

Keeping Trade Creditors in the Loop:

Can a Chapter 11 Debtor Confirm a Plan of Reorganization When it Owes More Money Than Its Property is Worth?

by Jason I. Blanchard

Secured creditors regularly make loans believing that if the loan goes into default, they can recover the full amount of the loan from their collateral; however, as additional security, lenders will often require third-party guarantees to safeguard against potential losses due to a decrease in the value of their collateral. As time goes by, though, lenders and borrowers are often presented with a situation where the secured debt exceeds the value of the collateral; in other words, the secured creditor has become undersecured. If otherwise eligible, the borrower may then choose to file for bankruptcy and attempt to keep the property while not paying the lender the full amount of the outstanding loan, which may cause the lender to pursue the non-debtor third-party guarantors. Although lenders generally view holding loan guarantees as advantageous, for an undersecured creditor in a Chapter 11 bankruptcy case, the existence of third-party guarantees may pose unforeseen challenges.

In all Chapter 11 cases, to confirm a plan of reorganization, a debtor must satisfy the various requirements of 11 U.S.C. § 1129, which includes the right of creditors to vote for or against the plan. Section 1129, as a general matter, authorizes debtors to either confirm a plan consensually under § 1129(a), or impose a plan on dissenting creditors by judicial cramdown pursuant to § 1129(b).¹ Of the many requirements of cramdown, two are particularly relevant to undersecured creditors: one is that at least one class of impaired creditors must vote to accept the plan in conformity with § 1126(c)²; and another is that claims or interests placed in a particular class in a plan must be substantially similar to all other claims or interests in that class.³ As such, to get an impaired class of creditors to approve the plan, a debtor will often bifurcate the claim of the dissatisfied undersecured creditor into a secured claim to the extent of the value of its collateral in one class, and an unsecured deficiency claim for the balance owed in another class, with all other general unsecured creditors then placed in yet another class. The debtor's reason for doing so is simple—the general unsecured (non-lender) creditors have nothing to lose because their claims are rather small and they are being offered the opportunity to recover some of their debt, and are thus more likely to vote for the debtor's plan, thereby making cramdown possible.⁴

This separate classification technique can be used in any Chapter 11 case, but it is often seen in cases involving a single asset real estate (SARE) debtor,⁵ which generally refers to a debtor who owns one property subject to a secured debt and owes a relatively small amount of money to several small unsecured trade creditors. As such, classification of claims is often a dispositive factor in the SARE debtor's ability to get the affirmative vote of one creditor class and attain confirmation of a plan by cram down. If the trade claims are not separately classified from the secured creditor's deficiency claim, the deficiency claim may overwhelm the unsecured class and the debtor will likely not meet the requirement of having at least one assenting impaired class. If the deficiency claim is separately classified, however, the general unsecured class of creditors may accept the plan by the requisite percentages and amounts and thereby make it possible for the plan to be confirmed.⁶

Thus, bankruptcy courts must often decide whether a debtor may separately classify a deficiency claim from the other general unsecured creditors' claims. This may raise the further question of what effect, if any, do third-party guarantees have on a debtor's ability to separately classify the lender's deficiency claim. This issue was recently decided by the Ninth Circuit Bankruptcy Appellate Panel (B.A.P.) in *Wells Fargo Bank v. Loop* 76.⁷

Factual Background

In *Loop*, the SARE Debtor (*Loop*), a limited liability company, was formed for the sole purpose of constructing, developing, and operating an office/retail complex in Scottsdale, Arizona. The debtor obtained a \$23 million secured construction loan from Wells Fargo. In conjunction with the loan, Wells Fargo also obtained guarantees of the loan from, *inter alia*, the debtor's managing members, which often occurs in the SARE context.⁸ *Loop* subsequently defaulted on the loan and Wells Fargo filed suit in state court seeking appointment of a receiver. *Loop* then filed for Chapter 11 relief, which precipitated Wells Fargo's commencement of an action against the non-debtor guarantors.⁹

In the Chapter 11 case, Wells Fargo filed a claim in an amount

which exceeded the value of the property; accordingly, the debtor proposed a plan which essentially called for three voting classes—(1) Wells Fargo's secured claim, (2) Wells Fargo's undersecured claim, and (3) the other general unsecured creditors.¹⁰ Wells Fargo objected to confirmation of the plan arguing, *inter alia*, that the plan violated § 1122(a) because its deficiency claim was relegated to a class separate from other general unsecured claims in an attempt to gerrymander an affirmative vote in favor of the plan.¹¹

