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THE CLASSIFICATION VETO IN SINGLE-ASSET CASES UNDER BANKRUPTCY CODE SECTION 1129(a)(10)

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Elbridge Gerry—who pronounced his name with a hard "*g*"—is one of those lucky men, along with Lynch and Boycott, whom the dictionary has

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immortalized and preserved in ordinary American conversation. Perhaps this honor is mitigated by the fact that "gerrymandering" describes the unsavory practice of subdividing voters to produce a preconceived political result. Furthermore, "gerrymandering" conjoins the ancient, honorable name of Gerry with that of the slime-dwelling salamander and is usually mispronounced with a soft "*g*."

Gerry, who had a distinguished career, deserves better. He was a signer of the Declaration of Independence, a delegate to the Constitutional Convention (whose product he neither admired nor signed),[1] a successfully duplicitous diplomat in France, and Vice President of the United States.[2] Gerry's etymological apotheosis is founded upon his signature, as governor of Massachusetts, to a redistricting bill that created a congressional district incorporating the morphology of a salamander. Contemporary wags referred to the drawing of such unnatural boundaries as "gerrymandering."

Gerry had a role to play in the history of bankruptcy as well. While a delegate to the Constitutional Convention, Gerry proposed that the "contract clause" be extended to cover the federal government. If this had occurred, the history of bankruptcy jurisprudence would have been much different; but, fortunately for posterity, Gerry's motion died for want of a second. This ornery assault upon federal bankruptcy may have provided at least some small part in motivating that great Carolingian and author of the Constitution's bankruptcy clause, Charles Pinckney, to remark, "I have never met a man of less candor and as much duplicity as Mr. Gerry."[3]

Some two hundred years later, Gerry—or at least his gerrymandering method—has had its revenge upon bankruptcy jurisprudence. According to section 1129(a)(10): "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."[4] When a chapter 11 case involves a dominant undersecured creditor, section 1129(a)(10) suggests that the single secured creditor might have a veto over the chapter 11 proceeding. Such a creditor can cause all classes—the secured creditor class *plus* the class of unsecured creditors—to vote against the plan, *unless* the plan proponent can *gerrymander* the creditors so as to produce a yes-voting noninsider class to get by the requirement of section 1129(a)(10).[5]

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1. *See generally* STEVE TALLY, BLAND AMBITION 41-43 (1992).

2. Gerry died in office and was among the one-third of our vice presidents who failed to serve out their terms—whether due to death, promotion, resignation, or plea bargaining. *See generally id.* at 41-47.

3. *Id.* at 45.

4. 11 U.S.C. § 1129(a)(10) (1988).

5. *See In re* Meadow Glen, Ltd., 87 B.R. 421, 423 (Bankr. W.D. Tex. 1988) (Ayers, C.J.) ("If 'creative' classification and impairment are prohibited, it becomes almost impossible for debtors like these to propose a plan which can be con-

At stake is whether the so-called "single-asset" case can be reorganized in chapter 11. The single-asset case typically involves a real estate investment in which a separately incorporated entity or partnership owns a single piece of real estate. Classification determines the outcome of many of these cases because, if the debtor must classify the gigantic unsecured deficit claim together with the minor trade claims that probably exist (or which can be made to exist), the class of unsecured creditors will surely vote against the plan.[6] Because of section 1129(a)(10), no plan can be confirmed if no class of creditors agrees to it. On the other hand, if cooperative trade creditors can be classified separately, the debtor can meet section 1129(a)(10) with ease. At that point, only cram down under section 1129(b) stands between the debtor and confirmation of a plan.[7]

In the landmark case of *Phoenix Mutual Life Insurance Co. v. Greystone III Joint Venture (In re Greystone III Joint Venture)*,[8] Judge Edith Jones, confounding her seat on the Fifth Circuit Court of Appeals with a more Sinaitic emolument, has declaimed, "thou shalt not classify similar claims differently in order to gerrymander."[9] Yet, in her commandment, "gerrymander" means only a discrimination between creditors that cannot be justified.[10] Judge Jones held open the possibility that separate classification is permissible if a "rational" reason could be located. That is, the Bankruptcy Code's principle of "equal protection" of creditors[11] might be placated with a showing of mere rationality, as opposed to the "compelling" standard that constitutional law would apply to invidious discrimination. Therefore, Judge Jones's "eleventh commandment" is at least as susceptible to evasion as its first ten predecessors—if only rational discriminatory grounds can be located.

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firmed . . . .").

6. *See In re* 266 Washington Assocs., 141 B.R. 275, 284 (Bankr. E.D.N.Y.) (Feller, J.), *aff'd sub nom.* 266 Washington Assocs. v. Citibank, N.A. (*In re* Washington Assocs.), 147 B.R. 827 (E.D.N.Y. 1992).

7. The undersecured creditor in a single-asset case will tend to insist that its claim be classified with the others, in order to sabotage the plan. But sometimes general creditors insist on separate classification, as when they are outvoted in a class that wishes to accept the plan. A creditor wishing separate classification probably wishes to trigger the cram-down rules that apply only to dissenting creditors. *In re* Jersey City Medical Ctr., 817 F.2d 1055 (3d Cir. 1987) (Mansmann, J.).

8. 995 F.2d 1274 (5th Cir. 1991), *cert. denied*, 113 S. Ct. 72 (1992).

9. *Id.* at 1279.

10. *Cf.* Hanson v. First Bank, 828 F.2d 1310, 1313 (8th Cir. 1987) (Wollman, J.) (last minute counter-plan the day before the deadline was proof that the sole subjective motive for classification scheme was gerrymandering).

11. *See* 11 U.S.C. § 1123(a)(4) (1988) (requiring that a plan "provide the same treatment for each claim or interest of a particular class, unless the holder . . . agrees to a less favorable treatment"); *id.* § 1129(b)(1) (plan may "not discriminate unfairly").

This is not how *Greystone* is being interpreted. Rather, *Greystone* is seen as a per se rule against separately classifying the unsecured deficit claim of a dominant creditor.[12] Courts have been utilizing the per se rule against classifying the unsecured deficit differently from trade claims as a way of getting rid of unwanted chapter 11 plans, regardless of the quality of the reasons a debtor might present for unified classification.[13] These single-asset cases constitute about half the current chapter 11 docket of a given bankruptcy judge.[14] Unified classification means that a dominant undersecured creditor can show that a chapter 11 plan can never be confirmed. This showing might be made upon a motion to lift the automatic stay under section 362(d)(2), because the debtor has no equity in the collateral and the property is "not necessary to an effective reorganization."[15] In other words, if *Greystone* receives a per se treatment, a

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12. *See infra* note 155.

13. One bankruptcy judge has gone so far as to ban all *evidence* of practical differences between the unsecured deficit and trade claims. *See* Boston Post Rd. Ltd. Partnership v. FDIC (*In re* Boston Post Rd. Ltd. Partnership), 154 B.R. 617, 622 n.3 (D. Conn. 1993) (referring to an exclusion by Judge Robert Krechevsky). On appeal, Judge Alan Nevas pronounced himself "troubled by the Debtor's assertion that it was precluded from presenting evidence to the Bankruptcy Court in support of its business reasons for classifications." *Id.* Judge Nevas asked debtor's counsel what the differences were. Counsel responded that the plan itself called for different treatment. As the plan was before the court, Judge Nevas decided that the exclusion of evidence was harmless error. *Cf.* T-H New Orleans Ltd. Partnership v. Financial Sec. Assurance, Inc. (*In re* T-H New Orleans Ltd. Partnership, 5 F.3d 86 (5th Cir. 1993) (DeMoss, J.) (reversing bankruptcy court for failure to give debtor an opportunity to develop reasons for separate classification).

14. *Good Faith: A Roundtable Discussion*, 1 AM. BANKR. L. REV. 11, 15-16 (1993) (remarks of Judges Fenning, Greendyke, Hillman and Mark).

15. 11 U.S.C. § 362(d)(2)(B) (1988). According to § 362(d):

> On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay . . .
>
> (2) with respect to a stay of an act against property under subsection (a) of this section, if—
>
> (A) the debtor does not have an equity in such property; and
>
> (B) such property is not necessary to an effective reorganization.

Id. For cases in which the stay was lifted because unified classification prevented any chance for plan confirmation, see John Hancock Mut. Life Ins. Co. v. Roswell-Hannover Joint Venture (*In re* Roswell-Hannover Joint Venture), 149 B.R. 1014, 1017 (Bankr. N.D. Ga. 1992) (Bihary, J.); Piedmont Assocs. v. Cigna Prop. & Cas. Ins. Co., 132 B.R. 75, 78 (N.D. Ga. 1991) (Forrester, J.); *In re* Meadow Glen, Ltd., 87 B.R. 421 (Bankr. W.D. Tex. 1988) (Ayers, C.J.).

Of course, the classification issue can also be raised at the confirmation hearing. 11 U.S.C. § 1128; *e.g.*, Travelers Ins. Co. v. Bryson Props., XVIII (*In re* Bryson Props., XVIII), 961 F.2d 496, 502 (4th Cir.) (Restani, J.), *cert. denied*, 113 S. Ct. 191

bankruptcy judge can rid herself of the case not much more than 30 days after the petition itself was filed.[16]

This Article argues that, while gerrymandering *simpliciter* is *verboten*, fundamental priority and practical differences usually exist to distinguish the unsecured deficit and the trade claims. Indeed, the reasons for separate classification are so overwhelmingly strong that perhaps there ought to be a per se rule *in favor* of separate classification—precisely the opposite of what courts have been doing. Though clearing dockets is an important social goal, it cannot justify a clear misapplication of the Bankruptcy Code. If courts will *listen* to the reasons for separate classification, they will find that section 1129(a)(10) cannot clear their admittedly crowded dockets at all. Rather, courts will have to give single-asset debtors their day in court—inconvenient though that may seem.

