# Buying Votes in Chapter 11

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According to § 1129 of the Bankruptcy Code, a court shall only confirm a chapter 11 plan if all of the requirements listed in (a)(1) through (a)(16) are met. Pursuant to (a)(3) therein, the plan must be proposed in good faith and not by any means forbidden by law. Furthermore, the plan must be accepted by at least one class of impaired claims, and the acceptance cannot include acceptance of the plan by an insider.[1]

With respect to confirmation requirements, confirmation is grounded in notions of fair dealing and disclosure by and among the debtor and the creditors within the bounds of the Code and the relief afforded therein to the debtor. The voting process is contemplated to provide some reasonable *indicia* of support following the review of the global circumstances by impacted creditors and to prevent confirmation where "side-dealing" is present.[2] When impaired creditors vote for or against a chapter 11 plan, the court presumes that they do so with free and informed consent to their altered treatment going forward. If support from at least one impaired creditor class were not required, the chapter 11 confirmation process would be changed technically as well as theoretically.[3] The fully and freely informed vote of the impaired creditor is essential to the spirit of chapter 11 and the Code. Therefore, it must follow that an inappropriately influenced vote cannot serve the purposes of chapter 11.

## Artificial Impairment of Claims, Vote Manipulation and Gerrymandering

Cases that deal with inappropriately influenced voting through financial incentives often also deal with a number of related issues including artificial impairment of claims, vote manipulation and gerrymandering. Section 1129 could be characterized as providing a formula for calculating votes in the context of chapter 11 confirmation. By adjusting the membership makeup of any particular class, the value of individual claims, and/or the impaired characterization thereof, a party can formulate a calculation either for or against confirmation.

Section 1124 provides that a claim is truly impaired when the legal, equitable or contractual rights of the creditor are materially altered.[4] When claims are inappropriately grouped together or separated into classes for the sole purpose of engineering confirmation, this constitutes gerrymandering. Artificial impairment occurs where the change in a creditor's claim rights are quite minimal and where evidence establishes that the impairment was solely devised for the purpose of technical compliance with § 1129(a)(10) and obtaining confirmation of a plan.[5]

The cases reviewed in this article highlight that artificial impairment, gerrymandering and vote manipulation are more likely to come into play where numerous disclosure statements or plans have been filed and/or where there is a vast financial and/or practical dilemma facing the debtor (and a related entity) that has not been resolved over a significant period of time, whether in or outside of bankruptcy. The fine line between confirmation strategy and confirmation manipulation can blur in these instances.

## Sole Corporate Shareholder Financially Incentivizing Vote Precludes Confirmation

*In re Quigley* presents a detailed discussion not only with regard to artificial impairment and gerrymandering, but also concerning the monetary incentivization of an impaired class to vote in favor of a chapter 11 plan.[6] In writing the *Quigley* decision, Hon. **Stuart M. Bernstein** of the Southern District of New York provided a treasure trove of legal material for any bankruptcy practitioner dealing with voting manipulation issues in a chapter 11.

The *Quigley* story begins in 1916, the year Quigley Co. was founded as a manufacturer of refractory products. From 1940-70, Quigley sold three asbestos-containing products that caused asbestos-related injuries. In 1968, Pfizer acquired Quigley and was Quigley's sole shareholder. In 1992, Quigley sold substantially all of its assets, did not operate any business thereafter and filed its chapter 11 petition on Sept. 3, 2004.

Despite the cessation of operations and sale of Quigley's assets, Quigley and Pfizer were named as defendants in 411,110 asbestos personal-injury cases. On top of that, a future claims representative estimated to the court that there were roughly 261,567 claims yet to be made. As Quigley was financially dependent on Pfizer, Pfizer was the only entity with any real ability to negotiate and pay tort claims. Pfizer also carried joint insurance.

Over a significant period of time, Quigley and Pfizer attempted numerous ways to address these tort claims. They utilized the services of a claims-handling nonprofit organization. They participated in a class-action settlement that was eventually overturned by the Supreme Court. They entered into various agreements and even tried to support favorable asbestos-litigation legislation. As time wore on, the financial outlook associated with these tort claims deteriorated for Pfizer and Quigley. Many of the asbestos producers, who were also named defendants in the various civil actions, filed for bankruptcy relief. Quigley's and Pfizer's potential exposure continued to grow.

