VOTE INCENTIVIZATION SCHEMES IN CHAPTER 11

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I. Introduction

As set forth in the Bankruptcy Code[1], the confirmation process in chapter 11 is grounded in notions of good faith and fair dealing. The Bankruptcy Code also requires a certain

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mechanical and mathematical tabulation of classes, votes and claim amounts be met in order to obtain confirmation through solicitation and acceptance. The Code also provides a mechanism for obtaining confirmation over the rejection of a class through cram down. The debtor, its insiders, and creditors will likely engage in an analysis of the likelihood of acceptance or rejection by the various claimants and classes will be developed using the mathematical formulas as the guide for resulting hypothetical outcomes. Outsiders and asset speculators may also engage in that same analysis. That being said, vote manipulation, in and of itself, does not necessarily equate to a lack of good faith. Likewise, strategic classification and claims purchases also do not necessarily constitute a lack of good faith.

Debtors, creditors and insiders, alike, can and do engage in vote manipulation to achieve the desired results consistent with their self-interests. Debtors engage in vote manipulation by proposing plans that artificially impair friendly creditors or gerrymander classes so as to meet the class acceptance requirements set out in §§ 1126 and 1129. Creditors typically engage in vote manipulation by purchasing claims or financially incentivizing claimholders in other ways. Insiders can do all of the above either directly or indirectly, which makes those cases especially intriguing and, of course, result in heightened court scrutiny. Outsiders to the bankruptcy may also engage in vote manipulation through the purchase of claims. This article will focus on the very narrow issue of vote incentivization.

As with many aspects of the Bankruptcy Code, there is no bright line between appropriate bankruptcy strategy and negotiation and a lack of good faith in the process of solicitation or formulation of a plan. Rather, there are certain indicia of a lack of good faith that bankruptcy courts highlight in their decisions that a practitioner should consider in determining whether the bankruptcy strategy and negotiations which produced the plan proposed or controlled a confirmation outcome have impermissibly crossed the line.

The penalties that the Bankruptcy Code imposes relative to impermissible vote manipulation are found in § 1126 wherein a claim may be "designated" (i.e. disqualified) and, of course, in the denial of confirmation. Given the mathematical formula set forth in the Bankruptcy Code for confirmation, every vote really does count. The designation of one claim can and does lead to the failure of the confirmation process and the plan as a whole. On the other hand, vote designation can disqualify rejecting votes, and a plan may be confirmed as a result.

II. Background

a. What is good faith under § 1129(a)(3)?

Section 1129 sets forth the general rules governing confirmation. The proponent of confirmation bears the burden of proof by a preponderance of the evidence in meeting the elements set forth therein.[2] Pursuant to § 1129(a)(3), the party seeking confirmation must demonstrate that the "plan has been proposed in good faith and not by any means forbidden by law." Section 101 sets forth a myriad of definitions under the Bankruptcy Code. However, § 101 is silent on the matter of "good faith"; and, as a result, case law must be the source for

explanations as to the definition of "good faith." A review of the case law leads to the conclusion that the definition of "good faith" differs between courts.[3]

Good faith as contemplated in § 1129(a)(3) is defined by the Seventh Circuit as the existence of a "reasonable likelihood that the plan will achieve a result consistent with the objectives and purposes of the Bankruptcy Code."[4] The Seventh Circuit also looks to case law in Chapter 13 cases as instructive on the definition of "good faith" noting that a court is required to review a proposed plan for "accuracy" and a "fundamental fairness in dealing with one's creditors."[5] The Seventh Circuit draws a distinction between the good faith necessary to confirm a chapter 11 plan and the good faith that is required in conjunction with the filing of the chapter 11 bankruptcy case.[6] Although the Seventh Circuit does not state the difference in this way; presumably, the burden of establishing good faith for purposes of confirmation is more stringent than that required of a debtor relative to the appropriateness of its initial filing of a chapter 11 bankruptcy.

Some courts take the position that the process of plan development is more important than the ultimate contents of the plan.[7] In so considering the solicitation and confirmation process, courts look to the "totality of the circumstances" and a single, atypical act by the plan's supporter does not necessarily constitute a lack of good faith.[8] A plan must be proposed with "honesty and good intentions" and must reasonably be believed to be confirmable.[9] If a plan is filed with ulterior motives and lacks full disclosure, good faith is not present.[10] Side dealing by shareholders of a corporation with some creditors to the detriment of other creditors may be indicative of a lack of good faith.[11] Good faith precludes the artificial impairment of de minimus claims held by a friendly creditor.[12] Good faith further precludes the "gerrymandering" of classes.[13] A combination of any of these acts is certainly indicative of a lack of good faith.[14] Both artificial impairment and gerrymandering will be discussed in greater detail in subsequent sections of this material.

