AMERICAN BANKRUPTCY INSTITUTE

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Plan Issues Facing Secured and Unsecured Creditors

Hosted by the Secured Credit and Unsecured Trade Creditors Committees

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Panel Topic: Unsecured trade creditors and secured creditors confront similar plan analysis issues including gerrymandering, vote incentivization schemes, drop dead provisions and golden shares. This panel will discuss some of those "creative" plan provisions and interesting confirmation issues.

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Claims Classification and the Persistent Problem of Gerrymandering

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Confirmation of chapter 11 plans often involves the balancing of two competing goals: (1) allowing stakeholders who would be most affected by a chapter 11 plan to have the greatest say in whether or not it is confirmed; and (2) preventing "hold-out" creditors from blocking plans that otherwise could benefit a larger number of stakeholders who, individually, hold smaller claims. By allowing plan proponents to classify claims separately for purposes of voting on a plan, the Bankruptcy Code provides proponents with considerable flexibility and power to influence the outcome of a plan vote. Because the section of the Code that addresses claim classification leaves open the outer boundaries of that discretion, courts must engage in a fact-intensive inquiry to determine whether a given classification scheme is justified or abusive.

These materials begin by closely examining the unclear statutory language governing classification, and the quandaries (or opportunities) that it creates. They then consider the various standards and tests developed by the U.S. Circuit Courts of Appeal to draw a line between appropriate and inappropriate classification schemes. Next, they analyze cases decided in the last two years that substantively address the problem of "gerrymandering"—separately classifying similar claims to create an affirmative vote of an impaired class of claimholders. As these recent cases demonstrate, it is extremely difficult (if not impossible) to articulate clear rules that apply universally to all cases. Rather, the application of the standards governing classification is often

driven by the composition of the particular claimholders in a case, the treatment of the different classes under the proposed plan, and the primary objectives to be accomplished under the plan.

A. Unclear Statutory Framework

The language governing the classification of claims for purposes of plan voting is as notable (if not more so) for what it does ***not*** say, than for what it actually does say. Section 1122 of the Bankruptcy Code provides as follows:

> **§ 1122. Classification of claims or interests.**
>
> (a) Except as provided in subsection (b) of this section, a plan may 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.
>
> (b) A plan may designate a separate class of claims consisting only of every unsecured claim that is less than or reduced to an amount that the court approves as reasonable and necessary for administrative convenience.

It is abundantly clear that section 1122(a) prohibits the inclusion of claims that are not "substantially similar" in the same class. Section 1122 does not, however, explicitly address the mirror image of that proposition: whether ***similar*** claims ***must*** be placed in the same class. *See e.g., Boston Post Road Ltd. P'ship v. FDIC (In re Boston Post Road Ltd. P'ship)*, 21 F.3d 477, 481 (2d Cir. 1994).

In addressing this gap, some courts have concluded that, as a matter of statutory construction, a "wholly permissive" approach in classifying substantially similar claims separately is flawed. These courts reason that such an approach would render section 1122(b) superfluous. *See, e.g., Phoenix Mut. Life Ins. Co. v. Greystone III Joint Venture (Matter of Greystone III Joint Venture)*, 995 F.2d 1274, 1278 (5th Cir. 1991). But the logic of this reasoning has been criticized on the grounds that section 1122(b) permits classification of claims that are ***not*** substantially similar for administrative convenience purposes. *In re Bloomingdale Partners*, 170 B.R. 984, 989-90 (Bankr. N.D. Ill. 1994). Consequently, the plain language of section 1122 of the Bankruptcy

Code is not so plain in its application.

B. Equally Unclear Guidance at the Circuit Court Level as to the Boundaries of Permissible Classification

Out of this statutory lacuna, the circuit courts have articulated several standards to address the boundaries of claim classification. In the oft-cited *Greystone* decision, the Fifth Circuit observed that the "one clear rule that emerges from otherwise muddled caselaw on § 1122 claims classification: thou shalt not classify similar claims differently in order to gerrymander an affirmative vote on a reorganization plan." 995 F.2d at 1279. The Fifth Circuit noted the following reasoning articulated by the Sixth Circuit with approval:

> [T]here must be some limit on a debtor's power to classify creditors in such a manner.... Unless there is some requirement of keeping similar claims together, nothing would stand in the way of a debtor seeking out a few impaired creditors (or even one such creditor) who will vote for the plan and placing them in their own class.

Id. (quoting *In re U.S. Truck Co.,* 800 F.2d 581, 586 (6th Cir.1986)). To enforce the "one clear rule," the court held that a plan proponent that classifies "substantially similar" claims separately must articulate a reason for the classification that is "independent of the debtor's motivation to secure the vote of an impaired, assenting class of claims." *Id*. The *Greystone* court went on to consider the proponent's arguments that the "legal differences" among the separately classified claims and "good business reasons" supporting separate classification, found them lacking, and concluded that the separate classification of the mortgage holder's deficiency claim was improper.[1] *Id*. at 1279-81. In part, this ruling is attributable to a lack of evidence proffered by the plan proponent. *See id*. at 1281.

Other circuits have embraced a flexible, but not boundless approach to classification. The

[1] The court never expressly stated whether "legal difference" or "good business reasons" would be sufficient to support separate classification.

Second Circuit requires a plan proponent to adduce credible proof of a legitimate reason for separate classification of similar claims. *In re Boston Post Road Ltd. P'ship*, 21 F.3d at 483 (separate classification of limited number of trade creditors that were not essential to the debtor's future was improper). The Third Circuit has held that bankruptcy courts have "broad discretion" in deciding if chapter 11 plans classification schemes are appropriate, and that the lower courts' determinations will be upheld so long as the classification scheme is "reasonable" and "does not arbitrarily designate classes." *In re W.R. Grace & Co.*, 729 F.3d 311, 326 (3d Cir. 2013). Because of the "we'll know it when we see it" approaches of these circuits, the "one clear rule" is not so clear in application.

The Ninth and Seventh Circuits have provided additional substance to the skeletal structure of "reasonableness." The Ninth Circuit explicitly requires plan proponents to come forward with "legitimate business or economic justification" in order to separately classify otherwise similar claims. *Barakat v. Life Ins. Co. of Va. (In re Barakat)*, 99 F.3d 1520, 1526 (9th Cir. 1996). With respect to the separate classification of unsecured trade creditors, the bankruptcy court rejected the justification that such creditors continued to do business with the debtor post-petition and expected to earn future profits from continued business with the debtor. *Id*. at 1528. It further noted that many alternative service providers would be available so that the trade creditors could not be considered "essential" to the debtor's continued operations. *Id*. at 1528-29. The Ninth Circuit affirmed.