The bankruptcy court held that, under § 1122(a), a claimant who has a third-party source of repayment for its claim is dissimilar from a claimant who lacks such alternative sources of payment, and went on to confirm *Loop's* plan. Wells Fargo appealed. The issue before the B.A.P. was whether a bankruptcy court may consider a third-party source for recovery of a creditor's unsecured deficiency claim as a factor when determining whether that claim is substantially similar to other unsecured claims under § 1122(a).¹²

Discussion

Before the B.A.P. began its analysis, it discussed § 1122(a) and how Ninth Circuit courts have generally determined whether claims separately classified are substantially similar. Section 1122(a) states, "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."¹³ Although § 1122(a) does not expressly require that a plan classify similar claims together, it does, however, specifically forbid placement of dissimilar claims in the same class. Because the Code does not set forth criteria for determining whether claims are "substantially similar," the B.A.P. stated that it must begin by looking to the "nature of each claim, i.e., the kind, species, or character of each category of claims."¹⁴ If the court determines that the claims in question are not substantially similar, the analysis ends and separate classification is permitted. However, if the court determines that the claims are substantially similar, the Chapter 11 plan may only place those claims in different classes upon a showing of a business or economic justification.¹⁵

Because the bankruptcy court's holding relied on, in large part, the U.S. Court of Appeals for the Ninth Circuit's decisions in *In re Johnston*¹⁶ and *In re Barakat*,¹⁷ the B.A.P. elaborated on the facts and determinations made therein. In *Johnston*, the Ninth Circuit held that the debtor's separate classification of the lender Steelcase's deficiency claim was appropriate where the lender held a personal guaranty of the secured debt.¹⁸ The Ninth Circuit concluded that the deficiency claim held by Steelcase was differently situated from all other general unsecured claimants, and thus not substantially similar under § 1122(a), due to the following: the Steelcase claim was partially secured by collateral of the primary obligor, the debtor's business; Steelcase was involved in litigation with the individual debtor with respect to the guaranty, unlike the other unsecured claimholders; and, Steelcase, if successful in state court, could obtain full compensation prior to distribution to the other unsecured claimholders.¹⁹

In *Barakat*, the Ninth Circuit considered whether the SARE debtor's separate classification of a creditor's deficiency claim from the general unsecured claimholders was permissible under § 1122(a). The circuit court held that absent a showing of business or economic justification for separate classification, the debtor's classification was improper. Further, the *Barakat* court held that *Johnston* did not apply, since the circumstances present in

Johnston, such as a third-party source of recovery, were not present.²⁰

A Flexible Approach to Claims Classification

After exploring the contours of the Ninth Circuit's decisions in *Johnston* and *Barakat*, the B.A.P. turned to Wells Fargo's arguments against separate classification of its deficiency claim. Wells Fargo argued that *Johnston* was inapplicable and that *Barakat* should control in that, for purposes of § 1122(a), the bankruptcy court should have focused on how the "nature" of the deficiency claim related to assets of the debtor, rather than on the existence of non-debtor personal guaranties, which are not estate assets.²¹ The B.A.P. rejected this argument in part, holding that under *Johnston*, courts may take a "more flexible approach to claim classification," and that classification "does not rest entirely on how [the claim] relates to assets of the debtor."²²

Wells Fargo further contended that its deficiency claim was substantially similar to the other unsecured claims, and under *Barakat*, should not be separately classified due to lack of a business or economic justification. The B.A.P. disagreed. According to the B.A.P., the existence of a third-party source of recovery on Wells Fargo's deficiency claim, i.e., the guarantors, constituted a special circumstance not present among the other unsecured claims. The B.A.P. held that bankruptcy courts may consider the existence of third-party sources of payment, including guarantors, when determining whether unsecured claims are substantially similar for classification purposes under § 1122(a), and thus approved debtor's separate classification of the Wells Fargo deficiency claim, and affirmed confirmation of the plan.²³

A More Narrow Approach to Claims Classification

Other circuits have taken a more narrow approach to classification under § 1122(a). A notable example is the U.S. Court of Appeals for the Second Circuit, as demonstrated in *In re Boston Post Road Ltd., Partnership*.²⁴ The Second Circuit held that a debtor must provide a legitimate business or economic reason for separate classification of similar claims, and that that the different origins of the FDIC's unsecured deficiency claim and the general unsecured claims, "claims which enjoy similar rights and privileges within the Bankruptcy Code, do not alone justify separate segregation."²⁵ Similarly, in *In re Greystone III Joint Venture*,²⁶ the U.S. Court of Appeals for the Fifth Circuit held that § 1122(a) permits classification of "substantially similar" claims in different classes, but such classification may only be undertaken for reasons independent of the debtor's motivation to secure the vote of an impaired, assenting class of claims.