A court's finding of "good faith" shall not be overturned unless the opponent of the plan can show the finding was clearly erroneous.[15] Simply put, the good faith requirement in Chapter 11 is a critical test for confirmation.

b. Vote Manipulation – by the Debtor or Insiders of the Debtor

i. Artificial Impairment under §§ 1124 and 1129

The requirements for confirmation of a plan are set forth in 11 U.S.C. § 1129. Specifically, section 1129(a)(10) requires the following:

> If a class of claims is impaired under the plan, at least one class of claims that is impaired under the plan has accepted the plan, determined without including any acceptance of the plan by any insider.

Pursuant to § 1124, claims are impaired under the plan unless the legal, equitable, and contractual rights are unaltered. Good faith should curb a debtor's intentional impairment of

claims for the sole purpose of scheming to meet the confirmation criteria set forth in § 1129 and satisfying the cram down requirements and thereby forcing a plan on a rejecting, truly impaired class.[16] Congress enacted § 1129(a)(10) to require "some indicia of support by affected creditors and to prevent confirmation when that support is lacking."[17] Artificial impairment occurs when a plan proposes an insignificant or de minimus impairment on a class of claims to qualify those claims as impaired under § 1124.[18] Impairment "manufactured at the will of the debtor 'just to stave off the evil day of liquidation'" could be said to equally violate both §§ 1129(a)(3) and 1129(a)(10).[19] Some courts expect the debtor to be capable of providing a plausible explanation for the impairment beyond simply ensuring compliance with § 1129(a)(10) while others appear to require a legitimate business purpose.[20]

ii. Gerrymandering of Classes under §§ 1122, 1126 and 1129

Section § 1122(a) requires that the classes of claims be based on the nature of the claims and permits inclusion of claims or interest in a class only if the claim or interest being included is substantially similar to the other claims or interests in the class. While § 1122(a) does not prohibit placing substantially similar claims in different classes, the debtor's discretion to do so is not unlimited, and such separate classifications must be reasonable.[21] Classes must be carefully reviewed to prevent manipulative classifications from circumventing the Bankruptcy Code goal of according similar treatment to similar claims.[22] Bankruptcy judges have broad discretion to review the propriety of classes based on the facts and circumstances of the case.[23]

Section 1129(a)(8) requires that each class has either accepted the plan or is unimpaired. Section 1129(b)(1) permits the court to confirm a plan notwithstanding the failure of compliance with (a)(8). Section 1129 includes the "cram down" confirmation provision. It permits confirmation irrespective of rejection by an impaired class if that class and all below it are treated according to the absolute priority rule set forth in Section 1129(b). Section 1129(a)(10) provides that if there is a class of impaired claims under the plan, at least one class of claims that is impaired must vote to accept the plan without including the vote of any insider. Pursuant to § 1126(c) a class of claims accepts a plan if at least those holding two-thirds in amount and more than one-half in number of the allowed claims of such class have accepted the plan.

The question, however, remains under § 1122: How dissimilar must claims be to be separately classified; or, conversely, how similar must claims be to be classified together?[24] So long as the separate classification is not created "solely to engineer and assenting impaired class" and a business or economic justification exists, the separate classification will likely be permitted.[25] The common denominator, therefore, between artificial impairment versus legitimate impairment and, similarly, between proper classification and gerrymandering, boils down to whether or not there is a lack of good faith in the process of formulating the plan proposed.

c. Vote Incentivization – By Creditors/Insiders

i. Financial Incentives to Sway Claimholders

Insiders are particularly interesting in the context of vote manipulation because they can manipulate the vote by controlling the debtor and, as a result, the plan proposed. An insider can certainly influence the debtor as to whether classes of claims are gerrymandered, for example. In addition, insiders can purchase claims as well as financially incentivize claimholders to vote for a plan with funds or other means and mechanisms that are outside the knowledge or the jurisdiction of the bankruptcy court. An insider can effect vote manipulation with little or no transparency. It is no wonder, therefore, that the Court is likely to scrutinize insider transactions and incentivization schemes more closely.

d. Vote Designation pursuant to §§ 1126(c) and 1126(e)

The Bankruptcy Code authorizes the bankruptcy court to designate any entity who acted in bad faith in either soliciting acceptance or rejection of the plan or in voting on the plan pursuant to § 1126(e) upon the request of any party in interest. As discussed, the Bankruptcy Code does not define good faith. However, it seems clear that once the issue is raised a court must engage in a factual analysis of the circumstances of the particular case.[26] The Bankruptcy Code does not require "selfless disinterestedness."[27] Courts have specifically held that the mere fact that a creditor purchases a claim to secure the approval or rejection of the plan does not rise to the level of bad faith.[28] However, where a claimholder attempts to "extort" a personal advantage not available to the other creditors or has an impermissible ulterior motive, courts will find a lack of good faith.[29] Section 1126(e) "grants the bankruptcy court the discretion to sanction any conduct that taints the voting process, whether it violates a specific provision or is in bad faith."[30] As a result, the good faith requirement and the analysis thereof in § 1129(a)(3) logically mirror and involve the court's consideration of designating those offending votes pursuant to § 1126(e).