The Seventh Circuit incorporates the "business reason" justification, and adds further guideposts for determining the reasonableness of separate classification of similar claims. While noting that "[a] debtor in bankruptcy has considerable discretion to classify claims and interests in a chapter 11 reorganization plan," the debtor may not use claims classification in order to

gerrymander an affirmative vote on a plan. *In re Wabash Valley Power Ass'n, Inc.,* 72 F.3d 1305, 1321 (7th Cir.1995), *abrogated on other grounds*, *In re Castleton Plaza, LP*, 707 F.3d 821 (7th Cir. 2013). Separate classification may be permissible where: (1) significant disparities exist between the legal rights of the holders of the different claims which render the two claims not substantially similar; (2) there are good business reasons to separately classify claims; or (3) the claimants have sufficiently different interests in the plan. *Id*. Ongoing litigation with the debtor may constitute a good business reason for separate classification. *In re Multiut Corp.*, 449 B.R. 323, 335 (Bankr. N.D. Ill. 2011).

C. Recent "Gerrymandering" Decisions

1. *In re STC, Inc.*, 2016 WL 3884799 (Bankr. S.D. Ill. Apr. 7, 2016) (Grandy, J.)

The bankruptcy court confirmed a chapter 11 plan of reorganization that separately classified a judgment creditor's claim from the claims held by general unsecured trade creditors. The debtor in this case was a parts manufacturer (transformers, electronics and magnetic components) for a variety of industries, including military and maritime. The company experienced financial distress as a result of a judgment for patent infringement, including enhanced damages. The debtor filed a chapter 11 plan of reorganization that separately classified the judgment claim of approximately $8 million from the pool of general unsecured trade creditors with total claims of $73,002.40. Notably, the plan contemplated payment in full of the judgment creditor's claim over nine years at 3% interest and payment of 75% of trade creditors' claims. *Id.* at *2.

The judgment creditor objected to confirmation of the proposed plan, asserting, *inter alia,* that the debtor gerrymandered the classes to obtain a potentially-accepting impaired class. *Id*. at 4. With regard to the classification issue, the bankruptcy court considered each of the three

Wabash factors, *supra*. With respect to "different legal rights," the court concluded that the judgment creditor had different remedies available to it than those available to the trade creditors. Furthermore, the judgment creditor would be able to seek recovery from other defendants in the patent litigation. These remedies are not available to creditors holding general unliquidated, unsecured claims. *Id*. at *5. The court also concluded that the continuation of services by the trade creditors was essential to the debtor's continued business operations; thus, separate classification was supported by a "legitimate business reason." *Id*. at *6. Finally, the court noted that the judgment creditor was a direct and strong competitor of the debtor. As such, its "non-creditor interest"—having a different stake in the continued existence of the debtor—may cause it to vote apart from its economic interest of recovering on its claim. This too justified separate classification. *Id*.

2. *In re Rexford Props. LLC*, 558 B.R. 352 (Bankr. C.D. Cal. 2016) (Barash, J.)

In deciding a motion filed by the debtor seeking approval of a proposed classification scheme,[2] the bankruptcy court held that it was appropriate to provide for a separate class of trade creditor claims in the proposed chapter 11 plan of reorganization. The debtor owned and operated a waterpark in Fresno, California. Approximately one year into its chapter 11 case (and after denial of its initial plan), the debtor filed a proposed plan separately classifying unsecured trade creditors. This plan offered to pay trade creditors 100% of their claims on the effective date, provided that they agree to continue to provide services to the debtor for at least one post-confirmation operating season. *Id*. at 356. By contrast, general unsecured creditors would receive either: (a) 10% of their

[2] The motion was brought pursuant to Rule 3013 of the Federal Rules of Bankruptcy Procedure. This rule provides that the bankruptcy court may, on motion and after a hearing on notice, rule upon the appropriateness of claims classification pursuant to section 1122 of the Code. This determination may be made prior to a vote on a proposed plan by holders of impaired claims. Proceeding in this fashion may avoid the expense and delay of a confirmation process that is doomed from the outset due to a flaw in the classification of claims.

allowed claims in cash, or (b) 45% of the equity interests in the reorganized debtor. *Id*. The court stressed that its ruling would not include any determination as to the confirmability of the plan, particularly with regard to a cramdown evaluation of "unfair discrimination."

In considering the Ninth Circuit standard of articulating a "legitimate business or economic justification" for separate classification, the court rejected the notion that the standard required a showing that the services that a creditor provides must be "critical," "essential," or "necessary" for the debtor's continued survival. *Id*. at 362-63. The court reasoned that such a high burden is not only at odds with the law on claims classification, but would also present a significant and impractical proof problem. *Id*. at 363. Instead, the court concluded that a "legitimate business or economic justification" is established when: (i) the vendors provide genuine operational or financial benefits to the debtor, and (ii) the preferential treatment of vendor claims is reasonably calculated to induce the continued support of those vendors. *Id*. In light of this standard, the bankruptcy court considered evidence related to the separately-classified vendors, and ruled that the debtor has established a legitimate business or economic justification for separately classifying most (but not all) of the vendors' claims.

3. *In re Abeinsa Holding, Inc.*, 562 B.R. 265 (Bankr. D. Del. 2016) (Carey, J.)

Another recent case involved the global restructuring of a Spanish engineering and clean technology conglomerate and its U.S. subsidiaries.[3] In ruling on the confirmation of multiple, related chapter 11 plans (some involving reorganizing debtors, others involving liquidating debtors), the bankruptcy court was called upon to decide whether the separate classification of a public utility's unsecured claim under one of the reorganizing plans constituted impermissible

[3] As of the end of 2015, Abengoa, S.A. was the parent company of approximately 700 other companies around the world, including 577 subsidiaries, 78 associates, 31 joint ventures, and 211 Spanish partnerships, employing 35,000 people. *In re Abeinsa Holding, Inc*. 562 B.R. 265, 269 (Bankr. D. Del. 2016).

gerrymandering. *Id*. at 274. The court observed that "[t]he classification of claims or interests must be reasonable and cannot be grouped together for arbitrary or fraudulent purposes." *Id*. Applying this standard, the court ruled that "[i]t is reasonable for the Debtors to place claims related to significant, on-going litigation in a separate class." *Id*. To buttress this ruling, the court observed that the separate classification had no impact on the outcome of voting since the plan had been accepted by multiple impaired classes. *Id*. at 274-75.