As a result of the numerous failed attempts to resolve this situation outside of bankruptcy, Quigley and Pfizer developed a global strategy, wherein they would attempt to address and limit their liability using the bankruptcy court. The global strategy centered on



1 11 U.S.C. § 1129(a)(10).
2 *In re Windsor on the River Assocs.*, 7 F.3d 127, 132 (8th Cir. 1993).
3 *Id.*
4 11 U.S.C. § 1124(1).
5 *See, e.g., In re Estate of Larosa*, 2009 Bankr. LEXIS 517 (Bankr. N.D. W.Va. March 25, 2009); *In re Gregory Rockhouse Ranch*, 2007 Bankr. LEXIS 4343 (Bankr. D. N.M. Dec. 21, 2007).
6 *In re Quigley*, 437 B.R. 102 (Bankr. S.D.N.Y. 2010), is a 50-page decision dated Sept. 8, 2010, with significant factual detail, which the authors attempted to summarize from a very general perspective.

Pfizer entering into agreements to settle and limit its own liability. These agreements would make Pfizer's final settlement payment contingent on the confirmation of Quigley's chapter 11 plan, among other things.[7]

For purposes of the fourth amended plan at issue, Quigley and Pfizer strategically formulated Quigley's classes in such a way that Quigley's chapter 11 plan confirmation was essentially assured, which contained additional protections for Pfizer.[8] They formulated an impaired class that included those who settled with Pfizer and those who had not in such a way that this impaired class would very predictably vote in favor of the plan. Specifically, those who settled with Pfizer were incentivized to vote for Quigley's plan, and those who had settled outnumbered and represented a greater value of claims than those who had not. Pfizer incentivized these claimholders to vote for the plan by conditioning a final Pfizer settlement payment on confirmation of the Quigley plan.

As a result, the Ad Hoc Committee of Tort Victims (AHC) and the U.S. Trustee objected to confirmation on the basis of lack of good faith pursuant to 11 U.S.C. § 1129(a)(3) and artificial impairment under § 1129(a)(10), among other issues. The AHC and U.S. Trustee also sought to designate (*i.e.*, disqualify from voting) these tainted claims pursuant to § 1126(e).

One of the most interesting things about the *Quigley* decision is that Judge Bernstein noted that there is more to § 1129(a)(3) than the content of the plan,[9] stating that (a)(3) must be "viewed in light of the totality of circumstances surrounding the establishment of a chapter 11 plan" and "including the debtor's pre-filing conduct."[10] It appears that for Judge Bernstein, past actions matter. It made particular sense for the court to include in the opinion a detailed historical account of the debtor and its attempts to deal with these asbestos-related personal injury claims over a significant period of time both in and outside of bankruptcy.

The court ultimately concluded that the impaired class was motivated to accept the plan by virtue of financial incentives, which were structured so as to manipulate the Quigley confirmation vote. As such, the plan was not proposed in good faith, and the court concluded that the bad-faith findings under § 1126(a)(3) buoyed its conclusion that the tainted votes should be disqualified. Confirmation of the fourth amended plan was denied by the court.

## Impermissible Attempt to Incentivize Change of Vote

In *In re Featherworks Corp.*, Featherworks Corp. filed for chapter 11 relief.[11] The debtor was a subsidiary of Hudson Feather & Down Products Inc., which owned 100 percent of its common stock. Featherworks had essentially four significant creditors—namely, Hudson, Walter E. Heller & Co., Windsor Trading Company and Far West Garments Inc. Hudson was owned by Puro International Ltd., which was in turn owned by Windsor. Windsor belonged to the wife and daughter of the president of the debtor, Arthur Puro.

Hudson and Windsor were the debtor's largest creditors, and Far West was a former customer of the debtor with a breach-of-warranty judgment. Heller financed the debtor until the chapter 11 petition was filed. Among other things, the chapter 11 plan provided roughly $40,000 to unsecured creditors holding $12.5 million in claims; the funds were supplied by Windsor. The plan left Windsor and Puro in full ownership of Featherworks, free of all debts save the $40,000 to be paid.

Among other confirmation issues discussed, the court specifically looked at the voting process and, in particular, an attempt to change a vote by Heller. Heller voted against the plan, but subsequently filed a motion for authority to change its vote. In the motion, Heller stated that it initially decided to vote in favor of the plan until it took possession of the debtor's pre-petition inventory and determined it to be flawed. Heller decided to vote against the plan and to sue the debtor, Windsor and Puro.

To avoid litigation, Arthur Puro paid Heller $25,000 in exchange for certain releases for himself and Windsor, among other things. In its motion, Heller maintained that the receipt of the $25,000 was not the reason it changed its vote in favor of the plan, despite the fact that it changed its vote immediately upon receipt of the $25,000.