III. Vote Incentivization Schemes: Case Law

a. *In re Quigley*, 437 B.R. 102 (Bankr. S.D.N.Y. 2010) – The Pre-filing Conduct Matters Case.

In re Quigley Company, Inc. 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. [31] In writing the *Quigley* decision, 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 bankruptcy.

The *Quigley* story began in 1916, the year Quigley Company was founded. Quigley was a manufacturer of refractory products. Between 1940 and 1970, Quigley sold three asbestos-containing products that caused asbestos-related injuries. In 1968, Pfizer acquired Quigley. Pfizer was Quigley's sole shareholder. In 1992, Quigley sold substantially all of its assets and did not operate any business thereafter and filed its chapter 11 bankruptcy petition on September 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 of the two with any real ability to negotiate and to 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 non-profit organization. They participated in a class action settlement that was eventually overturned by the U.S. 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 to limit their liability using the bankruptcy court. The global strategy centered on Pfizer entering into agreements to settle and to 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.[32]

For purposes of the Fourth Amended Plan at issue, Quigley and Pfizer strategically formulated Quigley's classes in such a way that confirmation of the of the Quigley Chapter 11 plan was essentially assured, which chapter 11 plan contained additional protections for Pfizer.[33] They did this by formulating an impaired class which 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 § 1129(a)(3) and artificial impairment under § 1129(a)(10) among other issues. The AHC and U.S. Trustee, in addition, sought to designate (i.e., to disqualify from voting) these tainted claims pursuant to § 1126(e).

One of the most interesting things about the *Quigley* decision is that the Bankruptcy Court for the Southern District of New York noted that there is more to § 1129(a)(3) than the content of the plan.[34] The Court stated 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."[35] It makes particular sense, therefore, 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 in this case 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. Moreover, 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.

b. *In re Combustion Engineering, Inc.*, 391 F.3d 190 (3d. Cir. Del. 2004) – The Case of a Deal Between Two Creditors.

Like *Quigley, In re Combustion Engineering, Inc.*, dealt with the treatment of asbestos liability claims. Combustion Engineering defended asbestos liability claims for nearly four decades.[36] In so defending these claims, the financial positions of not only Combustion Engineering but its affiliates and parent companies were significantly and negatively impacted causing all of the companies to have a weak viability outlook.[37] Like *Quigley*, insurance became scarce.[38] In 2002, Combustion Engineering and its parent company, Asea Brown Boveri, Inc. (U.S. ABB") attempted to solve Combustion Engineering's asbestos problems as well as those of two U.S. ABB affiliates, ABB Lummus Global, Inc. ("Lummus") and Basic, Inc. ("Basic").[39] They attempted to do this through negotiation and presentation of a pre-package chapter 11 bankruptcy plan.[40] Combustion Engineering placed half of its assets in a pre-petition trust (the "CE Trust") to pay asbestos claimants part, but not all, of their claims. The remaining, unpaid portion of the asbestos liability claims were referred to as "stub claims" and were granted creditor status for purposes of the bankruptcy.[41] Combustion Engineering filed a pre-packaged chapter 11 plan subsequent thereto.

The proposed bankruptcy plan provided an injunction in favor of Combustion Engineering that channeled all of its asbestos claims to a post-confirmation trust ("Asbestos PI Trust").[42] The plan also extended the asbestos liability protection to Basic and Lummus, which were non-filing affiliates. Millions of dollars were offered by Combustion Engineering and its parent companies to cleanse all companies of asbestos liability.[43]

In negotiating its pre-packaged chapter 11 plan, Combustion Engineering and Lummus worked with an attorney for the interests of current claimants and an attorney to represent the interests of future claimants of Combustion Engineering.[44] By late 2002, the parties had negotiated the structure of the pre-packaged plan. The parties funded the pre-petition CE Trust and participation was offered to all pre-petition claimants.[45] The District Court found that the pre-petition claimants were not required to vote for the plan to participate.[46] However, the settlement agreement provided that counsel for participating claimants would recommend voting in favor of the plan.[47] Those who elected not to participate were limited to recovery through the bankruptcy.[48]

The settlement agreement associated with the CE Trust eventually provided for four sets of claimants. The first set of claimants included claimants who had reached final settlement with Combustion Engineering prior to November 15, 2002. They would received 95% of their settled claim value. The second set of claimants included claimants who had met all the requirements for settlement but whose settlement payments were due after November 15, 2002. They would receive 85% of their settled claim. The third set of claimants were claimants who did not fit into the prior two sets. They would receive 37.5% of their settled claim value followed by a second payment of 37.5% following the satisfaction of certain requirements for a maximum distribution of 75%. The fourth class of claimants included 25,000 – 30,000 of newly discovered claimants

and would receive 37.5% and subordinate their right to receive the second payment. The participating claimants agreed to forbear from prosecuting their claims against Combustion Engineering. The unpaid portion of these four sets of claims, the “stub claims,” allowed them to participate in the bankruptcy and share in the Asbestos PI Trust.