4. *In Re City Homes III LLC*, 564 B.R. 827 (Bankr. D. Md. 2017) (Gordon, J.)

Despite the zealous support of the debtors and the Unofficial Committee of Unsecured Creditors, and the tepid support of the U.S. Trustee,[4] the bankruptcy court denied confirmation of a Second Amended Chapter 11 Plan out of due process concerns relating to a broad third party release. The debtors were a group of related entities that owned real property in Baltimore, Maryland, and leased the property to low-income tenants. Because of numerous lead paint tort claims asserted against the debtors, they filed for chapter 11 relief in the fall of 2013. Approximately one year later, they proposed a liquidating chapter 11 plan, involving the managed liquidation of all debtor and related non-debtor real estate. *Id*. at 834.

A crucial issue in the case involved the treatment of tort claims, particularly those of unknown claimants. Resolving this problem was further complicated because the debtors were unable to procure insurance after approximately 1999. Thus, a portion of the proceeds from the contemplated sale of real estate was to be used to create a $300,000 fund to satisfy the claims that were otherwise not insured. To participate in the fund, lead paint claimants needed to submit claims within a fixed time after the effective date of the plan. Claimants could alternatively

[4] The U.S. Trustee indicated that it was "admittedly holding [its] nose" in supporting the plan. *In re City Homes III, LLC*, 564 B.R. 827, 858 (Bankr. D. Md. 2017).

proceed to have their claims litigated in state court; however, by doing so, they would be limiting their recovery to insurance proceeds and waiving any recourse against the estate. *Id*. Under either scenario, lead paint claimants would be bound by a release of their claims against various non-debtor parties, including the debtors' boards of directors and management.[5]

Although the court's decision to deny confirmation focused upon the impropriety of the non-debtor release, the court considered "gerrymandering" in analyzing the release. Of particular concern to the court was the debtors' continued efforts to limit notice, and the scope of the investigation to identify "known claimants" based on the debtors' books and records. *See, e.g., id.* at 839 & 864. The lack of participation in the confirmation process by uninsured lead paint claimants disturbed the court to an even higher degree. On that basis, the court concluded that the joint classification of "insured claims" and "uninsured claims" in a single class was improper since the treatment of the claimants would not be the same under the plan. *Id*. at 867-68. The former likely would have an opportunity to have their claims paid in full; the latter would be "limited to a pro-rata payment from a $300,000 fund and then only if they have knowledge of [the bankruptcy case] and file a claim that beats the two year deadline." *Id*. at 868. Thus, the court concluded that the claimants had been "lumped together" to create the false veneer of unanimous support for the liquidating plan. Ultimately, the court denied confirmation and, based on the positions taken by the debtors with regard to the release, ordered the immediate appointment of a trustee. *Id*. at 879.

5. *In re Hanish*, 570 B.R. 4 (Bankr. D.N.H. 2017) (Harwood, C.J.)

The issue of gerrymandering arose in the context of a disclosure statement battle between the debtor and its secured lender. The debtor was an owner operator of a Fairfield Inn and Suites

[5] The plan provided for severance payments for officers and employees from a pool of funds that exceeded the amount earmarked for uninsured claims.

located in Hooksett, New Hampshire. The total amount of the lender's allowed claim was $6,732,462.02. There was no dispute that the lender's claim was undersecured. *Id*. at 8.

After several attempts to propose a confirmable plan, the debtor came forward with its Amended Third Plan of Reorganization which contained three classes of unsecured claims: (1) the unsecured portion of the lender's claim—to be paid in full on the effective date; (2) general unsecured claims under $5,000—to be paid 80% on the effective date (an administrative convenience class); and (3) general unsecured claims over $5,000—to be paid in full in six and a half years. *Id*. at 10. The court denied approval of the disclosure statement because the plan was patently unconfirmable, and the debtor filed a motion to reconsider. *See id*. at 11-12.

The bankruptcy court noted that separate classification of an "administrative convenience class" is permissible under section 1122(b). Here, however, the class was impaired—raising the specter of gerrymandering and triggering closer scrutiny of the purported basis for the creation of a convenience class. *Id*. at 17. Such scrutiny involved analysis of the following issues: "consideration of how many claims fall within the class, the individual amounts of those claims, the total amount of claims within the class, the debtor's financial wherewithal to pay them at an accelerated rate, and a present value comparison of the payments to be received by the administrative convenience class and the general unsecured creditors." *Id*. at 17. Upon separate questioning by the court as to the basis for the separate classification, the debtor offered no justification and opted instead to withdraw the administrative convenience class.[6] *Id*. at 17-18. Thus, the gerrymandering issue proved moot for purposes of the issues on reconsideration.

[6] Until the court took up the issue on its own, the debtor's only defense to the secured lender's objection was that the lender lacked standing to challenge separate classification. *In re Hanish*, 570 B.R. 4, 17-18 (Bankr. D.N.H. 2017).

D. Concluding Thoughts

Ultimately, the classification of claims remains, as it always has been, *sui generis*—an issue decided by the bankruptcy courts based on the facts and circumstances before them, the nature of the case, and the ends to be achieved through confirmation of a chapter 11 plan. As the Seventh Circuit observed, "this is one of those areas of the law in which it is not possible to do better than to instruct the first-line decision maker, the bankruptcy judge, to seek a result that is reasonable in light of the purposes of the relevant law...." *In re Crawford,* 324 F.3d 539, 542 (7th Cir. 2003) (determining the legitimacy of proposed classifications of claims in the Chapter 13 context). Although frustrating from a planning and predictive standpoint, perhaps this fluid state of affairs is not entirely a bad thing: it allows bankruptcy courts room to navigate between the often-conflicting interests of stakeholders in the reorganization process.

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Drop Dead Provisions in Bankruptcy

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Drop dead provisions are commonly found in Chapter 13 plans. Upon a default in payments, the secured lender is given ex parte relief from the automatic stay, which allows the secured lender to immediately foreclose or repossess the collateral without the debtor having an opportunity to further delay the process.