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[7] In the past, the court noted, Pfizer and Quigley would settle their claims jointly.

[8] The court's decision concerns the fourth amended plan submitted by the debtor.

[9] *Quigley*, 437 B.R. at 125 (referring to *In re Bush Indus. Inc.*, 315 B.R. 292, 304 (Bankr. W.D.N.Y. 2004)).

[10] *Id.* (referring to, among others, *In re Greate Bay Hotel & Casino Inc.*, 251 B.R. 213, 240 (Bankr. D. N.J. 2000); *In re Madison Hotel Assocs.*, 749 F.2d 410, 425 (7th Cir. Wis. 1984); *In re Jasik*, 727 F.2d 1379, 1383 (5th Cir. Tex. 1984)).

[11] In re Featherworks Corp., 25 B.R. 634 (Bankr. E.D.N.Y. 1982).

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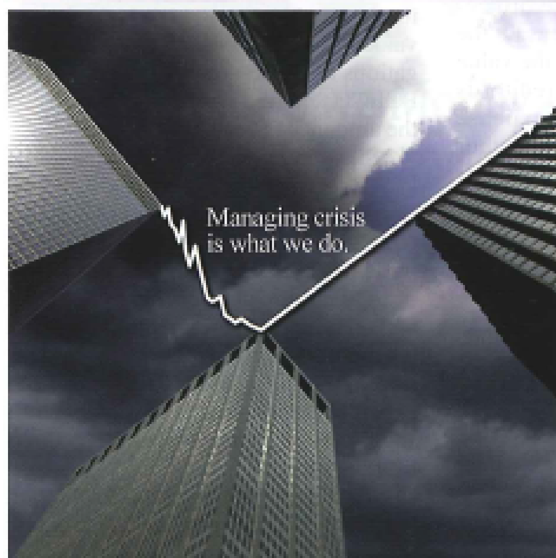


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All things considered, the court did not find that the acceptance of the plan by Heller was given in good faith. The court held that a "change in vote by the Debtor's major unsecured creditor, coincidental with the receipt from the same source as the $40,000 funding the plan of an additional $25,000 over and above what other creditors are receiving, will not be allowed."[12]

## Go with Your Gut

The cases summarized in this article generally suggest that financial incentive from parties related to the debtor in voting will raise red flags to the court. What is also apparent is that terms conditioning settlement relative to how votes must be cast are problematic. *In re Wiston XXIV* is an interesting case inasmuch as an admittedly inexperienced bankruptcy attorney had initial concerns about a voting agreement, but ultimately disregarded those initial concerns.[13]

*Wiston* was a single-asset real estate case in which the debtor moved to designate a creditor's claim based on alleged voting improprieties. If the court agreed with the debtor and disqualified the vote, the impaired class would be deemed to have accepted the plan. If it did not agree with the debtor, there was no impaired class that would be deemed to have voted in favor of the plan.

Essentially, two creditors of the debtor negotiated and entered into an agreement related to foreclosure of real estate, possession of personal property collateral therein and promises to refrain from seeking recovery of improper post-petition payments. Acceptance of the settlement agreement was conditioned on the creditors' voting to reject the debtor's plan, although this term was not expressly stated in the creditors' agreement. Counsel for one of the creditors expressed concern that his client's vote would be designated but was assured by the other counsel that everything would be fine. The settlement agreement was held for signature until it was clear that the rejection vote was, in fact, filed. The court concluded that the agreement was made primarily for defeating the plan and, in reaching its decision, highlighted that one of the attorneys to the agreement questioned the appropriateness of the voting condition at the outset.[14]

## Conclusion

These cases strongly suggest that conditioning a financial incentive to a creditor in exchange for a pre-determined plan vote is inappropriate under § 1129. Whether or not that condition is expressly set forth in the agreement does not appear to make much difference. If settlement is conditioned on voting, it presents a problem.

In addition to considering the understandings or written agreements of the parties relative to the vote, a court may also look to the past historical dealings of the involved parties and insider relationships. Where there is essentially a sweetheart deal for a related entity and a motive to financially incentivize others to vote similarly, look for the court not only to find a lack of good faith but also to consider designating the vote under § 1126(e). Simply put, good faith in the voting process is the backbone of the chapter 11 reorganization and confirmation process. ■

[12] *Id.* at 641.

[13] *In re Wiston XXIV Ltd. Part.*, 153 B.R. 322 (Bankr. D. Kan. 1993).

[14] *Id.* at 325.