Flexible classification often will be a necessary condition to reorganizing a single-asset case, but it is not also a sufficient condition. The debtor-in-possession faces other legal impediments to confirmation of a plan. In particular, even if the dominant undersecured creditor is separately classified so that a class of the yes-voting creditors can propel the debtor-in-possession past the rule of section 1129(a)(10), the no-voting dominant creditor is

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(1992); Phoenix Mut. Life Ins. Co. v. Greystone III Joint Venture (*In re* Greystone III Joint Venture), 995 F.2d 1274 (5th Cir. 1991) (Jones, J.), *cert. denied*, 113 S. Ct. 72 (1992). Or it might be raised at a hearing to approve a debtor-in-possession's disclosure statement. *In re* D & W Realty Corp., 156 B.R. 140 (Bankr. S.D.N.Y. 1993) (Abram, J.); *In re* Bjolmes Realty Trust, 134 B.R. 1000 (Bankr. D. Mass. 1991) (Queenan, J.).

At least one appellate court has indicated that the standards ought to be different between a ruling pertaining to the automatic stay and a ruling pertaining to confirmation of the plan. In John Hancock Mutual Life Insurance Co. v. Route 37 Business Park Assocs. (*In re* Route 37 Business Park Assocs.), 146 B.R. 640 (D.N.J. 1992) (Thompson, J.), *rev'd*, 987 F.2d 154 (3d Cir. 1993), Judge Anne E. Thompson wrote, "Under the facts of this case, we are skeptical whether the classification proposed by the partnership would pass muster at a confirmation hearing." *Id.* at 644. Nevertheless, she sustained the bankruptcy judge's refusal to lift the automatic stay because "the burden of proof in a § 362(d) motion is much more relaxed than the burden at confirmation." *Id.* It is not entirely clear whether Thompson was promulgating a rule of appellate review or a rule that bankruptcy judges were expected to follow.

Classification is a matter of law, and it ought to be apparent early on whether the secured creditor has a veto over the plan. Flexibility at the "lift stay" hearing surely is a virtue only with regard to factual criteria, such as feasibility of the plan. For this reason Judge Thompson found herself reversed on the notion that the sliding scale ought to apply to questions of law. *Route 37 Bus. Park Assocs.*, 987 F.2d at 162 ("[T]he explanations advanced by the debtor are invalid as a matter of law, and therefore no evidence that the debtor could offer at a confirmation hearing could cure their flaws. Accordingly, since we see no reasonable possibility of confirmation, we hold that the lift stay order should have been granted.").

16. 11 U.S.C. § 362(e) (stay lifted within 30 days unless court orders otherwise).

entitled to the cram-down rights of an unsecured creditor. These rights include the right to invoke the absolute priority rule. According to the absolute priority rule, dissenting general creditors may insist that no inferior party receive any property under the plan unless they themselves are fully paid.[17] The new value exception states that the absolute priority rule does not bar the sale of new equity interests to those who held the old, extinguished equity interests.[18]

If the absolute priority rule bars the new value exception, then even well-gerrymandered dominant creditors can block a reorganization of a single-asset entity. Unless the old equity holders can emerge as the owners of the reorganized entity, they will surely lose interest in the plan and allow the undersecured party to foreclose. Indeed, it is no coincidence that classification of the unsecured deficit and the new value exception have been litigated together in many of the leading cases, as if they were two facets of the same issue.[19] Indeed, between these two different cudgels by which a dominant secured party may club to death a single-asset chapter 11 proceeding, the classification veto has proven to be the more effective

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17. 11 U.S.C. § 1129(b)(2)(B)(ii).

18. *See* Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 202 (1988).

19. *See, e.g.,* Travelers Ins. Co. v. Bryson Props., XVIII (*In re* Bryson Props., XVIII), 961 F.2d 496, 502 (4th Cir.) (Restani, J.), *cert. denied*, 113 S. Ct. 191 (1992); Phoenix Mut. Life Ins. Co. v. Greystone III Joint Venture (*In re* Greystone III Joint Venture), 995 F.2d 1274 (5th Cir. 1991) (Jones, J.), *cert. denied*, 113 S. Ct. 72 (1992); John Hancock Mut. Life Ins. Co. v. Route 37 Bus. Park Assocs. (*In re* Route 37 Bus. Park Assocs.), 146 B.R. 640 (D.N.J. 1992) (Thompson, J.); Confederation Life Ins. Co. v. Beau Rivage Ltd., 126 B.R. 632, 635 (N.D. Ga. 1991) (Ward, J.); Piedmont Assocs. v. Cigna Prop. & Cas. Ins. Co., 132 B.R. 75, 78 (N.D. Ga. 1991) (Forrester, J.); *In re* SM 104 Ltd., No. 92-22698-BKC-AJC, 1993 WL 366619 (Bankr. S.D. Fla. Sept. 15, 1993) (Ginsburg, J.); *In re* 266 Washington Assocs., 141 B.R. 275, 284 (Bankr. E.D.N.Y.) (Feller, J.), *aff'd sub nom.* 266 Washington Assocs. v. Citibank, N.A. (*In re* Washington Assocs.), 147 B.R. 827 (E.D.N.Y. 1992); *In re* Creekside Landing Ltd., 140 B.R. 713, 715 (Bankr. M.D. Tenn. 1992) (Lundin, J.); *In re* Bjolmes Realty Trust, 134 B.R. 1000, 1004 (Bankr. D. Mass. 1991) (Queenan, J.); Penn Mut. Life Ins. Co. v. Woodscape Ltd. Partnership (*In re* Woodscape Ltd. Partnership), 134 B.R. 165 (Bankr. D. Md. 1991) (Derby, J.); *In re* Lumber Exch. Partnership, 125 B.R. 1000, 1006 (Bankr. D. Minn.) (O'Brien, J.), *aff'd*, 134 B.R. 354 (D. Minn. 1991) (Murphy, J.), *aff'd*, 968 F.2d 647 (8th Cir. 1992); *In re* Sherwood Square Assocs., 107 B.R. 872, 876 (Bankr. D. Md. 1989) (Derby, J.); *In re* Aztec Co., 107 B.R. 585, 587 (Bankr. M.D. Tenn. 1989) (Lundin, J.) (disapproving plan on other grounds); *see also* Teamsters Nat'l Freight Indus. Negotiating Comm. v. U.S. Truck Co. (*In re* U.S. Truck Co.), 800 F.2d 581 (6th Cir. 1986) (Kennedy, J.) (dominant labor union protested classification and also the new value exception).

For a discussion emphasizing this relationship between classification and the new value exception, see *In re* D & W Realty Corp., 156 B.R. 140 (Bankr. S.D.N.Y. 1993) (Abram, J.).

weapon.[20] Accordingly, this Article bypasses the new value battle and instead ponders the classification issue, which constitutes the *real* front lines in the war of secured creditors against chapter 11.[21]

I. VOTING IN CHAPTER 11

In chapter 11, the creditors vote on the mode of distribution. This

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20. On rehearing in *Greystone*, the appellate panel decided to withdraw all parts of the opinion relating to the new value exception, to the consternation of Judge Jones, leaving only the classification issue still standing. *Greystone*, 995 F.2d at 1284-85. This suggests that the new value exception is a weaker justification of the veto.

That classification constitutes an effective veto for dominant secured creditors has emerged only very recently. In a debate over the propriety of chapter 12 (farm reorganizations), two commentators assessing creditor rights under chapter 11 did not even mention § 1129(a)(10) as a source of veto. Rather, one asserted the absolute priority rule, and the other denied it in light of the new value exception, but neither raised the possibility that no class of creditors would vote to approve a farm reorganization in what often amounts to a single-asset case. *Compare* James J. White, *Taking from Farm Lenders and Farm Debtors: Chapter 12 of the Bankruptcy Code*, 13 J. CORP. LAW 1 (1987) *with* Patrick B. Bauer, *Where You Stand Depends on Where You Sit: A Response to Professor White's Sortie Against Chapter 12*, 13 J. CORP. LAW 33 (1987).

21. A different question I will also evade—except for what is set forth in this footnote—is whether different classifications will justify *substantive* differences in treatment between different classes of unsecured creditors. Only classification for voting purposes is discussed, as that issue determines whether the dominant undersecured creditor can veto the continuation of a chapter 11 proceeding.

The governing rule on inter-class discrimination is found in § 1129(b)(1), which applies only when a class of creditors has voted no. Section 1129(b)(1) allows confirmation only "if the plan does not discriminate unfairly, and is fair an equitable, with respect each class of claims or interests that is impaired under, and has not accepted, the plan." 11 U.S.C. § 1129(b)(1); *cf. id.* § 1123(a)(4) (requiring that a plan "provide the same treatment for each claim or interest of a particular class").

For cases upholding different substantive treatment for general creditor claims of the same rank, see *In re* Chateaugay Corp., 155 B.R. 625 (Bankr. S.D.N.Y. 1993) (Conrad, J.); *In re* Club Assocs., 107 B.R. 385 (Bankr. N.D. Ga. 1989) (Murphy, J.), *appeal dismissed*, 956 F.2d 1065 (11th Cir. 1992); *In re* Meadow Glen, Ltd., 87 B.R. 421 (Bankr. W.D. Tex. 1988) (Ayers, C.J.); *In re* AG Consultants Grain Div., Inc., 77 B.R. 665 (Bankr. N.D. Ind. 1987); *In re* White House Grain Co., 60 B.R. 16 (Bankr. E.D. Pa. 1986) (Goldhaber, J.) (creditors with conversion tort claims could be paid 100% while other general creditors got less); *In re* Rochem, Ltd., 58 B.R. 641 (Bankr. D.N.J. 1985) (Commisa, J.); *cf.* Barnes v. Whelan (*In re* Barnes), 689 F.2d 193, 201 (D.C. Cir. 1982) (Robb, J.) (requiring that like creditors be treated alike); *In re* Cranberry Hill Assocs., 150 B.R. 289 (Bankr. D. Mass. 1993) (Kenner, J.) (paying some creditors 65% now and paying the unsecured deficit 100% over time unfair to the unsecured deficit). *See generally* John C. Anderson, *Classification of Claims and Interests in Reorganization Cases Under the New Bankruptcy Code*, 58 AM. BANKR. L.J. 99 (1984).

differentiates chapter 11 from chapter 7 of the Bankruptcy Code. While general creditors in chapter 7 elect the trustee,[22] they may not vote on distribution, which is dogmatically fixed by Bankruptcy Code section 726. In chapter 11, however, creditors may vote on the distributional system promulgated by the plan.