However, drop dead provisions have also become an issue in Chapter 11 cases. The determining factors are first, whether the plan is feasible without the drop dead provision, and then, whether the secured lender will be paid in full if the drop dead provision is invoked. The discussion initially centered around whether the drop dead provision met the liquidation exception in Section 1129(a)(11), which reads as follows:

"The court shall confirm a plan only if all of the following requirements are met: …….

> Confirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan, unless such liquidation or reorganization is proposed in the plan".

In Danny Thomas[1], the 8th circuit concluded that the liquidation proposal relates to an immediate liquidation and not a provision that allows a later liquidation should the plan proposed fail, that the plan needs to be feasible first and then a second alternative of a drop dead provision will support a cram down to the objecting secured creditor. The debtor's argument was that since

previous courts had allowed the drop dead provision, that the drop dead provision by itself, created a feasible plan, which the court ultimately disagreed with.

The debtor had proposed a plan that on its own terms was going to run a cash deficit from the beginning, to be cured by speculative future rent and market value increases. In addition to the annual negative cash flow, the court indicated normal deterioration of the property would cause the value of the property to become less than the secured claim. "We do not believe that the "drop dead" provisions of the reorganization plan can save this otherwise infeasible plan, unlike the similar provisions in 203 North LaSalle Street, T-H New Orleans, and Nite Lite Inns, because nothing in the record indicates that Le Marquis will remain more valuable than Beal's secured claim during the life of the plan".

Going back to 1997, in the 7th circuit case of 203 N. LaSalle[2], the court found that even without considering the drop dead provision (a deed held in escrow, to be transferred in the event of a payment default), the plan was feasible as submitted, and to the extent it may not succeed, the secured lender would most likely be paid its remaining secured debt and/or get title to the property at which time the value of the property, based on expert testimony, should be in excess of the balance owed on the secured debt.

What made the 203 N. LaSalle case interesting and gave the Danny Thomas participants reason to think they were similar was that 203 N. LaSalle also projected operating losses. However, in 203 N. LaSalle, the operating losses were not projected until after year 6, at which time it was expected the negative cash flow would be funded by the owners or another lending source. In the event the losses were not funded, then it was expected the secured lender could take control of the building and sell it for more than the balance on its secured debt.

Therefore, in comparing the two cases, if the submitted plan is feasible and the secured lender will likely be paid in full if the property is sold at the time of default, then drop dead provisions will work as a back-up provision to the proffered plan. However, the inclusion of a drop dead provision will not, in and of itself, save a plan that is not feasible without the drop dead provision.

[1] *Danny Thomas Properties II Limited Partnership v. Beal Bank S.S.B.*, 241 F.3d 959 (8th Cir. 2001)

[2] *In re 203 N. LaSalle Street Partnership*, 126 F.3d 955 (7th Cir. 1997)

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The Super Powers of Golden Shares and Bankruptcy Kryptonite

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Just what is a "golden share"?

The holder of a golden share holds special voting rights and has the ability to block or outvote other shareholders in certain specified circumstances – i.e. super powers.

In the European countries, the golden share developed as a means for the government to protect national interests in privatized companies. As a company privatized, the government would obtain a golden share or golden shares in the private company, with the ability to block potential mergers or takeovers of the business, or foreign acquisition (particularly with regard to private companies operating in the defense and security industries)[7]. Over the years, the European Union has challenged the legality of golden shares in a number of countries, and the European Court of Justice has ruled that various golden share rules contravene European Union legislation. *Id.*

In the United States, the "golden share" is not a government tool, but instead has developed as a privately contracted method to exercise control over a business entity – most commonly by creditors. Sometimes the golden share rights are granted at inception of the relationship, and sometimes through a forbearance or other modification as the relationship progresses.

[7] Lyndon Driver, *The End of Golden Shares*, World Finance (May 7, 2013).

Why does this matter to bankruptcy practitioners?

The holders of golden shares a/k/a the "blocking directors" have attempted to use their contractual super powers to foreclose the ability of a debtor to file a voluntary bankruptcy petition and some bankruptcy courts are putting a stop to the practice.

***In re: Lake Mich. Beach Pottawattamie Resort, LLC*, 547 B.R. 899 (Bankr. N.D. Ill. 2016) (Judge Timothy A. Barnes):**

The Debtor, Lake Michigan Beach Pottawattamie Resort was the owner of a vacation resort in Michigan. BCL-Bridge Funding, LLC (the "Lender") had made a loan to the Debtor and received a mortgage and assignment of rents to secure the loan. Within six (6) months of the loan origination, the Debtor defaulted and the parties negotiated a forbearance agreement.

As a condition of the forbearance, the Debtor agreed to executed an amendment to its operating agreement whereby the Lender was made a "Special Member" of the Debtor and granted the right to approve or disapprove any "Material Action" by the Debtor. Material Action was defined in the operating agreement to include a variety of actions, including the filing of a voluntary petition, or consent to an involuntary petition, in bankruptcy. As a Special Member, the Lender did not have any rights to distributions, no tax consequences, and no requirement to make capital contributions. The amended operating agreement also provided that when exercising its powers, the Lender "shall be entitled to consider *only* such interests and factors as it desires, including its own interests, and shall to the fullest extent permitted by applicable law, have no duty or obligation to give any consideration to any interest of or factors affecting the Company or the Members".

Soon after the forbearance and the creation of the special member rights, the Debtor defaulted again, and the Lender initiated a foreclosure action and published notice of a non-judicial foreclosure sale. One day prior to the date of the sale, the Debtor filed a voluntary petition under

Chapter 11. The Lender filed a motion to dismiss the bankruptcy petition on various grounds, including the validity of the Debtor's bankruptcy petition, since the Lender, as the Special Member, had not consented to its filing.

The Debtor argued in response that the provision in the amended operating agreement requiring the special member's consent to a bankruptcy filing was void as against public policy because it amounted to "a prohibition of the Debtor's right to exercise its right to bankruptcy relief" and that it was not valid under Michigan law.

In its analysis of the Debtor's argument, the bankruptcy court considered the situation where a special purpose entity is created to hold assets, but has little or no real operations, and its by-laws/operating agreement required unanimous consent of directors/members to file bankruptcy. The organizational documents also provide that certain actions may not be taken if the seat of a specific director/member (who is chosen by the secured creditor) is vacant or that director/member does not vote in favor of the specified actions – the blocking director. The Court recognized that in such an instance, there is "a saving grace" built into the structure – that the blocking director must always adhere to his or her general fiduciary duties to the debtor in fulfilling the role (citing to multiple cases where courts emphasized that applicable fiduciary duties could not be ignored so that a director/member chosen by the secured creditor could act only in the interests of the secured creditor).