The plan provided for an injunction in favor of Combustion Engineering, Basic and Lummus channeling all claims into the Asbestos PI Trust. Following balloting, 111,986 votes were cast in favor of the plan, and 3,594 claimants voted against the plan.[49] Of the accepting votes, 99,000 were stub claimants who were participating in the Asbestos PI Trust. The bankruptcy court held hearings on the plan and disclosure statement and on the objections thereto. Several modifications of the plan were filed. The bankruptcy court found that the plan, as modified, satisfied the confirmation requirements in §§ 524 and 1129. The District Court acknowledged that the pre-packaged plan was imperfect but nevertheless rejected and overruled the various objections.[50] Specifically, the District Court found that the pre-petition trust payment did not incentivize the CE Settlement Trust participants to vote for the plan.[51] Furthermore, the District Court rejected the argument that the pre-petition payments and creation of the stub claims were intended to manufacture the accepting vote.[52] Ultimately, the District Court also overruled all of the objections and appeals and adopted all of the findings of the bankruptcy court and confirmation order.

Thirteen separate appeals were filed to various aspects of the District Court’s confirmation order with the United States Court of Appeals for the Third Circuit. Certain Cancer Claimants also filed a separate appeal. Emergency motions to stay the implementation of the plan were filed and “standstill” agreements were negotiated and executed. The appeals were consolidated and heard at oral argument.[53]

In addition to other objections raised, the Third Circuit addressed the creation of the “stub claims.”[54] The Certain Cancer Claimants argued that the pre-petition CE Trust “artificially impaired” or contrived the stub claims in order to garner sufficient votes in favor of confirmation.”[55] Unlike the Bankruptcy and District Courts, the Third Circuit found that the Debtor made a “pre-petition side arrangement with a privileged group of asbestos claimants, who as a consequence represented a voting majority despite holding, in many cases, only slightly impaired stub claims.”[56] The Third Circuit stated that the “monitoring function of § 1129(a)(10) may have been significantly weakened.”[57] The Court further noted that this type of vote manipulation was especially troubling in asbestos context where “a voting majority can be made to consist of non-malignant claimants whose interests may be adverse to those of claimants with more severe injuries.”[58] The Court found that Combustion Engineering made pre-pretition payments to current asbestos claimants that exceeded the recovery of other claimants, including the Cancer Claimants, in the bankruptcy. By paying up to 95% of their claims through the CE Settlement Trust these claimants had “little incentive to scrutinize the terms of the proposed Plan.”[59] Interestingly, the Third Circuit found that their pre-petition payments were “implicitly conditioned” on an acceptance vote.[60]

The Court further noted that the Plan originally provided a release for all avoidance/preference actions against the participants in the CE Settlement Trust.[61] While the provision was subsequently removed, the Court noted that its removal did not take place until

after the solicitation and voting process was completed.[62] Therefore, when the claimants participating in the CE Settlement Trust voted on the plan their incentive was two-fold. Those who did not participate in the CE Settlement Trust were limited to participation in the post-petition Asbestos PI Trust. Finally, the Court noted that future and other non-participating asbestos claimants, including the Cancer Claimants, had not been adequately represented during the pre-petition negotiation phase of the bankruptcy plan. The Third Circuit remanded the case for further consideration of the artificial impairment issue as well as other issues discussed in the decision and vacated the confirmation order.[63]

c. *In re Wiston XXIV Ltd. Part.*, 153 B.R. 322 (Bankr.D.Kan. 1993) – The Go with Your Gut Case.

Wiston is an excellent example of why each vote counts. *Wiston* was a single asset case that was problematic from the beginning. After approval of the debtor's sixth disclosure statement, the case came before the District Court for consideration of the confirmation of the debtor's fourth amended plan. Balcor Pension Investors ("Balcor") held the first mortgage on the debtor's apartment complex. Merchants Bank held the second mortgage on the debtor's apartment complex. Merchants Bank ("Merchants") was the only impaired class in the plan. Balcor objected to Merchants being classified separately as a secured claim asserting that it was a wholly unsecured claim and that no valid basis existed for separating Merchants from the other unsecured creditors. The Court sustained this objection and eliminated the only impaired class that voted for the plan.[64] Merchant's claim was moved to the class of unsecured creditors, which included two other voting claims, one of who was Kansas Power & Light ("KPL").[65] The addition of Merchant's meant that two of the three claimants voted in favor of the plan; however, KPL's claim constituted 38% of the amount of the class so the two-thirds portion of the statute was not satisfied under § 1126(c). [66]

The debtor, however, moved to designate the KPL vote pursuant to § 1126(e) because it believed that KPL's rejection was procured in bad faith. If KPL's vote were designated, then one class of impaired claims would be deemed to have accepted the plan. If KPL's vote were not designated, then no class of impaired claims would be deemed to have accepted the plan and confirmation would fail.