Voting in chapter 11 is by class. There is good reason for this. Prior to the enactment of Bankruptcy Act section 77B[23] and the reorganization chapters that soon followed,[24] businesses were reorganized by means of equity receiverships under the pre-*Erie* federal common law. The receiver could not force a creditor to compromise her claim. Instead, a creditor could hold out against a consensual plan in order to obtain a greater recovery.[25] Accordingly, while the principal creditors worked out some means to save the going concern of a firm, the lesser creditors soon learned the profit in protesting too much; such creditors were cashed out, so that the larger creditors—the ones who really stood to lose if the company were not reorganized—could proceed through compromise to reorganize the company.

The reorganization acts therefore introduced class voting, so that single creditors could not hold up the entire proceeding in order to get paid. The Bankruptcy Code, of course, continues these rules. It requires that two-thirds of claims (by amount) in the class vote yes, and, in addition, that a flat majority (by head count) also vote yes.[26] If the class votes in favor of the plan, dissenting creditors within the class are forced to go along with the majority, at least for voting purposes.[27] If the class votes no, then the plan may still be confirmed, but only if the debtor crams down the plan.[28]

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22. 11 U.S.C. § 702.

23. Act of June 7, 1934, ch. 424, 48 Stat. 911, 912-22 (1934) (repealed 1978).

24. Chandler Act, ch. 575, 52 Stat. 840 (1938) (repealed 1978).

25. Werner, Harris & Buck v. Equitable Trust Co., 35 F.2d 513, 514 (10th Cir. 1929) (McDermitt, J.) ("Each bondholder has the absolute right to determine for himself, in case of default, whether he shall take his loss and quit, or continue to gamble . . . ."); E. Merrick Dodd, Jr., *Reorganization Through Bankruptcy: A Remedy for What?*, 48 HARV. L. REV. 1100, 1100-03 (1935). The Bankruptcy Act of 1867 and the little-used creditor compositions of § 12 of the Bankruptcy Act of 1898 contained class voting as well. *See* Chaim J. Fortgang & Thomas Moers Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 CARDOZO L. REV. 1, 87 (1990).

26. 11 U.S.C. § 1126(c).

27. Thus, in *In re* 11,111, Inc., 117 B.R. 471 (Bankr. D. Minn. 1990) (Kressel, J.), two minor creditors, classified together with huge yes-voting creditors, demanded separate classification so that they could preserve their cram-down rights. Their motion was denied. The case is the mirror opposite of the typical situation discussed here, where the *debtor* wants to gerrymander minor yes-voting creditors into classes separate from those of the dominant undersecured creditor.

28. *In re* Northeast Dairy Co-op. Fed'n, 73 B.R. 239, 251-52 (Bankr. N.D.N.Y. 1987) (Gerling, J.).

It is easy to over-estimate the benefit of the creditor franchise. Generally, even if creditors vote no, the plan can still be confirmed, provided the so-called "cram-down" rules of section 1129(b) are met.[29] A no vote, then, does nothing more than trigger the cram-down protections, with this important exception: If *no* class of impaired creditors votes yes, the plan cannot be confirmed, by virtue of the rule in section 1129(a)(10).[30] If one class does vote yes, then all the dissenters in other no-voting classes can be crammed down under section 1129(b).[31] The trick, then, is to classify the creditors in such a way as to produce at least one yes-voting class of impaired creditors.

Classification for voting purposes is governed by section 1122, which provides:

> (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.[32]

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29. *See* 11 U.S.C. § 1129(b). *See generally* Olympia & York Fla. Equity Corp. v. Bank of N.Y. (*In re* Holywell Corp.), 913 F.2d 873, 879-80 (11th Cir. 1990) (Cox, J.) (describing the relationship between Bankruptcy Code § 1129(a) and (b)); Teamsters Nat'l Freight Indus. Negotiating Comm. v. U.S. Truck Co. (*In re* U.S. Truck Co.), 800 F.2d 581, 583 (6th Cir. 1986) (Kennedy, J.) ("Confirmation under subsection (b) is commonly referred to as a 'cram down' because it permits a reorganization plan to go into effect over the objections of one or more impaired classes of creditors.").

30. 11 U.S.C. § 1129(a)(10). Section 1129(a)(10) is set forth *supra* text accompanying note 4. Prior to 1984, § 1129(a)(10) did not specify whether the yes-voting class had to be impaired. Meanwhile, § 1126(f) states: "Notwithstanding any other provision of [§ 1126], a class that is not impaired . . . [is] conclusively presumed to have accepted the plan." 11 U.S.C. § 1126(f). Creditors tried to argue that an unimpaired class is enough to satisfy § 1129(a)(10), though some courts have reasoned that only the yes vote of an *impaired* class could count. *In re* Barrington Oaks Gen. Partnership, 15 B.R. 952, 967-70 (Bankr. D. Utah 1981) (Mabey, J.). *See generally* Ethan D. Fogel, *Confirmation and the Unimpaired Class of Creditors: Is a "Deemed Acceptance" Deemed an Acceptance?*, 58 AM. BANKR. L.J. 151 (1984).

In 1984, Congress amended § 1129(a)(10) to make express the requirement that an *impaired* class of creditors must vote yes. Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, § 512(a)(9), 98 Stat. 333, 387.

31. *See In re* S & W Enters., 37 B.R. 153 (Bankr. N.D. Ill. 1984) (disapproving the use of administrative classes for the purpose of meeting the requirements of § 1129(a)(10)).

32. 11 U.S.C. § 1122.

Section 1122 is easily applied to oversecured creditors. Since the classes of creditors must contain those with substantially similar claims, secured parties routinely end up in a one-member class.[33] An undersecured creditor's secured and unsecured claims (following bifurcation) cannot be put in the same class under this rule.[34] Also, placing a secured party with different collateral (even highly fungible collateral) in the same class is not allowed.[35]

It is often observed that, while section 1122 prohibits placing dissimilar claims in the same class, it does not require that similar creditors be placed in the same class.[36] Indeed, section 1122 itself authorizes separate classifica-

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33. BANKR. R. 3014 advisory committee note ("[O]rdinarily each secured creditor is in a separate and distinct class."); *In re* Richard Buick, Inc., 126 B.R. 840 (Bankr. E.D. Pa. 1991) (Scholl, J.) (secured parties with different collateral cannot be put in same class for voting purposes); *In re* Holthoff, 58 B.R. 216, 219 (Bankr. E.D. Ark. 1985) (Mixon, J.) ("Secured creditors with liens in different property or liens in the same property but with different priorities may not be classified together since their legal rights are not substantially similar.").

34. *In re* Coventry Commons Assocs., 155 B.R. 446, 450-51 (E.D. Mich. 1993) (Duggan, J.); 266 Washington Assocs. v. Citibank, N.A. (*In re* Washington Assocs.), 147 B.R. 827, 830 (E.D.N.Y. 1992) (Dearie, J.); *In re* B & B W. 164th St. Corp., 147 B.R. 832, 838 (Bankr. E.D.N.Y. 1992) (Duberstein, J.); *In re* E.I. Parks No. 1 Ltd. Partnership, 122 B.R. 549, 557 (Bankr. W.D. Ark. 1990) (Mixon, J.). Both *Coventry Gardens* and *Washington Associates* describe placing the secured and unsecured portions of a secured creditor's claim in the same class as tantamount to making the § 1111(b)(2) election on behalf of the secured creditor, which, of course, only the secured creditor can make. *In re* Birdneck Apt. Assocs., II L.P., 156 B.R. 499, 506 (Bankr. E.D. Va. 1993) (Tice, J.) (ruling that failure to make election does not allow the debtor to impose it).

Coventry Commons additionally holds that giving the secured creditor more than the minimum required under § 1129(a)(7)(B) does not relieve the secured creditor of its right to make or decline the election. *Coventry Commons*, 155 B.R. at 452. The § 1111(b)(2) election is discussed *infra* in the text accompanying notes 93-107.

For dicta favoring the unitary classification of a creditor's secured and unsecured deficit claims, see *In re* D & W Realty Corp., 156 B.R. 140, 145 (Bankr. S.D.N.Y. 1993). In *D & W Realty*, Judge Prudence Abram approved a disclosure statement for a plan in which the secured and unsecured deficit claims were in fact separately classified.

35. Brady v. Andrew (*In re* Commercial W. Fin. Corp.), 761 F.2d 1329, 1338 (9th Cir. 1985) (Pregerson, J.) (mortgage participations). This was not always the practice under the Bankruptcy Act. In the famous case of Seidel v. Palisades-on-the-Desplaines (*In re* Palisades-on-the-Desplaines), 89 F.2d 214 (7th Cir. 1937), all the secured creditors were placed in one class, and most of them outvoted an unhappy secured creditor to accept the plan. Judge William Sparks ruled that, since all the creditors were to receive more under the plan than under the alternative liquidation scenario, such a classification error might be overlooked. *Id.* at 218. *See generally* Anderson, *supra* note 21, at 102-03.

