated as nonrecourse, the creditor would be entitled only to the collateral or the value of the collateral. Treating the nonrecourse claims as recourse, however, entitles the secured creditor to the collateral or the value of the collateral, as well as an unsecured claim for the deficiency.

Pursuant to Section 1111(b)(2), an election to be treated as fully secured must be approved by at least two-thirds in amount and more than one-half in number of such claims. Such an election, however, may not be made if the underlying collateral is of inconsequential value or if the holder of the claim has recourse against the debtor on its claim and such property is being sold or is going to be sold under a plan.

A creditor's decision as to whether to make an 1111(b)(2) election will often depend on whether it believes the value of the collateral will increase with time. If a creditor believes the value of the collateral will increase, it may make the strategic decision to make an 1111(b)(2) election and forego the benefit of receiving an unsecured deficiency claim in exchange for receiving the benefit of a fully secured claim, which will allow it to capture the increased value of its collateral.

In the event an 1111(b)(2) election is not made by the secured creditor, a practical consideration for the plan proponent is that while it will be dealing with a smaller amount for the creditor's secured claim, it will also need to consider what effect the creditor's unsecured deficiency claim will have on the class of general unsecured creditors, and whether or not it should seek to separately classify such claim to increase the prospects of having the class of general unsecured claims accept the plan. In the event an 1111(b)(2) election is made by the secured creditor, the plan will need to properly provide for the increased value of the creditor's secured claim.

Impairment

Pursuant to Section 1124(1), a class of claims or interests is impaired under a plan unless the plan leaves unaltered the legal, equitable, and contractual rights of each holder of each claim or interest in the class. If a class is impaired and receives a distribution under the plan, the plan proponent must solicit votes from that class. The plan proponent does not have to solicit votes from an unimpaired class because an unimpaired class is deemed to have accepted the plan pursuant to Section 1126(g). Likewise, a plan proponent does not have to solicit votes from a class that is impaired and receives no distribution as that class is deemed to have rejected the plan.

According to Section 1124(2), the plan will leave a claim or interest unimpaired, and thus not entitled to vote on a proposed plan, if the plan provides for the following four necessary provisions and does not otherwise alter the legal, equitable or contractual rights of the holder of the claim or interest.

The plan must provide for the cure of all defaults with regard to such claim or interest except for defaults that relate to:

- the insolvency or financial condition of the debtor;
- the filing of the bankruptcy case;
- the appointment of, or taking possession by, a trustee or a custodian; or
- the satisfaction of any penalty rate or penalty provision relating to a default arising from the debtor's failure to perform nonmonetary obligations under an executory contract or unexpired lease.

Thus, a claim or interest is not necessarily impaired even if the underlying obligation is in default. Section 1124(2) affords the debtor the opportunity to cure a default and reinstate the underlying obligation as if the default had not occurred. Section 1124(2) provides that right despite contract language or applicable law that entitles the holder of a claim or interest to accelerated payment upon the debtor's default. This provision permits the debtor to capitalize on, for example, a below-market interest rate by curing any defaults and reinstating the loan. However, a creditor may object to the reinstatement of the debt on a number of grounds, including that the debtor's plan is not feasible.

Moreover, certain practicalities may prevent the debtor from reinstating the obligation, such as a contractual provision that triggers a default upon a change in control. See, for e.g., In re Young Broad. Inc., 430 B.R. 99, 142 (Bankr. S.D.N.Y. 2010) (denying confirmation of a plan because a proposed reinstatement of debt violated change-in-control provisions and because the plan was not feasible).

Also, the plan must provide for the reinstatement of the maturity of the claim or interest to the maturity that existed before the default. Therefore, if the maturity is fairly soon after the effective date, reinstatement of the debt may not be practical as the debtor will need to refinance the debt shortly anyway.

The plan must provide for compensation for any damages incurred as a result of the reasonable reliance by such holder of the claim or interest on the breached contractual provision or applicable law. The plan must also provide for compensation to the holder of the claim or interest (other than the debtor or an insider) for any actual pecuniary loss arising from the debtor's failure to perform a nonmonetary obligation. This requirement, however, does not apply if the default arises from the failure to operate a nonresidential real property lease subject to Section 365(b)(1)(A), which refers to the types of nonmonetary obligations that need not be cured in order for a debtor to assume an unexpired lease.

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