1993

# From the Bankruptcy Courts: A Flexible Approach to Classification of Claims

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## A FLEXIBLE APPROACH TO CLASSIFICATION OF CLAIMS

If a chapter 11 plan is not accepted by every impaired class of claims or interests, it could be confirmed only if the plan is crammed down the rejecting classes in accordance with Section 1129(b) of the Bankruptcy Code. Most of the cases involving the requirements of a Section 1129(b) cram down focus on the need for the plan to be "fair and equitable" and that it not "discriminate unfairly" with respect to the nonaccepting classes. However, another requirement that has been receiving increasing attention in recent years is that at least one impaired class of claims, not counting the votes of insiders, accepts the plan.[1] In essence, a plan may not be crammed down every class of creditors.

In view of the requirement that at least one impaired class of claims votes to accept the plan, debtors often structure their plans so that at least one noninsider class will accept by the necessary margin. It is not surprising that bankruptcy courts have been asked to rule on the propriety of such classification schemes.

The importance of classification issues has been especially evident in single-asset real estate cases. The surge in the number of single-asset real estate ventures that have experienced declining real estate values, reduced rental income, and serious cash flow problems during the past few years, has resulted in a greater volume of chapter 11 cases in which a single creditor is both the largest secured creditor and the largest unsecured creditor. If that creditor does not vote in favor of a proposed chapter 11 plan, could the plan be crammed down? The answer to this question depends, in part, on whether the plan may place the unsecured deficiency claim of the nonaccepting mortgagee in a class that is separate from the class of impaired general unsecured creditors who are willing to accept the plan. Many courts have held that an impaired undersecured deficiency claim may not be placed in a class separate from the class of unsecured creditors, thus making it virtually impossible to obtain confirmation of a plan

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[1] 11 U.S.C. § 1129(a)(10).

in the absence of the mortgagee's acceptance.[2]

### Kliegl Bros.

The increase in litigation involving classification issues in single-asset real estate cases, and the reluctance of courts to permit separate classification of undersecured deficiency claims, should not lead readers to think that all unsecured claims of equal rank must *always* be placed in one class. The recent decision in *In re Kleigl Bros. Universal Electric Stage Lighting Co., Inc.*,[3] is a good reminder that having more than one class of unsecured claims in a chapter 11 plan may be justified under certain circumstances.

In *Kliegl Bros.*, a chapter 11 operating trustee proposed a plan that contained eight classes. Two allegedly impaired classes accepted the plan. The first accepting class consisted of a postpetition lender who agreed to the plan's provision that has the effect of subordinating a part of its claim to the claims of prepetition unsecured creditors. The second acccepting class consisted only of the International Brotherhood of Electrical Workers (IBEW), a union with general unsecured claims for the nonpriority portion of unpaid prepetition wages. The plan proposed to pay IBEW 75 percent of its unsecured claims. The plan placed the other general unsecured creditors in a separate class and proposed to pay them only 15 percent of their allowed claims. The class of general unsecured claims rejected the plan "in sufficient numbers that even if the unsecured claims of the union were included in the same class as the general unsecured creditors, that class would still reject the Trustee's plan."[4]

The trustee, in seeking confirmation of the plan, asserted that the plan may be crammed down nonaccepting classes, including the class of general unsecured claims, because, in part, at least one impaired class has accepted it. The U.S. trustee and the debtor objected to confirmation, arguing that the two accepting classes were both not properly constituted and that, accordingly, no impaired class has voted in favor of the plan as is required under Section 1129(a)(10).

The bankruptcy court stated the issues as follows: "(1) is the postpetition secured lender entitled to vote to accept the plan, and (2) can the general unsecured portion of the union's claim be separately classified so as to enable it to constitute a consenting class?"[5]

### Postpetition Creditor Is Not Entitled to Vote

Section 1126 of the Code, which governs the acceptance of plans of

[2] See, e.g., In re Bryson Properties, XVIII, 961 F.2d 496 (4th Cir. 1992); In re Greystone III Joint Venture, 948 F.2d 134 (5th Cir. 1991); In re Cantonwood Assocs. Ltd. Partnership, 138 Bankr. 648 (D. Mass. 1992).