During the pendency of the chapter 11, the debtor made payments to two creditors, Merchants on its second mortgage and KPL relative to a lease of a 500-ton chiller and related equipment. The Court notes that the debtor may have been motivated to pay Merchants because its general partner had personally guaranteed the debt.[67] These payments ceased after approximately 18 months when the debtor became aware that the Merchants was wholly unsecured and KPL had failed to perfect a disguised financing lease. Before the Fourth Plan, KPL had either failed to vote or voted to accept the plan because the debtor proposed payment in full over five years. The Fourth Plan, however, provided payment in full but proposed no payments for 18 months, paying interest only for the next 18 months, and then amortized the balance over seven years.[68] All creditors were to be paid in full over time, which Balcor found unacceptable.

Balcor objected to all six disclosure statements and four plans. It objected to the debtor not seeking recovery of the 18 months of payments made to Merchants and KPL. The debtor proposed in its fourth plan a recoupment concept from KPL and Merchants. Balcor subsequently contacted KPL and an agreement was negotiated. The agreement provided that if Balcor obtained title to the apartment complex through foreclosure, KPL would give Balcor the 500lb-chiller in exchange for $105,000 and Balcor's promise not to seek recovery of the 18 months of payments made by the debtor to KPL. Although not expressly stated, it was implicitly understood that KPL would reject the debtor's plan. Counsel for KPL expressed some concern that the written agreement and implicit understanding would cause the Court to designate the vote.[69] Balcor's counsel assured KPL's counsel that it would be "alright."[70] Balcor held the contract without executing until it was assured that KPL voted against the plan.

The Court further notes that Balcor "should have known" that its perfected security interest in the 500 pound chiller would take priority over KPL's unperfected disguised lease. Balcor, nevertheless, argued that it made its agreement with KPL solely for economic reasons rather than solely to defeat yet another plan proposed.

The Court held that the KPL vote should be designated because its purpose was to block confirmation. Moreover, the agreement between KPL and Balcor had the effect of permitting Balcor to purchase the KPL claim without having to pay for it up front.[71] As a result of feasibility concerns, however, the plan was not confirmed.[72]

d. *In re Applegate Property, Ltd.*, 133 B.R. 827 (Bankr. W.D.Tex. 1991) – The Expression of Intent to Coerce Case.

Applegate involves claims purchasing as a means to control the vote. In *Applegate*, Applegate Limited Partnership, the debtor, filed its plan of reorganization. Subsequently, one of the creditors, Resolution Trust Corporation ("RTC") filed a competing plan of reorganization. The competing plans were set for confirmation on the same day.

RTC asserted that a related entity of the debtor was "covertly" purchasing claims in order to control the vote.[73] The evidence supported that the related entity was purchasing unsecured claims designated as class 5 claims in both plans for full face value. The related entity, however, was not purchasing all class 5 claims. The claims purchased constituted 57.82% of the unsecured claims.

The debtor argued that the claims purchasing by the related entity occurred because it was afraid that RTC would purchase the claims to block confirmation of the debtor's plan and to assure confirmation of its own.[74] In addition to objections related to claim purchasing, RTC asserted that the disclosure statement did not contain "adequate information" as a result of the debtor's failure to disclose the relationship between the debtor and its affiliate. The Court held that the "relationship of a debtor with affiliates is the type of information that should ordinarily be disclosed."[75] The failure to do so is "misleading."[76]

With regard to the issue of vote designation, the Court had to decide two issues given the two competing plans. First, it had to decide whether or not to strike the purchased votes in

favor of the debtor's plan as well as the votes cast against RTC's plan. Among other issues, RTC argued that the purchased votes were not solicited in good faith.[77] RTC's argument relative to the lack of good faith was that there was disparate treatment of the class 5 claims because the related entity only paid some of the claimants in full and that because the related entity and the debtor shared general partners, the partners had breached their fiduciary duty.[78] The Court, however, did not address these issues. It, instead, held that the "straightforward policy of *Section 1129(a)(10)* prevents the debtor from using an insider-dominated class to satisfy the requirement that at least one impaired class of creditors vote for the plan."[79] Because the votes did not count toward confirmation of the debtor's plan, further inquiry as to their disqualification was unnecessary.