36. Teamsters Nat'l Freight Indus. Negotiating Comm. v. U.S. Truck Co. (*In re* U.S. Truck Co.), 800 F.2d 581, 585 (6th Cir. 1986) (Kennedy, J.); *see also* Olympia & York Fla. Equity Corp. v. Bank of N.Y. (*In re* Holywell Corp.), 913 F.2d 873, 879-80 (11th

tion of *pari passu* creditors when "administrative convenience" is served.[37] This principle differentiates modern section 1122 from old Bankruptcy Act section 597 (chapter X), which provided that "the judge shall fix the division of creditors and stockholders into classes according to the nature of their respective claims and stock."[38] Old section 597 was interpreted to require that creditors of equal rank with claims against the same property be placed in the same class.[39] In contrast, section 751(1) of old chapter XI followed a different rule: the plan could "include provisions for treatment of unsecured creditors on a parity with each other, *or* for the division of such debts into classes and the treatment thereof in different ways."[40]

Whether the Bankruptcy Code follows the inflexible chapter X rule or the tolerant chapter XI rule remains unclear.[41] The legislative history is

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Cir. 1990) (Cox, J.) (proponent of plan has wide, but not unlimited discretion to classify creditors creatively); *In re* Jersey City Medical Ctr., 817 F.2d 1055, 1060-61 (3d Cir. 1987) (Mansmann, J.) (bankruptcy judges have wide discretion in finding classifications rational); *In re* AOV Indus., 792 F.2d 1140, 1150 (D.C. Cir. 1986) (Mikva, J.) (requiring an objecting creditor to show not only that similar claimants appear in different classes, but also that those in its class have disparate claims); *In re* Atlanta W. VI, 91 B.R. 620 (Bankr. N.D. Ga. 1988) (Cotton, J.) (plan could separately classify a general creditor who intended to advance a postpetition loan); *cf.* Barnes v. Whelan (*In re* Barnes), 689 F.2d 193, 200-01 (D.C. Cir. 1982) (Robb, J.) (chapter 13, which incorporates § 1122 by reference in § 1322(b)(1)).

Section 1129(b)(1) provides that a plan may not "discriminate unfairly." This section is usually not read to bar classification of *pari passu* creditors in different classes (for voting purposes) if the discrimination is rational. *See In re* Jersey City Medical Ctr., 817 F.2d 1055; *In re* Meadow Glen, Ltd., 87 B.R. 421, 425 (Bankr. W.D. Tex. 1988) (Ayers, C.J.). Whether it is possible to pay different classes of general creditors different dividends is another matter. *See supra* note 21.

37. On administrative convenience, see *In re* Mastercraft Record Plating, Inc., 32 B.R. 106 (Bankr. S.D.N.Y. 1983), *rev'd on other grounds*, 39 B.R. 654 (S.D.N.Y. 1984). In *Mastercraft* Judge Prudence Abram wrote: "The purpose of § 1122(b) is to allow a plan to reduce the number of creditors eligible to vote. This result is accomplished by offering creditors holding small claims of perhaps a few hundred dollars each a 100% payment and thus providing that they are not impaired." *Id.* at 108.

38. Bankruptcy Act § 197, 11 U.S.C. § 597 (1976) (repealed 1978).

39. *In re* Los Angeles Land & Invs., Ltd., 282 F. Supp. 448, 453 (D. Haw. 1968) (Tavares, J.), *aff'd*, 447 F.2d 1366 (9th Cir. 1971); William Blair, *Classification of Unsecured Claims in Chapter 11 Reorganization*, 58 AM. BANKR. L.J. 197, 212-13 (1984).

40. Bankruptcy Act § 357(1), 11 U.S.C. § 757(1) (1976) (repealed 1978) (emphasis added). These rules applied only to unsecured claims. The secured creditors could not be impaired under old chapter XI. Blair, *supra* note 39, at 214.

41. Judge Cornelia Kennedy assumes that, by aping the language of § 751 in § 1122, Congress intended to institute the rule of flexible classifications. Teamsters Nat'l Freight Indus. Negotiating Comm. v. U.S. Truck Co. (*In re* U.S. Truck Co.), 800 F.2d 581,

confusing, stating merely: "This section codifies current case law surrounding the classification of claims and equity securities."[42] Courts are divided over the issue. Some have insisted that "[t]he general rule regarding classification is that 'all creditors of equal rank with claims against the same property shall be placed in the same class.'"[43] Others have permitted creditors of the same rank to be put in different classes if the creditors are nevertheless dissimilarly situated.[44] In short, one can divide the case law as follows: One group demands the presence of differences in legal priority; the other group recognizes practical differences in order to justify separate classification of unsecured claims.[45]

Meanwhile, it is worth remembering that if either a practical difference or a priority difference between unsecured claims is "substantial," then section 1122(a) directly prohibits placing them in the same class.[46] This

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586 (6th Cir. 1986). She further argues that chapter X was stiff and formal, while old chapter XI was generally flexible. Because *new* chapter 11 is flexible, the more flexible classification rule should be followed as well.

Some commentators point to the legislative history of § 1122, which describes § 1122 as requiring "classification based on the nature of the claims." H.R. REP. NO. 595, 95th Cong., 1st Sess. 406 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6362. "Nature of the claims" was a phrase from old Chapter X and was often taken back then to mean "rank," not informal differences unreflective of legal priority. This point is bolstered by reference to the bill drafted in 1973 by the Commission on the Bankruptcy Laws of the United States. *See* REPORT OF THE COMM'N ON THE BANKRUPTCY LAWS OF THE U.S., H.R. DOC. NO. 137, 93d Cong., 1st Sess., pt. II, at 241 (1973). According to § 7-302 of this predecessor bill, classes could be organized if the claims were "of substantially similar character *and* the members of which enjoy substantially similar rights." According to one commentator, the change from emphasis on *rights* to mere *nature* means that Congress intended a liberal classification rule. Blair, *supra* note 39, at 201-02; *see also* Louis S. Robin, *Classification of Claims: An Examination of Disregarding Legislative History*, 98 COM. L.J. 225 (1993).

42. H.R. REP. NO. 595, *supra* note 41, at 406, *reprinted in* 1978 U.S.C.C.A.N. at 6362; S. REP. NO. 989, 95th Cong., 2d Sess. 118 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5785, 5904.

43. Granada Wines, Inc. v. New England Teamsters & Trucking Indus. Pension Fund, 748 F.2d 42, 46 (1st Cir. 1984) (Coffin, J.) (quoting Scherk v. Newton (*In re* Rocky Mountain Fuel Co., 152 F.2d 747, 750 (10th Cir. 1945)).

44. *E.g., In re* Jersey City Medical Ctr., 817 F.2d 1055, 1060-61 (3d Cir. 1987) (Mansmann, J.); *U.S. Truck*, 800 F.2d at 587; *In re* Chateaugay Corp., 155 B.R. 625 (Bankr. S.D.N.Y. 1993) (Conrad, J.).

45. One additional case asserts that *no* reason need be given for separate classification. Because § 1122(a) does not prohibit gerrymandering, it is allowed. Contrary views are vilified as the mere creation of policy. *In re* ZRM-Okla. Partnership, 156 B.R. 67, 70-71 (Bankr. W.D. Okla. 1993) (Bohanon, J.).

46. *In re* SM 104 Ltd., No. 92-22698-BKC-AJC, 1993 WL 366619 (Bankr. S.D. Fla. Sept. 15, 1993) (Ginsburg, J.); *In re* Club Assocs., 107 B.R. 385, 401 (Bankr. N.D. Ga.

requirement is often overlooked in the single-creditor cases, where the courts seem to treat classification as within the discretion of either the debtor-in-possession or the courts. Yet, at best, this should only be true with regard to *insubstantial* differences. If the differences are substantial, then separate classification is compelled.[47]

As we shall see, in single-asset cases, especially where the dominant secured creditor has advanced nonrecourse credit—separate classification *is* compulsory, because the artificial recourse claim has a different priority from that of the trade creditors.[48]

II. THE HISTORY OF SECTION 1129(A)(10)

In *In re Greystone III Joint Venture*,[49] Judge Leif Clark ruled that separate classification of trade creditors and the unsecured deficit was indeed appropriate. The opinion contains a detailed history of section 1129(a)(10), worthy of study in itself.[50] The history, as interpreted by Judge Clark, is supposed to show that a radically undersecured party is not entitled to a classification that guarantees it a veto of the plan by virtue of section 1129(a)(10). Strictly speaking, the historical exploration was not necessary to the result, because Clark finally concluded that pure gerrymandering could not justify a separate classification of trade debt.[51] Rather, Clark demanded reasons other than the desire to cram down the plan against the protesting undersecured creditor. This was precisely the position that Judge Edith Jones took in reversing Judge Clark.[52]

Nevertheless, the historical account is most illuminating for the

1989) (Murphy, J.), *appeal dismissed*, 956 F.2d 1065 (11th Cir. 1992).

47. *In re* Heron, Burchette, Ruckert & Rothwell, 148 B.R. 660, 670 (Bankr. D.D.C. 1992) (Teel, J.) (suggesting that different priority is per se a "substantial" difference between creditors).

48. *See infra* text accompanying notes 74-92.

49. 102 B.R. 560 (Bankr. W.D. Tex. 1989), *aff'd*, 127 B.R. 138 (W.D. Tex. 1990), *rev'd*, 995 F.2d 1274 (5th Cir. 1991), *cert. denied*, 113 S. Ct. 72 (1992).

50. *Greystone*, 102 B.R. at 562-66.

51. *Id.* at 568; *see also* Olympia & York Fla. Equity Corp. v. Bank of N.Y. (*In re* Holywell Corp.), 913 F.2d 873, 880 (11th Cir. 1990) (Cox, J.); Piedmont Assocs. v. Cigna Prop. & Cas. Ins. Co., 132 B.R. 75, 78 (N.D. Ga. 1991) (Forrester, J.); *In re* Lumber Exch. Partnership, 125 B.R. 1000, 1006 (Bankr. D. Minn.) (O'Brien, J.), *aff'd*, 134 B.R. 354 (D. Minn. 1991), *aff'd*, 968 F.2d 647 (8th Cir. 1992); *In re* Valrico Square Ltd. Partnership, 113 B.R. 794 (Bankr. S.D. Fla. 1990) (Weaver, J.). Judge Richard Bohanon, however, takes the strong position that because § 1122(a) does not prohibit gerrymandering, then the plain meaning of the Bankruptcy Code permits it. *In re* ZRM-Okla. Partnership, 156 B.R. 67, 70-71 (Bankr. W.D. Okla. 1993).

52. *Greystone*, 995 F.2d at 1278-79.

light—or the darkness—it sheds on the attitude of Congress toward bankruptcy jurisdiction over the singe-asset case.