[3] 149 Bankr. 306 (Bankr. E.D.N.Y. 1992).

[4] 149 Bankr. at 307.

[5] *Id.*

reorganization, provides that "[t]he holder of a claim or interest allowed under section 502 of this title may accept or reject a plan."[6] The court properly held that only prepetition claims are allowed under Section 502. "Since nowhere under section 502 is a post-petition secured lender mentioned or implied, the class containing this lender as its sole member is not as a matter of law entitled to vote on the plan."[7] Although the bankruptcy court cited several decisions holding that the concept of impairment under Section 1124 applies only to prepetition claims,[8] it nonetheless stated that it did not have to reach the question of whether the class consisting of the postpetition lender was an impaired class. Whether or not impaired, the postpetition lender class was not eligible to vote and could not be the one accepting class needed for confirmation under Section 1129(a)(10).

### Placing the Union's Unsecured Claim in a Separate Class

Section 1122(a) of the Bankruptcy Code provides as follows:

> (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 important to point out that, although this section requires that all claims in a particular class must be substantially similar, it does not say that all similar claims must be in the same class. The bankruptcy court in *Kliegl Bros.* mentions the "split of opinion as to whether similar claims simply *may* be classified together or whether they *must* be so classified."[9]

The view that all similar claims must be classified together was articulated by the court in *In re Mastercraft Record Plating, Inc.*:[10]

> Although section 1122(a) deals with the placing of dissimilar claims in the same class, it by necessary implication deals with the placing of similar claims in the different classes. There is no authority for classifying similar claims differently other than section 1122(b) just discussed. . . Classification cannot be used to divide like claims into multiple classes in order to create a consenting class so as to permit confirmation."[11]

The court in Kliegl Bros. noted, however, that there is disagreement on the application of the view expressed in *Mastercraft*. Many of the

[6] 11 U.S.C. § 1126(a).

[7] 149 Bankr. at 307.

[8] The court cited In re Tavern Motor Inn, Inc., 56 BR 449, 452 (Bankr. D. Vt. 1985); In re Blackwelder Furniture Co. of Statesville, 31 BR 878, 881 (Bankr.W.D.N.C. 1983).

[9] 149 Bankr. at 307-308.

[10] 32 Bankr. 106 (Bankr. S.D.N.Y. 1983).

[11] *Id.* at 108.

cases following the *Mastercraft* approach do so only in the limited circumstance where it is patently obvious that the debtor's sole motivation for creating more than one class of nonpriority unsecured claims is to create one impaired noninsider class that accepts the plan, thus satisfying the requirements of Section 1129(a)(10).[12] Several courts, including the Court of Appeals for the Fifth Circuit in *In re Greystone III Joint Venture*,[13] have expressed the clear warning that the division of similar claims into separate classes for the sole purpose of gerrymandering will not be tolerated.

In contrast to those decisions holding that the separation of similar claims into different classes is prohibited only if the primary purpose is to create an accepting class of impaired claims, the bankruptcy court in *In re S & W Enterprises*[14] has adopted the broader rule that all general unsecured claims must be in the same class unless they are separable under Section 1122(b) as small claims lumped together for administrative convenience. The judge in the *Kliegl Bros.* case commented that the position announced in *S & W Enterprises* "is clearly the exception, because it completely abandons any necessity of finding an intent to create a consenting class before collapsing multiple classes."[15]

### A More Flexible Approach to Classification

A more flexible view on the separation of similar claims into different classes was expressed by the bankruptcy court in *In re AG Consultants Grain Division, Inc.*[16]

> "In essence, [*AG Consultants*] holds that it its appropriate to classify unsecured creditors separately if the differences in classification are in the best interest of the creditors, foster reorganization efforts, do not violate the absolute priority rule, and do not needlessly increase the number of classes. . . . Thus, if it is reasonable to classify like claims separately, it may be done.[17]

In *Kliegl Bros.*, the court was persuaded that the flexible approach employed in *AG Consultants* was the better one, "as long as the result is not inherently unfair."[18] By adding that the result of separating similar claims into different classes must not be inherently unfair, the court in *Kliegl Bros.* treated the classification issue as one that is closely linked to the requirement found in Section 1129(b)(1), that is, that the plan does not unfairly discriminate against any nonaccepting impaired class.