Ultimately, the Court in *Lake Mich. Beach Pottawattamie Resort, LLC* determined that Michigan law imposed fiduciary duties on a director/member, and the language in the amended operating agreement purporting to grant the Lender the ability to block actions of the Debtor without consideration of its fiduciary duties to the Debtor or its creditors, was void. Therefore, the bankruptcy petition was not subject to dismissal.

***In re Intervention Energy Holdings, LLC,* 553 B.R. 258 (Bankr. D. Del. 2016) (Judge Kevin J. Carey).**

The Debtors Intervention Energy Holdings, LLC (IE Holdings), the parent, and Intervention Energy, LLC (IE) were limited liability companies formed in 2007 under the laws of the State of Delaware. In 2012 EIG Energy Fund XV-A, L.P. ("EIG") and the Debtors entered into a Note Purchase Agreement whereby EIG provided up to $200 million in senior secured notes, secured by liens on virtually all of the Debtors' assets. In late 2015, after the Debtors failed to satisfy certain covenants provided for in the loan documents, the parties entered into a forbearance agreement that provided: (1) EIG would waive all defaults if the Debtors could raise $30millon by a specified date to pay down part of the EIG debt; and (2) The Debtors would amend the operating agreement of IE Holdings to make EIG a member of IE Holdings, with 1 common unit, and would require unanimous approval of the holders of common units prior to any voluntary bankruptcy filing of IE Holdings.

Facing imminent default under the forbearance agreement, the Debtors filed voluntary petitions under Chapter 11. The filing of the petitions had been approved by 22,000,000 of the 22,000,001 common shares. EIG immediately moved to dismiss the petitions arguing that IE Holdings was not authorized to file the petitions due to the lack of unanimous consent of all 22,000,001 shares.

Delaware law authorizes the abrogation of fiduciary duties of limited liability companies and their members. Specifically, 6 Del. C. § 18-1101(e) provides as follows:

> A limited liability company agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a member, manager or other person to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement; provided, that a limited liability company agreement may not limit or eliminate liability for any act

> or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.

EIG argued that its right to block the filing of a bankruptcy petition was a contracted-for protection and that the ability of a limited liability company to abrogate fiduciary duties provided the authority for the parties to contract for such a right in Delaware.

Instead of "determining the scope of LLC members' freedom to contract under applicable state law provisions," the bankruptcy court looked to federal public policy.

The bankruptcy court referred to the long-established general rule that a party cannot contract away its rights under the Bankruptcy Code, and quoting *In re Tru Block Concrete Prods., Inc.* 27 B.R. 486, 492 (Bankr. S.D. Cal. 1982) recognized that "[i]t is a well-settled principal that an advance agreement to waive the benefits conferred by the bankruptcy laws is wholly void as against public policy."

The court determined that the "unmistakable" and "indisputable" intent of the amendments to the operating agreement were to block any bankruptcy filing, and that such a provision was void as against federal public policy. Specifically, the Court stated as follows:

> A provision in a limited liability company governance document obtained by contract, the sole purpose and effect of which is to place into the hands of a single, minority equity holder the ultimate authority to eviscerate the right of that entity to seek federal bankruptcy relief, and the nature and substance of whose primary relationship with the debtor is that of creditor – not equity holder – and which owes no duty to anyone but itself in connection with an LLC's decision to seek federal bankruptcy relief, is tantamount to an absolute waiver of that right, and, even if arguably permitted by state law, is void as contrary to federal public policy. Under the undisputed facts before me, to characterize the Consent Provision here as anything but an absolute waiver by the LLC of its right to seek federal bankruptcy relief would directly contradict the unequivocal intention of EIG to reserve for itself the decision of whether the LLC should seek federal bankruptcy relief. Federal courts have consistently refused to enforce waivers of federal bankruptcy rights. I know join them, and conclude that the Debtors possessed the necessary authority to commence their chapter 11 proceedings.

***In re: Lexington Hosp. Grp., LLC*, 2017 Bankr. LEXIS 3129 (September 15, 2017) (Judge Gregory R. Schaaf):**

Lexington Hospitality Group, LLC ("LHG"), was a Kentucky limited liability company formed in May 2015. Janee Hotel Corporation ("Janee") was the sole member of LHG at the time of its formation. The original operating agreement vested the authority to manage the business and affairs of LHG in the Company Manager, identified as Janee.

The Company Manager was authorized to conduct day-to-day operations and was granted certain powers and duties. However, the prior approval of the Member was required for certain specific actions. The original operating agreement was silent on the authority of the Member or the Manager to file bankruptcy for LHG.

LHG acquired a Clarion hotel in Lexington, Kentucky, and financed the purchase with PCG Credit Partners, LLC, who obtained a mortgage and a blanket lien on all assets of LHG. At the time of the loan, an amended operating agreement was executed, which added as a member, 5532 Athens LLC (an entity owned and/or controlled by PCG). 5532 Athens also received a 30% interest in LHG.

The amended operating agreement also included a provision prohibiting a bankruptcy filing unless the "Independent Manager" authorized such a filing – and there was approval of at least 75% of the members. The Independent Manager was Julia McCullough. The Independent Manager was only authorized to vote on whether to file bankruptcy and was instructed to consider the interests of the Company, the interests of creditors, and the economic interests of 5532 Athens. The amended language also eliminated any fiduciary duty or liability that the Independent Manager might have to other members or managers.

The amended operating agreement also provided that LHG would not file bankruptcy "without the advance, written affirmative vote of the Lender and all members of the Company."

In February 2017, LHG entered into a forbearance agreement with PCG. Pursuant to the terms of the forbearance agreement, an additional 20% interest in LHG was transferred to 5532 Athens. An additional 1% would be transferred to PCG if LHG did not meet certain financial benchmarks by June 30, 2017.

PCG declared a default under the documents and filed a lawsuit in state court, along with a motion seeking appointment of a receiver over LHG. A few days later, LHG filed a voluntary petition under Chapter 11. Moore, as the President of Janee, as Manager, signed the corporate resolution authorizing the filing. PCG moved to dismiss the bankruptcy case.