Second, the Court had to decide whether the votes counted against the RTC plan. Section 1129(a)(10) addresses only "accepting" votes. It does not address "rejecting" votes. The Court carefully distilled the issue as follows:

> The issue thus narrowed is whether an affiliate or insider of the Debtor can purchase unsecured claims in a given class in order to block the purchase of such claims by a competing entity of the Debtor, to block confirmation of the competing entity's plan, without violating *Section 1126(e)*[80].

The Bankruptcy Court noted that the U.S. Supreme Court stated that the "… purpose of imposing a 'good faith' standard on the voting process was to prevent the use of 'obstructive tactics and hold up techniques' to procure an unfair advantage over other creditors in the confirmation process."[81] A creditor who indicates an intent to cast or casts his vote in order to coerce payment to him to change his vote or to increase the purchase price of his claim does not do so in good faith.[82] However, the *Applegate* Court is careful to also note that "good faith voting and solicitation does not demand selfless disinterest."[83] The Court did not accept the debtor's argument that it needed to buy the claims before RTC did it to them. The Court held that the proper way of dealing with similar conduct on the part of RTC was to have their votes disqualified.[84] They similarly declined to permit future debtors from utilizing this as an excuse for the conduct.[85] As a result, the Court ultimately disqualified the related entity votes against the RTC plan and did not count the votes towards acceptance of the debtor's plan.[86]

e. *In re Featherworks,* 25 B.R. 634 (Bankr. E.D.N.Y. 1982) – The Extra Payment Case.

In the case of *In re Featherworks Corp.,* Featherworks Corporation ["Featherworks"] filed for chapter 11 relief. [87] The debtor was a subsidiary of Hudson Feather & Down Products, Inc. ["Hudson"], which owned 100 percent of its common stock. Featherworks had essentially four significant creditors, namely, Hudson, Walter E. Heller & Co. ["Heller"], Windsor Trading Company ["Windsor"] and Far West Garments Inc. ["Far West"]. Hudson was owned by Puro International Ltd., ["Puro"] 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 largest creditors of the debtor. 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, which 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 in the case, 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 to acceptance. 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 in consequence 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.

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."[88]

f. *In re DBSD North America, Inc.*, 421 B.R. 133 (Bankr. S.D.N.Y. 2009): The Ulterior Motives Case.

The debtors were a development-stage enterprise formed in 2004 to develop a specialized satellite system to provide wireless satellite communications to consumers.[89] The debtor made significant progress in developing the satellite as well as in obtaining regulatory approval.[90] The debtors, however, had limited revenues and operations, although the satellite system had substantial value. DISH and its related entities owned 14 satellites and had substantial operations and revenue.[91] DISH was not a creditor of the debtor. Following the filing of an amended chapter 11 plan, DISH purchased all of the first lien debt and, through an affiliate, purchased the second lien debt only from sellers who were not bound to vote their claims in favor of the plan by virtue a certain "Plan Support Agreement."[92] DISH purchased these claims for "par-paying the price for which most other creditors could only hope."[93] Moreover, DISH seemingly acknowledged in the proceedings that it was overpaying for the debt but was willing to make the "investment" to "obtain a blocking position" and "to control the bankruptcy process" to obtain this "strategic asset," namely, the satellite system.[94]

The debtor ultimately filed another plan and disclosure statement to which DISH voted all of its claims to reject the plan.[95] All other classes voted to accept the plan.[96] The debtors sought to designate DISH's vote. DISH argued that its conduct was that of a "model bankruptcy citizen" and noted that it had "not moved to terminate exclusivity, and it has not proposed a competing plan."[97] However, on the morning of the confirmation hearing, DISH filed a motion

seeking to terminate the 180 day exclusivity period and for authority to propose a competing plan.[98] Although details are not provided, DISH made a proposal to the debtors to enter into a major transaction; however, the scope of that proposal was vastly beyond the treatment of its purchased first and second lien positions.[99]

The Court ultimately held that "DISH made its investment in this chapter 11 case, not as a traditional creditor seeking to maximize a return on the debt it holds, but as a strategic investor, 'to establish control over a this strategic asset."[100] The Court further notes that DISH used its "status as a creditor to provided advantages over proposing a plan as an outsider or making a traditional bid for the company or its assets."[101] As a result, the votes of DISH were disqualified as a result of bad faith.[102]

IV. Conclusion

Generally speaking, the following facts and circumstances seem to be recurrent in the cases discussed:

- A long and unresolved pre-bankruptcy history
- The involvement of insiders with the debtor and in the solicitation of the plan
- The existence of ulterior motives
- A long and contentious bankruptcy history including multiple disclosure statements and plans
- Monies made available to some participating creditors outside of bankruptcy but not made available to all similarly situated creditors
- Conditioning of distribution of those monies, implicitly or expressly, outside of bankruptcy on a particular vote inside bankruptcy
- Conditioning payments outside of bankruptcy on a particular vote inside bankruptcy
- Offering to purchase some, but not all, of the votes in a particular class
- Offering different amounts for the purchase of claims in a particular class
- Conditioning purchase of a claim and/or execution of the contract to purchase a claim on the vote
- Procuring unfair advantage over other creditors
- Indicating an intent to cast a vote in a certain way in order to coerce payment or to increase the purchase price for the claim
- Receipt of payment from an insider not otherwise available to other participating bankruptcy creditors
- The actions of the creditor result in a block to confirmation
- The actions of the insider relative to the bankruptcy creditors assure confirmation
- Disparity in recovery between similarly situated creditors and classes
- Inequitable results or providing substantial releases or benefits to insiders of the debtor
- Using the purchase of claims to circumvent the asset bidding and sale process in bankruptcy
- Lack of transparency and disclosure

- The existence of agreements outside of bankruptcy directly affecting the solicitation process

Many of the abovementioned facts and circumstances can and do happen without necessarily running afoul of the good faith requirement of the Bankruptcy Code. The debtor and creditors alike are not required to act with selfless disinterest. As a result, the difference between smart, aggressive bankruptcy strategy and a manipulative scheme is likely one of degree after all facts and circumstances are fully considered by the court. Lawyers should heed well good, old fashion gut feelings as to the appropriateness of a course of conduct in the solicitation and process associated with confirmation.

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[1] The Bankruptcy Code is codified at 11 U.S.C. §§ 101 et. seq. and is referred to herein as the Bankruptcy Code or the Code.
[2] *JT Thorpe Co*, 308 B.R. 782, 785 (Bankr. S.D.Tex. 2003).
[3] *In re Boulders on the River, Inc.*, 164 B.R. 99 (9th Cir. BAP 1994) (holding that good faith in confirmation of the plan is different than good faith in filing the petition).
[4] *In re Madison Hotel Assocs*., 749 F.2d 410 (7th Cir. 1984).
[5] *Id. at 425.*
[6] *Id*.
[7] *In re Quigley*, 437 B.R. 102 (Bankr. S.D.N.Y. 2010).
[8] *In re McCormick*, 49 F.3d 1524, 1526-27(11th Cir. 1995)(dealing with Fifth Amendment Privilege asserted by the Debtor).
[9] *In re Koelbl*, 751 F.2d 137 (2d. Cir. N.Y. 1984).
[10] *Id*.
[11] *In re Windsor on the River Assoc. Ltd.*, 7 F.3d 127, 132 (8th Cir. Iowa 1993).
[12] *In re Dunes Hotel Assocs.*, 188 B.R. 174 (Bankr. D.S.C. 1995).
[13] See *Quigley. See also, In re Windsor on the River Assoc. Ltd*, 7 F.3d 127, 132 (8th Cir. Iowa 1993).
[14] *In re Dunes Hotel*, 188 B.R. 174 (Bankr. D.S.C. 1995).
[15] *In re Koelbl*, 751 F.2d 137 (2d. Cir. N.Y. 1984).
[16] *In re Dunes Hotel Assocs.*, 188 B.R. 174, 183 (Bankr. D.S.C. 1995).
[17] *In re Lettick Typografic, Inc.*, 103 B.R. 32, 38 (Bankr. D. Conn. 1989).
[18] *In re Combustion Eng'g, Inc.*, 391 F.3d 190, 246 (3rd Cir. Del. 2004).
[19] *In re Greate Bay Hotel & Casino, Inc.*, 251 B.R. 213, 239 (Bankr. D.N.J. 2000) (citing to *In re Windsor on the River Assocs., Ltd.*, 7 F.3d 127, 132 (8th Cir. 1993).
[20] *Greate Bay Hotel* at 239; *Beal Bank, S.S.B. v. Waters Edge Ltd. Pshp.*, 248 B.R. 668 (D. Mass. 2000).
[21] *In re Jersey City Medical Center*, 817 F.2d 1055 (3d Cir. N.J. 1987).
[22] *Id.* at 1061.
[23] *Id*. However, there are courts that appear to take a literal approach to § 1122. *See e.g.*, *In re ZRM-Oklahoma Partnership*, 156 B.R. 67 (Bankr.W.D. Okla. 1993) suggesting that gerrymandering and concerns about protecting creditors are a matter of policy and not clearly set forth in the Bankruptcy Code.
[24] It is interesting to note that most of the cases reviewed are concerned with separate classification rather than the combination of claims that may be dissimilar in order to meet the test set forth in 11 U.S.C. § 1126(c).
[25] *In re Chateaugay Corp.*, 89 F.3d 942, 950 (2d. Cir. N.Y. 1996).
[26] *In re 255 Park Plaza Assocs. Ltd. Pshp.*, 100 F.3d 1214, 1219 (6th Cir. Mich. 1996).
[27] *Id*. (citing to *In re Applegate Property, Ltd.*, 133 Bankr. 827, 834 (W.D. Tex. 1991).
[28] *See e.g., In re Marin Town Center*, 142 B.R. 374, 379 (N.D. Cal. 1992); *In re Figter Ltd.*, 118 F.3d 635 (9th Cir. Cal. 1997); *In re 255 Park Plaza Assocs. Ltd. Pshp.*, 100 F.3d 1214, 1219 (6th Cir. Mich. 1996).
[29] *In re Quigley*, 437 B.R. 102 (Bankr. S.D.N.Y. 2010)
[30] *Id.*