Conclusion

Whether courts permit the separate classification of claims is often a dispositive factor in whether a debtor, especially a SARE debtor, can confirm a plan. The B.A.P.'s holding in *Loop* should make it easier for debtors in the Ninth Circuit to confirm a plan with separate classification of unsecured claims where the lender holds guarantees from third parties, so long as all other applicable confirmation criteria can be satisfied. However, it remains an open question in circuits across the country whether an undersecured creditor's rights against non-debtor third parties may render its deficiency claim dissimilar from the other unsecured claims, such that

the deficiency claim may be separately classified under § 1122(a). ☉

Jason I. Blanchard is a law clerk for Hon. Alan S. Trust, U.S. Bankruptcy Court, Eastern District of New York. None of the statements contained in this article constitute official policy of any judge, court, agency, government official, or quasi-governmental agency.



Endnotes

¹See *Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 441, 119 S. Ct. 1411, 1415, 143 L. Ed. 607, 616 (1999); 8 COLLIER ON BANKRUPTCY ¶ 1129.03 (Alan N. Resnick & Henry J. Sommer eds., 16th ed.) ("[c]onfirmation can be 'cramped down' the throat of the dissenting class.").

²See 11 U.S.C. §§ 1122(a), 1126(c) ("A class of claims has accepted a plan if such plan has been accepted by creditors ... that hold at least two-thirds in amount and more than one-half in number of the allowed claims of such class held by creditors ... that have accepted or rejected such plan.").

³See 11 U.S.C. § 1129(a)(10).

⁴See *In re L.G. Salem Ltd. P'Ship*, 140 B.R. 932, 935 (Bankr. Mass. 1992).

⁵See, e.g., *In re Boston Post Road, Ltd., P'ship*, 21 F.3d 477; see also *In re Nat'l/Northway Ltd. P'ship*, 279 B.R. 17, 29 (Bankr. Mass. 2002) (discussing how most cases in which classification of claims happens to be an issue are SARE cases).

⁶See *Boston Post Road, Ltd., P'ship*, 21 F.3d 477, 480, 482 (2d Cir. 1994); see also *In re Woodbrook Assocs.*, 19 F.3d 312, 318-19 (7th Cir. 1994); *In re Bryson Props.*, XVIII, 961 F.2d 496, 502 (4th Cir. 1992), cert. denied, 506 U.S. 866, 112 S. Ct. 191, 121 L. Ed. 2d 134 (1992); *In re Greystone III Joint Venture*, 995 F.2d 1274, 1277 (5th Cir. 1991); *L.G. Salem Ltd. P'Ship*, 140 B.R. at 935.

⁷*Wells Fargo Bank v. Loop 76*, 465 B.R. 525 (B.A.P. 9th Cir. 2012).

⁸See, e.g., *In re Kaplan Breslaw Ash, LLC*, 264 B.R. 309, 313-14 (Bankr. S.D.N.Y. 2001); *In re Johnston*, 21 F.3d 323, 327 (9th Cir. 1994).

⁹*Loop 76*, 465 B.R. at 529.

¹⁰*Id.* Although not particularly pertinent to the discussion here, it is worthwhile to mention that *Loop's* plan proposed a separate class composed of an impaired secured claim by Genesee Funding LLC. Wells Fargo filed an objection to this claim, arguing that it consisted of a bogus transaction with a fictitious company for the purposes of creating and accepting an impaired class. The Bankruptcy Court overruled Wells Fargo's objection and the B.A.P. affirmed. *Id.* at 529-30, 542-44.

¹¹*Id.* at 531-32; see *Greystone III Joint Venture*, 995 F.2d at 1279.

¹²*Loop 76*, 465 B.R. at 534-36.

¹³*Id.* at 536 (quoting 11 U.S.C. § 1122(a)).

¹⁴*Id.* (quoting *Johnston*, 21 F.3d at 327).

¹⁵*Id.* (citing *In re Barakat*, 99 F.3d 1520, 1526 (9th Cir. 1996)); see also *Greystone III Joint Venture*, 995 F.2d at 1280-81; *Boston Post Road*, 21 F.3d at 483 (2d Cir. 1994).

¹⁶*In re Johnston*, 21 F.3d 323 (9th Cir. 1994).

¹⁷*In re Barakat*, 99 F.3d 1520 (9th Cir. 1996).