Citing to *Intervention Energy Holdings*, the bankruptcy court recognized that based n public policy considerations, courts have held that contractual provisions in operating agreements that essentially prohibit a company's ability to file bankruptcy without a creditor's consent are void. However, the bankruptcy court also recognized that members of a business entity might freely agree among themselves not to file bankruptcy. So, the question became "whether the Bankruptcy Restrictions [in the amended operating agreement] were imposed by PCG, as a creditor, to create an absolute waiver of LHG's right to file bankruptcy."

The court found that the bankruptcy restrictions, and the dilution of Janee's membership interests, created such an absolute waiver of LHG's right to file bankruptcy and therefore were void as against federal public policy.

The amended operating agreement included a clause providing that if any provision of the agreement were deemed invalid or unenforceable that the remainder of the agreement remained valid. Based on the remaining terms of the amended operating agreement, and Kentucky law, the bankruptcy court determined that the Manager had authority to authorize the bankruptcy filing and commence the Chapter 11 case.

So what does this all mean? Discussion Questions:

Are all "golden share" arrangements unenforceable?

What if the "golden share" provision was created at formation of the entity?

What if the holder of the "golden share" still has fiduciary duties to the company and its creditors?

What should you advise a debtor client who is being asked to enter into a golden share or blocking share agreement?

What about a creditor asking for such a provision?

Are there ethical considerations for counsel in enforcing or challenging golden share or blocking share provisions?

Would the decision in *In re: Lake Mich. Beach Pottawattamie Resort, LLC* have been different if the Debtor were a Delaware entity?

Are there *Stern* issues implicated in the consideration of "golden share" provisions?

American Bankruptcy Institute
Winter Leadership Conference

November 30th – December 2nd, 2017

Voter Incentives

Chad J. Shandler, CPA
COHNREZNICK ADVISORY

Most people reading this paper are aware that, under Chapter 11 U.S.C. § 1125(f), a bankruptcy plan outlines how creditors will be treated as the bankruptcy is wound down. A plan must include a classification of claims and must specify how each class of claims will be treated. Creditors whose claims are "impaired," i.e., those whose contractual rights are to be modified or who will be paid less than the full value of their claims, vote on the plan by ballot. Outside of bankruptcy, a creditor is primarily concerned that their capital is not at risk, and they are indifferent to return. Provided they are paid in due course, returns to creditors do not vary based on an organization's strategic operating decisions. Shareholders, on the other hand, are concerned with strategy and returns.

In bankruptcy, following the absolute priority rule, impaired creditors step into the shoes where equity once stood. The extent of their recovery rests on the ability of the estate to maximize value, and so the bankruptcy process is designed to provide the most significant voting power to the most senior impaired class. In its ultimate form, bankruptcy provides a structure for the fair and equitable distribution of an estate's assets among creditors.

A plan can provide incentives, provisions made to classes which may induce them to vote for a plan. However, a plan must be proposed with "honesty and good intentions" and must reasonably be believed to be confirmable. Per §1129(a) a plan can only be confirmed if it satisfies

the statutory requirements for confirmation, which include findings by the bankruptcy court that the plan is:

1. Proposed in good faith, the plan is fair and equitable and does not unfairly discriminate against similarly-situated creditors,
2. The plan is feasible,
3. The plan provides creditors with at least as much as the creditors would receive in a hypothetical liquidation.

It is the goal of creditors in bankruptcy to maximize their recovery. At the same time, Debtors may have their own agenda, and while bankruptcy should adhere to priority rules, there are cases where ulterior motives might induce insiders to manipulate classes of claims, impacting the outcome of voting in a way that goes against the interest of certain creditors. To reduce this risk, under Sections 1126(c) and 1129(a)(10) of the Bankruptcy Code, the votes of holders of insider claims cannot be counted for cramdown purposes. In addition, if the court finds that a plan is designed in a way that artificially creates or incentivizes classes, serving the interests of certain creditors at the expense of others who have equivalent claims, §1126 allows the court to "designate" or disqualify certain claims. Disqualifying votes can scuttle the confirmation of a plan, or, if the value is provided by parties looking to scuttle a plan, can lead to the confirmation of a plan.

There are a number of ways to provide value to creditors in a plan. The list includes, but is not limited to, gifting, settlement agreements and the purchase of claims. Gifting occurs when a senior or secured creditor that is not impaired provides value to a creditor or shareholder whose status is below an intervening impaired class. If a member of another class believes they are being treated unfairly, the court may determine the value is being provided in order to influence or corrupt the design of a plan in favor of certain plan participants.

DBSD was formed by ICO Global in 2004. In *Dish Network Corp. v. DBSD, North America, Inc.* shareholders had created a holding company that completely controlled the debtor.

The senior creditors negotiated a deal with ICO in which the senior creditors would receive the bulk of the ownership of the reorganized company. Unsecured creditors would receive a small piece of equity and ICO would receive shares and warrants. One of the unsecured creditors objected and the Second Circuit held that the Bankruptcy Code continued the anti-gifting rule from the era of the equity receivership and refused to confirm the plan.

In re Quigley was an asbestos related case. Quigley manufactured certain products containing asbestos. In 1968 Quigley was acquired by Pfizer, Quigley's sole shareholder. Quigley and Pfizer were named as defendants in 411,110 asbestos cases with approximately 261,567 claims to be filed. Over the course of several years Quigley and Pfizer attempted address the tort claims, including participating in a class action settlement that was subsequently overturned by the Supreme Court, entering into various agreements and supporting favorable asbestos litigation legislation. On September 3, 2004, Quigley filed for bankruptcy. The Amended and Restated Plan of Reorganization Under Chapter 11 of The Bankruptcy Code (as modified as of August 6, 2009) (the "Fourth Amended Plan") created Class 4 – Asbestos PI Claims. These claims were automatically channeled to and assumed by the Asbestos PI Trust. Per the plan:

> The Asbestos PI Trust shall be funded in accordance with the provisions of Section 9.3 of the Plan. Except as set forth in Section 11.6(b)(ix) of the Plan, the sole recourse of the holder of an Asbestos PI Claim on account of such Claim shall be to the Asbestos PI Trust and each holder shall have no right whatsoever at any time to assert its Asbestos PI Claim against any Asbestos Protected Party, or, subject to the terms of Section 11.7 below, a Settling Asbestos Insurance Entity, or, subject to the terms of Section 11.8 below, a Non-Settling Asbestos Insurance Entity.[1]
>
> The Asbestos PI Trust shall be a "qualified settlement fund" within the meaning of section 468B of the United States Internal Revenue Code and the regulations issued thereunder. The purposes of the Asbestos PI Trust shall be to assume all Asbestos PI Claims (whether now existing or arising at any time hereafter) and to use the Asbestos PI Trust Assets to pay holders of Asbestos PI Claims in accordance with the Asbestos PI Trust Agreement and the Asbestos PI Trust Distribution Procedures, and in such a way that provides reasonable assurance that the Asbestos PI Trust shall value and be in a financial position to pay present and future Asbestos PI Claims that involve similar Claims in substantially