Prior to the Bankruptcy Code, courts could cram down single-asset real estate cases in old chapter XII even if every creditor voted no. Old chapter XII had no absolute priority rule;[53] an undersecured creditor could be limited to the value of the collateral, and the old equity interests would survive to benefit from any appreciation in value that accrued after confirmation of the plan. All that the undersecured party could hope for was the appraised value of the collateral as it existed at the time the plan was confirmed.

Nevertheless, some old cases rebelled at the prospect of cram down when all the creditors opposed the plan. Accordingly, these cases required that, before a plan could be confirmed, some of the impaired creditors had to vote in favor of the plan.[54] It was these cases, obviously, that inspired section 1129(a)(10).

None of the cases asserting this judge-made rule, though, was a one-asset case where the creditor asserted an absolute right to veto the reorganization plan even though other minor creditors favored it. The function of section 1129(a)(10) as a dominant-creditor veto seems to be a modern function for the old rule. The rule, taken on its own terms, simply expressed the idea that reorganization had to benefit creditors somehow and that a yes-voting creditor was necessary to prove this benefit existed.[55] It is far from clear that the old rule required a yes-voting *class* of voters; some support *within* a no-voting class might have sufficed.[56]

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53. Bankruptcy Act § 472(5), 11 U.S.C. § 872(5) (1976) (repealed 1978).

54. Herweg v. Neuses (*In re* Herweg), 119 F.2d 941 (7th Cir. 1941) (Sparks, J.) (chapter XII); *see* Richard F. Dole, Jr., *The Chapter XII Cram-Down Provisions*, 82 COMM. L.J. 197, 198 (1977) ("apparently an unbroken judicial gloss").

55. Thus, according to Judge Barbara Crabb:

> [I]f no class of creditors agrees to the plan, it would not be equitable to impose acceptance of the plan upon the creditors by enforcing the debtor's interest in confirmation of the plan through the cramdown authority. The point is, if no impaired class accepts the plan, the debtor has failed to negotiate effectively with its creditors in devising a reorganization plan. I find nothing in the Bankruptcy Reform Act to indicate that Congress intended that the bankruptcy courts could saddle creditors with a stake in a reorganized corporation under a plan that had received no acceptances from impaired classes of creditors.

In re Polytherm Indus., 33 B.R. 823, 835 (W.D. Wis. 1983).

56. In the original case promulgating the rule, all creditors unanimously opposed the plan; no one dominant creditor was demanding a veto contrary to the wishes of other creditors who wished to vote yes. *Herweg*, 119 F.2d 941; *see also* Taylor v. Wood, 458 F.2d 15 (9th Cir. 1972) (per curiam) (the *only* existing creditor voted no); Sumida v. Yumen, 409 F.2d 654, 659 (9th Cir. 1969) (Carter, J.); Meyer v. Rowen, 195 F.2d 263

During 1977, when the drafting of the Bankruptcy Reform Act was most intense, two noted bankruptcy judges repudiated the old cases that had required a class of creditors to vote yes on the plan; they crammed down plans even though not a single class of creditors had voted for the plan.[57] One of the points made by these judges was that a debtor could easily generate trade debt and then default upon it. The trade debt could be impaired and induced to vote yes on the plan. Therefore, these judges thought that the old equity rule insisting on one yes vote was useless.[58]

If these two cases irritated the real estate lenders, the case that truly inflamed them was *Great National Life Insurance Co. v. Pine Gate Associates (In re Pine Gate Associates)*.[59] In *Pine Gate*, several nonrecourse, undersecured creditors had financed the construction of some condominia. In the middle of construction, the debtor filed for bankruptcy and, after a valuation of the collateral, successfully put a limit on the maximum size of the secured claims. As a result, any gain in collateral value would go to the equity holders. Since the lenders were nonrecourse, they could not even share in the gain on the strength of the unsecured deficit claims. Indeed, if they were cashed out by an amount equal to the value of their secured claim, they were deemed unimpaired by the reorganization plan and, therefore, were deemed to have voted yes on the plan.[60]

In response to these cases, the Senate version of the Bankruptcy Reform Act encoded the current principle of section 1129(a)(10).[61] But one flaw in the Senate bill requiring a yes vote from a class of creditors was that, in many real estate deals, the dominant secured party has no recourse against

(10th Cir. 1952) (Murrah, J.) (single creditor; "no creditors can be found to consent" to the plan).

57. *See* Massachusetts Mut. Life Ins. Co. v. Marietta Cobb Apts. Co. (*In re* Marietta Cobb Apts. Co.), 3 Bankr. Ct. Dec. (CRR) 720 (Bankr. S.D.N.Y. 1977) (Babbitt, J.); *In re* Hobson Pike Assocs., 3 Bankr. Ct. Dec. (CRR) 1205 (Bankr. N.D. Ga. 1976) (Norton, J.).

58. *Marietta Cobb*, 3 Bankr. Ct. Dec. (CRR) at 724; *Hobson Pike*, 3 Bankr. Ct. Dec. (CRR) at 1210, 1213-14; *see also* Acacia Mut. Life Ins. Co. v. Perimeter Park Inv. Assocs. (*In re* Perimeter Park Inv. Assocs.), 697 F.2d 945 (11th Cir. 1983) (Fay, J.) (agreeing with these interpretations of the Bankruptcy Act).

59. 2 Bankr. Ct. Dec. (CRR) 1478 (Bankr. N.D. Ga. 1976); *see* General Elec. Mort. Corp. v. South Village, Inc. (*In re* South Village, Inc.), 25 B.R. 987, 999 (Bankr. D. Utah 1982) ("Section 1111(b) was designed to overrule *In re Pine Gate Associates*.").

60. *See In re* Polytherm Indus., 33 B.R. 823, 833-34 (W.D. Wis. 1983) (Crabb, J.).

61. S. 2266, 95th Cong., 2d Sess. § 1130(a)(12) (1978). For a history that traces § 1129(a)(10) back to the testimony of Edward J. Kalik, a senior vice president of Massachusetts Life Insurance Co., see *In re* Polytherm Indus., 33 B.R. at 833-34; *see also* Fogel, *supra* note 30, at 160-61 (quoting the National Association of Real Estate Investment Trusts as complaining that "recent, well-publicized cases" had shifted value from secured creditors to junior interests).

the debtor. If the debtor troubled to create a little unsecured trade debt, these trade creditors could comprise a separate class that would vote yes on the plan, thereby negating the opposition of the dominant undersecured party.[62] Hence, the Senate, after conferring with the House, added section 1111(b)(1)(A), which transformed nonrecourse lenders into recourse lenders in any chapter 11 case.[63] Section 1111(a)(1)(b), together with section 1129(a)(10), effectively gave dominant undersecured creditors in single-asset cases a veto over confirmation of a plan—*unless* some class of impaired creditors could be set up to vote in favor of the plan.

Judge Clark thought that the history of the Bankruptcy Code showed that creative classification could negate the veto that the dominant undersecured creditor might otherwise have by virtue of section 1129(a)(10). In his view, the Senate may have favored the veto, but the House did not. When the bankruptcy bill went to conference, the Senate accepted the House version of cram down.[64] The Senate subsequently added section 1111(b)(1)(A), changing nonrecourse lenders into recourse lenders. It also retained the one-class-must-vote-yes rule of section 1129(a)(10).

Judge Clark claimed that section 1129(a)(10) was an *alternative* to cram down—that section 1129(a)(10) was thoughtlessly retained "without explanation or comment, and apparently without consideration of either that section's relationship or impact upon the cram-down provisions brought into the draft from the House version."[65] As evidence, Clark recalled "that the Senate version had the requirement of at least one accepting class even though it did *not* have a 'cram-down' provision."[66] He pointed out that explanations of cram down never alluded to a role for section 1129(a)(10).[67]

Meanwhile, both the Senate and House versions of the bankruptcy legislation

62. This point had been used to justify the rejection of the old equity rule that one class must vote yes; if the rule was so easily evaded in nonrecourse cases, why bother having the rule? *See Marietta Cobb*, 3 Bankr. Ct. Dec. (CRR) at 724; *Hobson Pike*, 3 Bankr. Ct. Dec. (CRR) at 1210, 1213-14.

63. This transmogrification is discussed in David Gray Carlson, *Undersecured Claims Under Bankruptcy Code Sections 506(a) and 1111(b): Second Looks at Judicial Valuations of Collateral*, 6 BANKR. DEV. J. 253 (1989).

64. Accordingly, the Senate dropped its own provision governing real estate mortgages. According to this discarded provision, the only impairment of mortgages allowed was cure and reinstatement or extension of payment schedules (in a way that protected present value). S. 2266, *supra* note 61, § 1129(d).

65. *Greystone*, 102 B.R. at 565 (footnote omitted).

66. *Id.* at 565 n.6.

67. *Id.* at 565 & n.7.

contained nearly identical provisions regarding classification, and the legislative history only confirms that Congress did not envision any particular restrictions on the creative use of the classification powers, other than that (1) dissimilar claims could not be forced into the same class and (2) an impaired and dissenting class could not be treated differently than another class of equal dignity.[68]

In Clark's view, both houses favored creative classification, but only the Senate favored a veto for undersecured creditors in single-asset cases. He therefore cast a plague upon both houses of Congress.