¹⁸In *Johnston*, both individual and corporate debtors filed petitions under Chapter 11; the lender, Steelcase, held a secured debt from the corporate debtor, and the personal guaranty of the individual debtor. In the debtor's corporate case, Steelcase filed a secured claim pursuant to a financing agreement that was also backed by the debtor's personal guaranty. Steelcase had sued the debtor on his personal guaranty prior to the filing of the individual Chapter 11 case. Because Steelcase's claim in the corporate case was undersecured, the debtor separately classified Steelcase's deficiency claim as an unsecured claim in its own class. *Johnston*, 21 F.3d at 325–328.

¹⁹*Id.*

²⁰*Barakat*, 99 F.3d at 1524–1526.

²¹*Loop 76*, 465 B.R. at 539 (citing *In re Los Angeles Land & Invs., Ltd.*, 282 F. Supp. 448, 453–54 (D. Haw. 1968) (a claim's nature refers to “an analysis of the legal character or the quality of the claim as it relates to the assets of the debtor”)).

²²*Loop 76*, 465 B.R. at 540.

²³*Id.*; but see *In re 4th Street East Investors, Inc.*, 2012 Bankr. LEXIS 2144, at *22-23 (Bankr. C.D. Cal. June 29, 2012) (holding that Ninth Circuit courts are only required to consider the existence of third-party sources of payment, and that the mere existence of a guaranty is an insufficient basis for separate classification of a deficiency claim. The court reads *Johnston* to hold that it is permissible for a bankruptcy court to find, as a matter of fact, that a non-debtor source of repayment of a claim renders it dissimilar from other claims lacking such a source of repayment outside of the plan, but to make that determination the court should be presented with evidence as to whether there is any non-debtor collateral for the debt, whether there is pending litigation that may establish rights of the lender to be different from the rights of general unsecured creditors, and whether the debtor has shown that the lender's claim is meaningfully collectable from any non-debtor source).

²⁴*In re Boston Post Road Ltd., P'ship*, 21 F.3d 477 (2d Cir. 1994). In *Boston Post Road*, the SARE Chapter 11 debtor separate-

ly classified the Federal Deposit Insurance Corporation's (FDIC) deficiency claim from the trade creditors' unsecured claims, to which the FDIC objected. Debtor argued, *inter alia*, that separate classification was warranted because the FDIC's and trade creditors' claims arose under different circumstances, i.e., the FDIC's claim arose in a circuitous way while the trade creditors' claims arose in a straightforward manner. That is, the debtor had borrowed money from the Connecticut Bank and Trust Company and granted it a lien against an office complex; the debtor then defaulted; the bank subsequently commenced foreclosure proceedings; and the U.S. Comptroller of Currency seized the bank's assets and transferred the mortgage to the FDIC. By contrast, the trade creditors' class consisted of claims by a landscaper, property appraisers, trash removers, and accountants. The bankruptcy court denied confirmation and the district court affirmed.

²⁵*Id.*; see also *Bryson Props.*, XVIII, 961 F.2d at 502; *In re 18 RVC, LLC*, 2012 Bankr. LEXIS 4991, at *13-15 (Bankr. E.D.N.Y. Oct. 22, 2012) (holding that under the standard articulated in *Boston Post Road* the existence of a personal guarantee, without more, is not a legitimate reason for separately classifying the unsecured deficiency claim); *4th Street East Investors, Inc.*, 2012 Bankr. LEXIS 2144, at *22-23; but see *Woodbrook Assocs.*, 19 F.3d at 318-19 (upholding separate classification of a deficiency claim apart from general unsecured claims); *In re Rivera*, 2012 Bankr. LEXIS 4211 (Bankr. D.P.R. September 10, 2012) (authorizing the Chapter 13 debtor's separate classification and preferential treatment of an unsecured claim based on the existence of a third-party guarantee from the other unsecured claims because the debt in question concerned co-debtor consumer debt); *In re Simmons*, 288 B.R. 737 (Bankr. N.D. Tex. 2003) (permitting separate classification of student loan debt from other unsecured claims in Chapter 13 because of the nondischargeability of the student loan).

²⁶*In re Greystone III Joint Venture*, 995 F.2d 1274, 1277 (5th Cir. 1991).

5th Bi-Annual Federal Bar Association Labor and Employment Law Conference

Presented by the Labor and Employment Law Section
Co-sponsored by the Corporate and Association Counsel Division and the
New Orleans Chapter of the FBA

The Westin New Orleans
New Orleans, Louisiana

More details are available at www.fedbar.org.