> the same manner, and to otherwise comply in all respects with the requirements of section 524(g)(2)(B) of the Bankruptcy Code.[ii]

The Fourth Amended Plan enabled Pfizer to limit their liability. They would make a fixed contribution to the Asbestos PI Trust, which in turn would indemnify and hold harmless the "Pfizer Protected Parties". "Pfizer Protected Parties" included (a) Pfizer; (b) Pfizer's Affiliates (other than Quigley) as of the date of the Plan, and (c) Mineral Technologies Inc. In effect, Pfizer limited its liability in filed and future asbestos cases. Claimants with settled cases, who would be receiving a significant portion of their payout, comprised a large enough interest to confirm the plan. The Ad Hoc Committee of Tort Victims and the U.S. Trustee objected to the plan citing a lack of good faith under §1129 and sought to designate the settled claims. The court designated the claims and the plan was not confirmed.

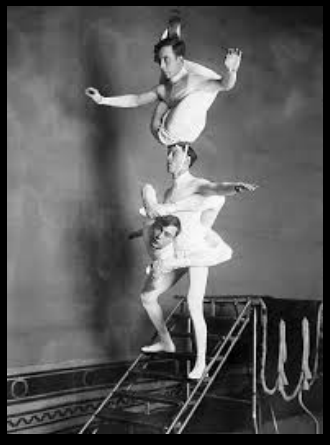
Value provided to creditors is not always in bad faith. Courts have made distinctions between gifts provided to encourage shareholders to structure a plan in favor of one creditor over another, and gifts provided to encourage shareholders, whose skills and knowledge are important to operations, to remain with the company post-bankruptcy. Courts have designated claims purchased by outsiders in order to avoid plan confirmation, and have designated claims where they felt certain creditors were unfairly enriched by class structures designed by insiders. The intent of the law is very clear. A plan can only be confirmed if it satisfies the statutory requirements for confirmation, which include findings by the bankruptcy court that the plan was:

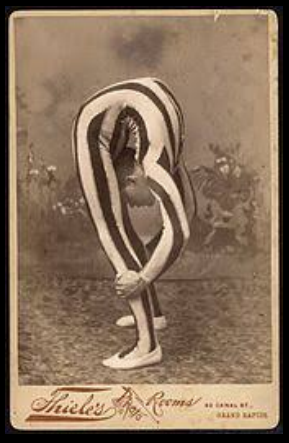
1. Proposed in good faith, the plan is fair and equitable and does not unfairly discriminate against similarly-situated creditors,
2. The plan is feasible,
3. The plan provides creditors with at least as much as the creditors would receive in a hypothetical liquidation.

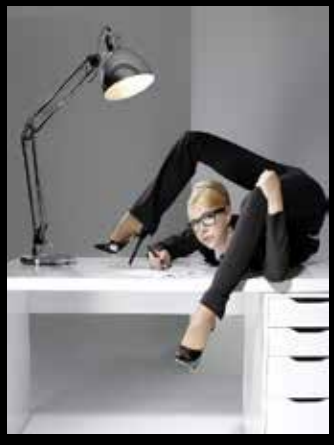
[i] Amended and Restated Plan of Reorganization Under Chapter 11 of The Bankruptcy Code (as modified as of August 6, 2009); Section 4.4.
[ii] IBID, Section 9.3.

Gerrymandering, Vote Incentivization Schemes, Drop Dead Provisions and Golden Shares

Creative Lawyering or Contorting the Code?







VOTE INCENTIVIZATION SCHEMES

ADPT DFW HOLDINGS LLC, *ET AL*. A/K/A ADEPTUS HEALTHCARE

- Filed for Chapter 11 on April 19, 2017 in the Northern District of Texas.
  - Judge Stacey Jernigan presided.
  - There are 140 Debtors.
- The Debtors were developers and operators of free standing operating rooms and were joint venture partner with three major hospital systems in Texas, Colorado and Arizona).
  - Public company.
  - The Adeptus Enterprise operated approximately 100 free standing operating departments and five (5) hospitals.

ADPT DFW HOLDINGS LLC, *ET AL*. A/K/A ADEPTUS HEALTHCARE CONT.

- What makes this interesting?
  - Deerfield Management (Senior Lender, Pre-Petition Lender, DIP Lender, and New Equity).
    - In early April 2017, Bank Group sold its position to funds related to Deerfield Management.
    - Approximately $213 million of bank debt was sold for approximately 8.2 cents on the dollar or $17.5 million.
    - Deerfield sought to convert up to $100 million of its debt to new equity and maintain a deficiency claim for the balance.
  - Official Committee of Unsecured Creditors.
  - Appointment of an Equity Committee.
  - Substantive Consolidation.
  - Securities Litigation

DROP DEAD PROVISIONS

PLAN CONFIRMATION WITH PROJECTED NEGATIVE CASH FLOW

- Section 1129(a)(11) states:
- "The court shall confirm a plan only if all of the following requirements are met: …….

  Confirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan, unless such liquidation or reorganization is proposed in the plan".

DANNY THOMAS PROPERTIES II RULING

- In Danny Thomas the Debtor projected annual cash losses from the beginning of the plan, but incorporated into the plan a "drop dead" provision, whereby if the cash shortfall problem was not solved, then the secured creditor could automatically take back the property.
- Secured creditor objected to the cram down
- Because of the negative cash flow, the Debtor was not able to show the secured creditor's position would not worsen
- Court ruled that the drop dead provision did not save what was otherwise an infeasible plan
- *Danny Thomas Properties II Limited Partnership v. Beal Bank S.S.B.*, 241 F.3d 959 (8th Cir. 2001)

203 N. LASALLE RULING

- In 203 N. LaSalle, the plan projected annual cash losses after year 6, with a "drop dead" provision that if they couldn't pay the secured lender, a deed in escrow would be released
- The court ruled that based on testimony the Debtor would be able to sell or refinance the property by year 6, thereby, having the ability to repay the secured debt without relying on the drop dead provision
- *In re 203 N. LaSalle Street Partnership*, 126 F.3d 955 (7th Cir. 1997)

THE DIFFERENCE

- In Danny Thomas the negative cash flow started immediately and their immediate solutions were based on speculative rent and market values
- In Danny Thomas, there was not the reasonable expectation the secured lender would be able to hold their position
- In 203 N. LaSalle, the negative cash flow did not start until year 6, but which time the debtor, per expert testimony, should be able to refinance or sell, thus protecting the secured lender from additional losses.