[31] *In re Quigley*, 437 B.R. 102 (Bankr. S.D.N.Y. 2010) is a 50 page decision dated September 8, 2010 with significant factual detail, which the authors attempt to summarize from a very general perspective.
[32] *Id*. In the past, the court noted, Pfizer and Quigley would settle their claims jointly.
[33] *Id*. The decision of the court concerns the Fourth Amended Plan submitted by the Debtor.
[34] *Quigley*, 437 B.R. at 125 (referring to *In re Bush Indus., Inc.*, 315 B.R. 292, 304 (Bankr. W.D.N.Y. 2004)).
[35] *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)).
[36] *Combustion* at 201.
[37] *Id*. at 203.
[38] *Id*.
[39] *Id*. at 201.
[40] *Id*.
[41] *Id*.
[42] *Id*.
[43] *Id*.
[44] *Id*. at 204.
[45] *Id*.
[46] *Id*. at 205.
[47] *Id*.
[48] *Id*.
[49] *Id*. at 208.
[50] *Id*. at 211.
[51] *Id*. at 212.
[52] *Id*.
[53] *Id*. at 213.
[54] *Id*. at 242.
[55] *Id*. at 243.
[56] *Id*. at 244.
[57] *Id*. The monitoring function being the indicia of support by those who have a financial stake in the plan.
[58] *Id*. citing to Stephen J. Carroll, et. al., *Asbestos Litigation Costs and Compensation: An Interim Report* 46 (RAND 2002)(reporting that non-malignant claimants typically represent 80 to 90% of outstanding asbestos claims).
[59] *Id*.
[60] *Id*.
[61] *Id*. at 244 – 245.
[62] *Id*. at 245.
[63] *Id*. at 248-249.
[64] *In re Wiston XXIV, Ltd. Part.*, 153 B.R. 322 (Bankr.D.Kans. 1993).
[65] *Id*. at 323.
[66] *Id*.
[67] *Id*.
[68] *Id*. at 324.
[69] *Id*.
[70] *Id.*
[71] *Id*. at 326.
[72] *Id*. at 328.
[73] *In re Applegate Property, Ltd.*, 133 B.R. 827 (Bankr. W.D.Tex. 1991).
[74] *Id*.
[75] *Id*. at 829.
[76] *Id*. at 831.
[77] *Id*. at 832.
[78]*Id*.
[79] *Id*. at 833.
[80] *Id*.
[81] *Id*. at 834 citing to *Young v. Higbee Co., 324 U.S. 204, 210-211 (1945).*

[82] *Id*. referencing *In re Federal Support Co.*, 859 F.2d 17 (4th Cir. 1988).
[83] *Id*.
[84] *Id*. at 837.
[85] *Id*. at 837.
[86] *Id*.
[87] *In re Featherworks Corp.,* 25 B.R. 634 (Bankr. E.D.N.Y. 1982).
[88] *Id*. at 641.
[89] *In re DBSD North America*, 421 B.R. 133, 134 (Bankr. S.D.N.Y. 2009), *aff'd*, 2010 WL 1223109 (S.D.N.Y. Mar. 24, 2010), *aff'd* as to Bankruptcy Court vote designation order and otherwise *rev'd*, 627 F.3d 496 (2d Cir. 2010).
[90] *Id*. at 134-135.
[91] *Id*.
[92] *Id*. at 135. The court does not address whether or not a "Plan Support Agreement" containing obligations relative to voting in favor of the plan is appropriate in this decision.
[93] *Id*.
[94] *Id*. at 136.
[95] *Id*. at 137.
[96] *Id*.
[97] *Id*.
[98] *Id*.
[99] *Id*.
[100] *Id*.
[101] *Id*. at 139 (citing to *In re Allegheny Int'l, Inc.*, 118 B.R. 282 (Bankr. W.D. Pa. 1990)).
[102] *Id*. at 143.