> Congress thus adopted an unclear middle position on the question of single asset real estate cases in bankruptcy. It could have given secured creditors veto power over reorganizations had it enacted the Senate version. It could also have effectively gagged the secured creditor had it settled solely on the House version. Instead Congress made sausage, and as a result, courts and practitioners are left with a reorganization chapter which, when applied to single asset real estate cases, is rife with inconsistencies.[69]

The inconsistency that the House and Senate left unresolved, according to Clark, was this: a nonrecourse secured creditor is given recourse and is given an unsecured claim, and the debtor must produce one yes-voting class of impaired creditors. Yet creative classification of trade debt is approved in section 1122:

> The only limitation on that tactic apparent on the face of the Code is the requirement that, as between the trade and the deficiency claim, the plan not unfairly discriminate. A creditor "victimized" by such tactics will be quick to point to Section 1129(a)(3), which requires the plan to have been proposed "in good faith," but that position is tenable only if one first concludes that the *purpose* of Section 1129(a)(10) was to assist in preventing debtors from obtaining access to the cramdown provisions, an assumption which this court finds is suspect.[70]

In the end, Judge Clark thought that single-asset cases should not be subject to veto by the dominant secured party. Rather, "in real estate cases such as this, the ultimate confrontation will take place over whether the plan can satisfy the stringent requirements of cram-down imposed by Section 1129(b), not whether it can satisfy the hyper-technical (and largely impractical)

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68. *Id.* at 565-66.
69. *Id.* at 566.
70. *Id.*

requirements of Section 1129(a)(10)."[71]

In spite of the energy with which Judge Clark portrays this history of section 1129(a)(10), his account is not entirely plausible. It is very possible to view the history as introducing a strong veto power over single-asset cases by dominant secured creditors by virtue of section 1111(b)(1)(A) in combination with section 1129(a)(10).[72] Together with the anti-discrimination rule of section 1129(b), these provisions could easily be interpreted to mean that classification cannot be manipulated to negate the veto that Congress intended undersecured creditors to have in single-asset cases. Indeed, that is precisely the position that Judge Edith Jones took on appeal in *Greystone*.[73] But this is getting ahead of our story.

III. PRIORITY DIFFERENCES BETWEEN RECOURSE AND NONRECOURSE CLAIMS

If the artificial recourse claim of the dominant secured creditor has a different priority from that of the trade creditors, separate classification is mandatory, and the classification veto is dead. Can such priority differences

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71. *Id.* Compare Judge Clark's indignant opinion in *In re* Anderson Oaks (Phase I) Ltd. Partnership, 77 B.R. 108, 112 (Bankr. W.D. Tex. 1987). In *Anderson Oaks*, not a single creditor in addition to the undersecured creditor existed. Therefore, Clark found the chapter 11 to have been filed in bad faith:

> Here, boiled down to its essence, is an attempt by an investor group to use the Bankruptcy Code as a device with which to force its lender into renegotiating their loan. It is true that Section 506 does contemplate limiting a secured claim to the value of the collateral securing the claim. It is equally true that Section 1129(b) contemplates forcing an involuntary loan upon recalcitrant creditors in order to attain confirmation of a plan. It is not true, however, that those provisions are available to any investor looking to refinance his loan. The requirement of at least one impaired class of creditors who have affirmatively voted for the plan *and who are not insiders* must be met in order to invoke the "cram-down" provisions of Section 1129(b). In short, there must be some one other than the debtor, other than the insiders, and other than the target of the cram down, who cares enough about the reorganization and whose rights must also be considered to invoke the equitable grounds that justify resort to cram down.

Id. at 112-13. This indignation against bad-faith filings in single-asset cases entirely evaporates when a debtor remembers to forget to pay trade creditors before filing for chapter 11 protection.

72. *E.g., In re* 500 Fifth Ave. Assocs., 148 B.R. 1010, 1015, 1021 (Bankr. S.D.N.Y. 1993) ("The purpose of the section 1111(b) election is to allow the undersecured creditor a right to potentially dominate the vote within the unsecured class; the larger the nonrecourse claim, the larger that claimant's voice sounds.") (Brozman, J.).

73. 948 F.2d at 139-40.

be located? The answer is a strong and definitive yes, thereby implying that a great many of the classification cases, such as *Greystone*, were wrongly decided. What follows is a list of differences in legal priority.

A. The Implications of Section 723(a)

The leading case of *In re Greystone III Joint Venture*[74] presents a very typical single-asset case. In *Greystone* the debtor owed a nonrecourse mortgagee $9.3 million, and the collateral (an office building) was worth $5,825,000. The undersecured deficit claim was therefore almost $3.5 million. The debtor also owed approximately $10,000 in unsecured trade debt.[75]

Because the debtor was a partnership, the trade creditors had claims against the general partners of the debtor.[76] Under the rule of section 1111(b)(1)(A),[77] the nonrecourse undersecured party was transformed into a recourse creditor. This artificial recourse was against the debtor only, however, not against the general partners,[78] who were not subject to the rule of section 1111(b)(1)(A).[79]

Because the trade claims had recourse against the general partner (while the secured party had none), a priority difference existed, which has often been overlooked. This difference exploits the key rule in section 1129(a)(7)(A) that entitles every creditor to at least as much in chapter 11 as she would have received in chapter 7.[80]

In chapter 7, the nonrecourse secured party would lose its artificial

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74. 102 B.R. 560 (Bankr. W.D. Tex. 1989), *aff'd*, 127 B.R. 138 (W.D. Tex. 1990), *rev'd* 995 F.2d 1274 (5th Cir. 1991), *cert. denied*, 113 S. Ct. 72 (1992).

75. *Greystone*, 127 B.R. at 139.

76. *Greystone*, 102 B.R. at 561.

77. 11 U.S.C. § 1111(b)(1)(A) (1988) ("A claim secured by a lien on property of the estate shall be allowed or disallowed under section 502 of this title the same as if the holder of such claim had recourse against the debtor on account of such claim, whether or not such holder has such recourse . . . .").

78. *Greystone*, 102 B.R. at 570.

79. *See In re* 500 Fifth Ave. Assocs., 148 B.R. 1010, 1015, 1018 (Bankr. S.D.N.Y. 1993) (Brozman, J.)

80. According to §1129(a)(7)(A),

> With respect to each impaired class of claims or interests—
> (A) each holder of a claim or interest of such class—
> (i) has accepted the plan; or
> (ii) will receive or retain under the plan on account of such claim or interest property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7 of this title on such date.

11 U.S.C § 1129(a)(7)(A).

recourse because this right comes from section 1111(b)(1)(A)—a rule not applicable in chapter 7. Meanwhile, in chapter 7, the trade creditors would have their recourse against the debtor partnership. Under the rule of section 723(a), the partnership's chapter 7 trustee would be subrogated to this recourse against the general partners.[81] The chapter 7 trustee's recovery would increase the bankruptcy dividend for the trade creditors, but the nonrecourse secured party would not share in this bounty. In fact, if the general partner were solvent, section 723(a) implies that trade creditors would recover 100 cents on the dollar in chapter 7.[82]

Meanwhile, back in chapter 11, section 1129(a)(7)(A) insists that the trade creditors receive 100 cents on the dollar—the amount they would have received in chapter 7 when a general partner is solvent.[83] Section 1111(b)(1)(A) changes the nonrecourse lender into a recourse creditor. But, under section 1129(a)(7)(A), this artificial recourse claim is entitled to a minimum of zero, because zero is what this claim would receive in chapter 7. This is not to say the artificial recourse claim *will* be allocated zero. In fact, once collateral is assigned to the secured claim and the trade creditors obtain 100 cents on the dollar, the artificial recourse claim is entitled to receive the equivalent of all remaining assets. The point is, however, that the trade claims are senior to artificial recourse claims; these claims have different priorities in chapter 11, not only permitting but compelling separate classification.[84]

If this argument is accepted, it is clear that a great many of the cases, such as *Greystone*, that honor the dominant undersecured creditor's classification veto were wrongly decided. But before we say so, it is necessary to

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81. According to § 723(a):

> If there is a deficiency of property of the estate to pay in full all claims which are allowed in a case under this chapter concerning a partnership and with respect to which a general partner of the partnership is personally liable, the trustee shall have a claim against such general partner for the full amount of the deficiency.

11 U.S.C. § 723(a).

82. *In re* Monetary Group, 55 B.R. 297, 299 (Bankr. M.D. Fla. 1989) (Proctor, J.).

83. Also, if the trade creditors receive 100 cents on the dollar, it is possible, but not required, that the trade creditors would be unimpaired. If trade creditors are unimpaired, they are deemed to vote yes, but their votes do not count toward satisfying § 1129(a)(10). This is no obstacle for debtors-in-possession. If the trade creditors are paid over time, and not in cash on the effective date of the plan, the trade creditors are probably impaired. *See* 11 U.S.C. § 1124 (defining impairment). The issue of unnecessary or sham impairment is discussed *infra* text accompanying notes 182-199.

84. *In re* Aztec Co., 107 B.R. 585, 587 (Bankr. M.D. Tenn. 1989) (Lundin, J.); *In re* SM 104 Ltd., No. 92-22698-BKC-AJC, 1993 WL 366619, at *13-17 (Bankr. S.D. Fla. Sept. 15, 1993) (Ginsburg, J.) (but refusing to confirm the plan because the cram down interest rate was too low and the plan was not feasible).

dispose of a subtle argument to the contrary.

According to the above argument, the trade creditors have a higher priority than the artificial recourse claim in chapter 11 because trade creditors would have access to assets in chapter 7 that the nonrecourse creditor could not get. When some unencumbered assets would exist in the hypothetical chapter 7 liquidation conjured forth by section 1129(a)(7)(A)(ii), the trade creditor priority exists even without the trustee's right to pursue the general partners under section 723(a). In a single-asset bankruptcy, however, the hypothetical chapter 7 estate may well have no assets at all—*except* the chapter 7 trustee's right to pursue the general partners under section 723(a). Under these circumstances, the trade creditor argument for chapter 11 priority rests entirely on the section 723(a) cause of action. Of course, the equity owners of the debtor-in-possession could always contribute some unencumbered assets to the bankrupt estate, thereby assuring the existence of a priority in both chapter 7 and chapter 11. But let us suppose, for a moment, that the trade creditors' priority claim rests exclusively on the section 723(a) cause of action in the hypothetical liquidation proceeding to which section 1129(a)(7)(A) refers.

The obstacle to priority for the trade creditors comes form the fact that section 723(a) has no parallel provision in chapter 11. That is, section 723(a) gives a chapter 7 trustee the right to pursue the general partners in the name of the trade creditors, but it does not so clearly authorize a chapter 11 trustee or debtor-in-possession to pursue the general partners.[85]

This fact might be seen to threaten the trade creditors' priority. If the section 723(a) right does not exist in chapter 11, then the trade creditors cannot gain this asset, and, thus, the trade creditors would once again be equal to the artificial recourse creditors. And if they are equal, the argument based on priority falls apart.