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[12] 149 Bankr. at 308.

[13] 948 F.2d 134 (5th Cir. 1991). See *supra* note 2.

[14] 37 Bankr. 153 (Bankr. N.D. Ill. 1984).

[15] 149 Bankr. at 308.

[16] 77 Bankr. 665 (Bankr. N.D. Ind. 1987).

[17] 149 Bankr. at 308.

[18] *Id.*

> The charge of unfair discrimination often arises with respect to the formation of classes of unsecured creditors in order to achieve a cram-down. . . In this context, the unfairness frequently alleged is that of placing like claims in different classes where one class is treated better than another.[19]

The court in *Kliegl Bros.* then set forth a four-part test that has been adopted by several courts for the purpose of determining whether there is unfair discrimination in the formation of the classes in the plan:

1. Whether there is a reasonable basis for the difference in treatment which would preclude a finding of an unfair discrimination,
2. Whether the debtor can consummate the plan without the challenged discrimination,
3. Whether the discrimination is proposed in good faith, and
4. The nature of the treatment of the 'discriminated' class, or as sometimes stated, whether the degree of discrimination is in direct proportion to its rationale.[20]

Although providing for a 75 percent recovery on unsecured claims of the union, while offering general unsecured creditors only a 15 percent recovery, is discriminatory, the court concluded after a careful examination of the facts that such discrimination was not unfair. Applying the four-part test, the court found that a reasonable basis existed for the difference in treatment in view of the union's insistence on at least a 75 percent recovery and a "suggestion"[21] that the IBEW might strike if paid less than 80 percent of its claims.

> We believe that such reasonable basis exists because the debtor's ability to continue to operate a union shop is absolutely critical to its ability to function successfully in its industry. Within the Metropolitan New York Area and most other major markets, virtually all on-site electrical work, including the installation of Kliegl products, is performed by the IBEW. The IBEW will not install or service non-union manufactured products. Consequently, were it not a union shop, Kliegl would be disqualified from bidding on, much less fulfilling, many of the contracts upon which its business depends. Maintaining the debtor's union shop, and thereby insuring its continued ability to compete for and get access to work in its industry, is clearly a reasonable basis for creating a separate class for the IBEW . . . Since the debtor could not survive without the IBEW, the discrimination between the classes of unsecured creditors appears reasonably proportional to the consequences of failing to receive IBEW support.[22]

Also significant was the fact that the debtor did not have sufficient

[19] *Id.*

[20] *Id.* The court cited In re 11,111 Inc., 117 Bankr. 471 (Bankr. D. Minn. 1990); In re Richard Buick, Inc., 126 Bankr. 840 (Bankr. E.D. Pa. 1991).

[21] The court acknowledged, however, that there was no testimony to support such a suggestion.

[22] 149 Bankr. at 309.

funds to pay all unsecured creditors 75 percent of their claims.

## Conclusion

The decision in *Kliegl Bros.* is an important reminder that reorganization plans may, under certain circumstances, classify nonpriority unsecured claims of equal rank in different classes. If there is a need for separate classification that goes beyond gerrymandering to satisfy Section 1129(a)(10), coupled with a disparity in treatment that is necessary under the circumstances, discriminatory treatment is permissible. This approach is easily forgotten as one reads those recent decisions in single-asset real estate cases holding that all unsecured claims, including mortgage deficiency claims, must be lumped together in the same class.