GERRYMANDERING

FACT PATTERN

- The debtor is a parts manufacturer for a variety of industries, including military and maritime. The company experienced financial distress because of a judgment for patent infringement. The debtor filed a chapter 11 plan of reorganization that separately classified the judgment claim of approximately $8 million from the pool of general unsecured trade creditors with total claims of $73,002.40. The proposed plan contemplates payment in full of the judgment creditor's claim over nine years at 3% interest and payment of 75% of trade creditors' claims.
- *In re STC, Inc.,* 2016 WL 3884799 (Bankr. S.D. Ill. Apr. 7, 2016) (Grandy, J.)

QUESTIONS AND ISSUES

1. Was the separate classification of the judgment claim impermissible gerrymandering?
2. Would it matter if the judgment creditor were a direct and strong competitor of the debtor?
3. Would the inclusion of a "drop dead" provision in the plan to resolve the judgment creditors' objection raise problems for confirmation? Would the inclusion of such a provision raise other potential challenges to confirmation?

FACT PATTERN

- The debtor owns and operates a waterpark in Fresno, California. The debtor filed a proposed plan separately classifying unsecured trade creditors. This plan offered to pay trade creditors 100% of their claims on the effective date, provided that they agree to continue to provide services to the debtor for at least one post-confirmation operating season. By contrast, general unsecured creditors would receive either: (a) 10% of their allowed claims in cash, or (b) 45% of the equity interests in the reorganized debtor.
- *In re Rexford Props. LLC*, 558 B.R. 352 (Bankr. C.D. Cal. 2016) (Barash, J.)

QUESTIONS AND ISSUES

1. Was the separate classification of the trade creditors impermissible gerrymandering?
2. Is there any way to test the appropriateness of the separate classification prior to balloting and confirmation? When would you? Any downside to doing so?
3. What kind of evidence would be required to support the legitimacy of the separate classification?
4. Does the structure of the plan create other concerns for confirmation—e.g., "unfair discrimination"?

FACT PATTERN

- The debtors are a group of related entities that lease real property to low-income tenants. Because of numerous lead paint tort claims asserted against the debtors, they filed for chapter 11 relief. They proposed a liquidating chapter 11 plan, involving the managed liquidation of all debtor and related non-debtor real estate. The plan contemplated the use of a portion of the proceeds from the contemplated sale to create a $300,000 fund to satisfy the tort claims that were otherwise not insured. To participate in the fund, lead paint claimants needed to submit claims within a fixed time after the effective date of the plan. Claimants could alternatively proceed to have their claims litigated in state court; however, by doing so, they would be limiting their recovery to insurance proceeds and waiving any recourse against the estate. Under either scenario, lead paint claimants would be bound by a release of their claims against various non-debtor parties, including the debtors' boards of directors and management.
- *In re City Homes III LLC*, 564 B.R. 827 (Bankr. D. Md. 2017) (Gordon, J.)

QUESTIONS AND ISSUES

1. Is gerrymandering at issue in this case? Would it have been more appropriate to classify the insured claims separately from the uninsured claimants?
2. Would the extent of notice provided to uninsured claimants change the analysis?
3. Is the inclusion of the third-party releases inappropriate under these facts? Does the size of the uninsured claimant fund affect that analysis?

GOLDEN SHARES

SCENARIO

- LLC Borrower defaults within 6 months of loan origination;
- As condition of forbearance, Lender requires amendments to LLC operating agreement including:
  - Make Lender a "Special Member" of LLC with the right to approve or disapprove any "Material Action" – including the filing of a Bankruptcy Petition
  - Special Member is ONLY required to consider its own interests and has no duty to consider any interest or factors affecting the LLC or its other members.
- Another Default leads to a foreclosure action by Lender;
- Debtor files a voluntary Ch. 11 petition.
- Lender moves to dismiss the case arguing a lack of authority to file.

In re: Lake Mich. Beach Pottawattamie Resort, LLC, 547 B.R. 899 (Bankr. N.D. Ill. 2016)

DISCUSSION

- Bankruptcy Court denied the Motion to Dismiss finding that the language giving the Lender the ability to block actions of the Debtor without consideration of its fiduciary duties to the Debtor and other Members was void.
- What if Michigan Law did not impose a fiduciary duty on members? Or allowed the members to contract around those duties?

SCENARIO

- Debtor LLCs formed under Delaware law default under loan documents;
- Lender agrees to waive defaults if a partial payment is made by a set date, and amendments are made to parent LLC's operating agreement including:
  - Issuance of 1 common unit to Lender
  - Operating Agreement modified to required unanimous approval of the holders of common units prior to a voluntary bankruptcy filing.
- Debtor LLCs cannot make the payment by set date, and file voluntary Ch. 11 petitions.
- Lender moves to dismiss bankruptcy because decision to file was not unanimous among common shares (22,000,000 to 1)

In re Intervention Energy Holdings, LLC, 553 B.R. 258 (Bankr. D. Del. 2016)

DISCUSSION

- Delaware law authorizes the abrogation of fiduciary duties of limited liability companies and their members. Specifically, 6 Del. C. § 18-1101(e) provides as follows:

> A limited liability company agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a member, manager or other person to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement; provided, that a limited liability company agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.

- Since Delaware law allows the members to abrogate fiduciary duties, what's the problem?

DISCUSSION CONT.

- The Bankruptcy Court determined that the "unmistakable" and "indisputable" intent of the amendments to the operating agreement were to block any bankruptcy filing, and that such a provision was void as against federal public policy.
- "It is a well-settled principal that an advance agreement to waive the benefits conferred by the bankruptcy laws is wholly void as against public policy." *In re Tru Block Concrete Prods., Inc.* 27 B.R. 486, 492 (Bankr. S.D. Cal. 1982).
- Should drafters continue to include these "golden share" or "blocking director" provisions in documents?
- If your client asks for such a provision, what advice can you provide?