There are several replies to this objection. First, the objection does not apply if the principals of the debtor-in-possession have contributed, or are willing to contribute, unencumbered assets to the bankrupt estate.[86] Since *any* contribution on unencumbered assets differentiates the artificial recourse claim from the natural recourse claims, the objection that section 723(a) does not exist in chapter 7 can be dismissed as an empty formalism.

Second, although section 723(a) does not exist in chapter 11, the trade

85. Robert Rosenberg, *Partnership Reorganization Under the Bankruptcy Reform Act: Filling in the Interstices*, 56 N.Y.U. L. REV. 1173, 1201 (1981).

86. In *In re* Heron, Burchette, Ruckert & Rothwell, 148 B.R. 660 (Bankr. D.D.C. 1992), Judge Martin Teel confirmed a plan in which all creditors were enjoined against collecting from participating general partners, in exchange for these partners' negotiated contributions to the bankrupt estate. If a nonrecourse secured party had been involved, these contributions would have constituted property that the trade creditors could reach, but which the artificial recourse claimant could not.

creditors may nevertheless be entitled to block a plan on the basis of section 1129(a)(7), even though the artificial recourse claimant cannot. If so, the transaction costs retain a kind of priority even without the existence of an unencumbered asset. For example, suppose the bankrupt estate has no unencumbered assets and, in chapter 11, the debtor-in-possession cannot claim to own an asset resembling the right in section 723(a). Nevertheless, the trade creditors might still insist that, *unless* they receive what they would have received in a hypothetical liquidation—*i.e.*, the value of the section 723(a) action—they may block confirmation of the plan for failure to meet the requirements of section 1129(a)(7).[87] This argument, if accepted, proves that the trade creditors have powers (if not priority to assets) that the artificial recourse claimant does not have.

Third, it is possible that a chapter 11 trustee *does* own the section 723(a) cause of action after all.[88] If so, then the section 723(a) asset belongs to the recourse creditors, but not to the artificial recourse claimant. The argument that section 723(a) exists in chapter 11 might go as follows. According to section 103(a) of the Bankruptcy Code, all parts of chapter 5—including section 541(a), which defines the bankrupt estate—apply to chapter 11. According to section 541(a)(3), the chapter 11 estate includes "Any interest in property that the trustee recovers under section . . . 723."[89] Therefore, section 541(a)(3) supplies the chapter 11 debtor-in-possession with rights under section 723(a).[90] Or, alternatively, the trustee's

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87. Bell Rd. Inv. Co. v. Arabians (*In re* Arabians), 103 B.R. 211, 216-17 (Bankr. 9th Cir. 1989) (Russell, J.); *In re* Monetary Group, 55 B.R. 297, 299 (Bankr. M.D. Fla. 1985) (Proctor, J.); Frank R. Kennedy & Gerald K. Smith, *Some Issues in Partnership and Partner Bankruptcy Cases and Recommendations for Legislative Change*, ANN. SURV. BANKR. L. 1, 22 (1990).

88. In *In re* Heron, Burchette, Ruckert & Rothwell, 148 B.R. 660 (Bankr. D.D.C. 1992), Judge Teel assumed that the chapter 11 estate owned a right similar to § 723(a). In performing the hypothetical liquidation test of § 1129(a)(7), he counted the § 723(a) right in valuing the hypothetical chapter 7 estate, and he also approved adding a similar right in valuing the chapter 11 property distributed under the plan. *Id.* at 682. This right (against partners who refused to contribute voluntarily to fund the plan) was deemed assigned to a creditors' committee and was counted as a distribution under the chapter 11 plan for the benefit of the general creditors. Thus, the case stands for the proposition that § 723(a) rights exist in chapter 11 as part of the bankrupt estate.

89. 11 U.S.C. § 541(a)(3) (1988).

90. Commercial Bank v. Price (*In re* Notchcliff Assocs.), 139 B.R. 361, 370-71 (Bankr. D. Md. 1992) (Schneider, J.); Kennedy & Smith, *supra* note 87, at 22-25. This last argument is weakened by the exact wording of § 723(a), which provides:

> If there is a deficiency of property of the estate to pay in full all claims *which are allowed in a case under this chapter* concerning a partnership and with respect to which a general partner of the partnership is personally liable, the trustee shall have a claim against such general partner for the full amount

strong-arm power under section 544(a) might imply the right of a debtor-in-possession to pursue the general partners.[91] According to section 544(a):

> The trustee shall have, as of the commencement of the case . . . the rights and powers of . . .
> (1) a creditor that extends credit to the debtor at the time of the commencement of the case, ant that obtains, at such time and with respect to such credit, a judicial lien on all property on which a creditor on a simple contract could have obtained such a judicial lien, whether or not such a creditor exists. . . .[92]

This argument relies not on the judicial lien, but on the fact that the trustee is deemed to have the powers of a creditor that extends credit to the debtor at the time of the commencement of the case. Such a creditor would have recourse against the general partners of the debtor, and so a debtor-in-possession has recourse against the general partners by virtue of section 544(a).

For these reasons, the nonexistence of section 723(a) in chapter 11 is no answer to the point that trade creditors with recourse outrank the artificial recourse claim of a dominant secured creditor. Because of the high priority of the trade claims, their separate classification from the artificial recourse claim is compelled by the plain meaning of section 1122(a). Accordingly, the classification veto does not exist in any case where the dominant undersecured creditor has no recourse under state law.

B. The Section 1111(b)(2) Election

That nonrecourse claims and recourse claims have different priorities in chapter 11 constitutes a powerful difference in legal priority. Therefore, every case involving these factors not only *can* sustain separate classification, but *must* sustain it. Furthermore, one can discover other differences in priority in cases where the secured creditor has natural recourse stemming from state law or where the debtor is not a partnership.

One of the more mysterious moments in chapter 11 is the difficult section 1111(b)(2) election. Section 1111(b) provides that, if an under-

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of the deficiency.

11 U.S.C. § 723(a) (emphasis added). Perhaps the emphasized language requires creditor claims to be allowed *under chapter 7*. In chapter 11, no such allowed claims exist, and, therefore, the chapter 11 trustee or debtor-in-possession can recover nothing under § 723(a).

91. Andrew v. Coopersmith (*In re* Downtown Inv. Club III), 89 B.R. 59 (Bankr. 9th Cir. 1988) (Carlson, J.).

92. 11 U.S.C. § 544(a).

secured party so elects, "then notwithstanding section 506(a) of this title, such claim is a secured claim to the extent that such claim is allowed."[93] This language is usually read to mean that if an undersecured creditor makes the election, she forfeits any unsecured deficit claim.[94] Hence, when a secured creditor actually makes the election, there is no need to address the classification issue at all.[95] The unsecured claim is eliminated, and the total claim of the dominant creditor is put in a single class.[96] When this occurs, no impediment exists to placing the happy trade creditors in their own class.

A numerical example will explain the consequences of the section 1111(b)(2) election as it is usually read. Suppose *A* has lent $1,000,000 to the debtor. The collateral is worth $100,000. There are no liens other than *A*'s on the collateral. Therefore, *A*'s secured claim has a section 506(a) ceiling of $100,000; that is, *A* is deemed to have a totally secured claim of $100,000 and an unsecured claim of $900,000. If the undersecured creditor is qualified to make the section 1111(b) election, and actually does so elect, the undersecured creditor must receive $1,000,000 under the chapter 11 plan, thereby gaining a preference of $900,000 over other general creditors.

While this effect may seem astonishing, it is tempered by section 1129(a)(7)(B), which permits a debtor-in-possession to provide the electing secured creditor with a present value equal to the value of the collateral—in

93. *Id.* § 1111(b).

94. It is clear that nonrecourse lenders who are given recourse under § 1111(b)(1)(A) should lose it, but it is less clear that recourse lenders who make the election should also forfeit their right to the unsecured deficit claim. Nevertheless, the proposition is universally asserted. *In re* Cook, 126 B.R. 575, 581 (Bankr. D.S.D. 1991) (Ecker, J.); *In re* North Indianapolis Venture, 113 B.R. 386, 391 (Bankr. S.D. Ohio 1990) (Sellers, J.); *In re* Waterways Barge Partnership, 104 B.R. 776, 782 (Bankr. N.D. Miss. 1989); *In re* Western Preferred Corp., 58 B.R. 201, 210 (Bankr. N.D. Tex. 1985); *In re* Union Square Assocs., 53 B.R. 532 (Bankr. E.D. Ark. 1985); *In re* Southern Mo. Towing Serv., Inc., 35 B.R. 313, 314 (Bankr. W.D. Mo. 1983); *In re* Griffiths, 27 B.R. 873, 876 (Bankr. D. Kan. 1983); Provident Bank v. BBT (*In re* BBT), 11 B.R. 224, 231 n.12, 237 n.20 (Bankr. D. Nev. 1981); 5 COLLIER ON BANKRUPTCY, ¶ 1111.02[5] (Lawrence P. King, ed., 15th ed. 1993); Theodore Eisenberg, *The Undersecured Creditor in Reorganizations and the Nature of Security*, 38 VAND. L. REV. 931, 965 (1985); Michael J. Kaplan, *Nonrecourse Undersecured Creditors Under New Chapter 11—The Section 1111(b) Election: Already a Need for Change*, 53 AM. BANKR. L.J. 269, 270 (1979).

For the view that only nonrecourse lenders should lose the recourse promised in § 1111(b)(1)(A), see Carlson, *supra* note 63.

95. *In re* Miami Ctr. Assocs., 144 B.R. 937, 943 (Bankr. S.D. Fla. 1992) (Cristol, J.).

96. The placement of the total undersecured claim in one class is not permitted *unless* the § 1111(b)(2) election is made. *See* 266 Washington Assocs. v. Citibank, N.A. (*In re* Washington Assocs.), 147 B.R. 827, 830 (E.D.N.Y. 1992) (Dearie, J.).

our example, $100,000. According to section 1129(a)(7)(B):

> With respect to each impaired class of claims or interests—
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> . . .
>
> (B) if section 1111(b)(2) . . . applies . . . , each holder of a claim . . . will receive or retain . . . property of a value, *as of the effective date of the plan*, that is not less than the value of such holder's interest in the estate's interest in the property that secures such claims.[97]

The benefit of the section 1111(b) election can therefore be eviscerated by an easy arithmetical trick. A debtor-in-possession must pay $1,000,000, but it may extend the length of the payout so that the value of $1,000,000 over time is really worth only $100,000. Accordingly, "what the section 1111(b) election giveth (a $900,000 preference), arithmetical manipulation (an extremely long payout) taketh away."[98]

In *In re Bjolmes Realty Trust*[99] Judge James Queenan ruled that the unsecured deficit is inherently different from trade debt and may always be classified in a different manner, because the undersecured party has the right to its section 1111(b) election.[100] Because of the election, the undersecured party could change its unsecured claim into a secured claim at will.

One criticism of the view that a potential section 1111(b)(2) election always justifies separate classification of an unsecured deficit claim is that an undersecured creditor might make an early election. If this election is viewed as irreversible, then Judge Queenan's remarks lose some of their force.[101] For example, in *In re D & W Realty Corp.*[102] the secured creditor represented to Judge Prudence Abram that it would not make the election. According to some authorities, section 1111(b)(2) elections are reversible until a debtor-in-possession changes its position in reliance on the secured

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97. 11 U.S.C. § 1129(a)(7)(B) (emphasis added).

98. Carlson, *supra* note 63, at 255.

99. 134 B.R. 1000 (Bankr. D. Mass. 1991).

100. *Id.* at 1004; *accord In re* Creekside Landing Ltd., 140 B.R. 713, 715 (Bankr. M.D. Tenn. 1992) (Lundin, J.); *In re* Aztec Co., 107 B.R. 585, 587 (Bankr. M.D. Tenn. 1989) (Lundin, J.) (disapproving plan on other grounds); Anderson, *supra* note 21, at 125. This reasoning has been rejected in favor of *Greystone* by other Massachusetts judges. *In re* Cranberry Hill Assocs., 150 B.R. 289 (Bankr. D. Mass. 1993) (Kenner, J.); *In re* L.G. Salem Partnership, 140 B.R. 932, 935 (Bankr. D. Mass. 1992) (Hillman, J.); *In re* Cantonwood Assocs., 138 B.R. 648, 655 (Bankr. D. Mass. 1992) (Goodman, J.); *see also In re* Sovereign Group 1985-27, Ltd., 142 B.R. 702 (E.D. Pa. 1992) (Bechtle, J.).

101. *Cf. In re* 500 Fifth Ave. Assocs., 148 B.R. 1010, 1017 n.7 (Bankr. S.D.N.Y. 1993) (Brozman, J.) (suggesting classification could not be resolved until the election was made).

102. 156 B.R. 140 (Bankr. S.D.N.Y. 1993).

creditor's choice.[103] Therefore, if the secured creditor is willing to state definitively that it will not make the election, then the mere *possibility* of election can no longer be relied upon as a reason to classify the unsecured deficit claim separately.

However, Judge Abram did not see it this way. She ruled that the election mandates separate classification, even after the election has definitively been made. Observing that section 1111(b) allows a *class* to make the election,[104] Abram theorized that placing a dominant unsecured deficit claim in the same class as the trade creditors would subject the trade creditors to the section 1111(b)(2) election—an absurd result. According to section 1111(b)(2), "if such an election is made, then notwithstanding section 506(a) of this title, such claim is a secured claim to the extent that such claim is allowed."[105] In other words, trade creditors would become secured creditors if the election is made. Their unsecured claims would disappear.[106] Yet, section 1129(a)(7)(B) would guarantee the "electing" trade creditors the value of their collateral, which is zero because they are unsecured creditors. As a result, trade creditors would lose all rights to a bankruptcy dividend if the class of unsecured creditors to which the unsecured deficit claim belongs insists on making the section 1111(b)(2) election.

The weakness in this argument is that the secured creditor had already promised that it would not make the election—as well it might, since the election is rarely rational.[107] Given that any possibility of election has

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103. Under Bankruptcy Rule 3014, a secured party may make the § 1111(b)(2) election "at any time prior to the conclusion of the hearing on the disclosure statement or within such later time as the court may fix." According to Judge William Thinnes: "A material alteration of the Plan by the debtor is tantamount to filing a different plan and if a material alteration is made it would be inequitable not to allow a creditor to fully evaluate the proposal and determine whether it wished to elect treatment under § 1111(b)." *In re* Keller, 47 B.R. 725, 730 (Bankr. N.D. Iowa 1985); *see also In re* RBS Indus., 115 B.R. 419, 421 n.2 (Bankr. D. Conn. 1990) (Shiff, J.). However, Judge Thinnes thought that if the plan has not been materially altered, the election is reversible. *Keller*, 47 B.R. at 730; *accord In re* Bloomingdale Partners, 155 B.R. 961, 970-74 (Bankr. N.D. Ill. 1993) (Barliant, J.); *In re* IPC Atlanta Ltd. Partnership, 142 B.R. 547, 553-54 (Bankr. N.D. Ga. 1992) (Drake, J.).

104. Sections 1111(b)(1)(A)(i), 1111(b)(1)(B) and 1129(a)(7)(B) all make reference to class voting. *See also* BANKR. R. 3014 (referring to class voting).

105. 11 U.S.C. § 1111(b)(2) (1988).

106. *D & W Realty*, 156 B.R. at 144 ("In the event the election is made, there is no unsecured claim."). That the unsecured claim of an electing creditor disappears is universally assumed. Yet, it is not absolutely required by the text of the Bankruptcy Code. For criticism of this assumption of disappearance, see Carlson, *supra* note 63, at 282-85.

107. As the election is usually read, an electing undersecured creditor loses the

disappeared, the absurdity that Judge Abram fears has also disappeared.

Abram, however, was satisfied that *in general* the structure of the Bankruptcy Code requires the availability of the election until the plan is actually written. Only then do we know which *classes* of creditors are entitled to the election.[108] Therefore, plans in general must always classify the unsecured deficit claim separately from the trade creditors. This implied requirement of separate classification effectively negates the dominant creditor veto that section 1129(a)(10) might otherwise imply.

On this argument, the actual willingness of an undersecured creditor to commit against making the election is irrelevant because structurally the Bankruptcy Code contemplates in general that the election might be made up until a time very late in the proceeding. On the same argument, however, the undersecured creditor's commitment to vote no on a plan might similarly be ignored because structurally the Bankruptcy Code in general allows voting very late in the proceeding. Judge Abram, then, would never let a dominant veto be exercised by a motion to lift the automatic stay, because the structure of the Bankruptcy Code cannot be overridden by an early representation of a no vote.

In any case, even if a bankruptcy judge will not listen to the undersecured creditor's assurance that the section 1111(b)(2) election will never be made, in some cases, the section 1111(b)(2) election will not be available. For example, if the plan calls for the collateral to be sold or abandoned, creditors with recourse under state law are not eligible for the election.[109] Nor can any undersecured creditors elect if, for them, the collateral has "inconsequential value."[110] In such cases, the section

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unsecured deficit, and with it a possible veto over the plan per § 1129(a)(10). The electing undersecured creditor also loses a dividend on the unsecured claim and, under the orthodox interpretation of the election, does not even obtain any appreciation value in the collateral that might accrue, unless the plan is in default. Therefore, the election is almost never advisable. *See* Carlson, *supra* note 63, at 291-300.

108. *D & W Realty*, 156 B.R. at 145 ("That a vote on the Code § 1111(b) election cannot be required before the plan and disclosure statement are filed supports the position that the plan must be drafted to permit the election to be made in the future.").

109. This follows by negative implication of § 1111(b)(1)(B)(ii), which provides that the election is not available to "the holder of a claim [who] has recourse against the debtor on account of such claim and such property is sold under section 363 of this title or is to be sold under this plan." 11 U.S.C. § 1111(b)(1)(B)(ii). That the section 1111(b)(2) election is unavailable if the collateral is to be abandoned is controversial. *See generally* Carlson, *supra* note 63, at 287 n.99.

110. "A class of claims may not elect . . . if—(i) the interest on account of such claims of the holders of such claims in such property is of inconsequential value . . . ." 11 U.S.C. § 1111(b)(1)(B)(i). For a case rejecting separate classification when an underwater lender was ineligible for the election, see *In re* SM 104 Ltd., No. 92-22698-BKC-AJC, 1993 WL 366619, *11-12 (Bankr. S.D. Fla. Sept. 15, 1993) (Ginsburg, J.);

1111(b)(2) election will not justify separate classification of the unsecured deficit.

The idea that a potential section 1111(b)(2) election distinguishes the unsecured deficit claim as a matter of rank is ironic because, in the view of Judge Edith Jones in *Phoenix Mutual Life Insurance Co. v. Greystone III Joint Venture (In re Greystone III Joint Venture)*,[111] the purpose of the section 1111(b)(2) election—or, rather, the purpose of *not* making the election and accepting a recourse unsecured deficit claim instead[112]—is to create a veto for the undersecured creditor. Unlike Judge Queenan, who thinks that the section 1111(b)(2) election justifies separate classification and therefore loss of the veto, Judge Jones thinks section 1111(b)(2) proves the veto should exist:

> The purpose of § 1111(b) is to provide an undersecured creditor an election with respect to the treatment of its deficiency claim. Generally, the creditor may elect recourse status and obtain the right to vote in the unsecured class, or it may elect to forego recourse to gain an allowed secured claim for the entire amount of the debt. If separate classification of unsecured deficiency claims arising from non-recourse debt were permitted solely on the ground that the claim is non-recourse under state law, the right to vote in the unsecured class would be meaningless. Plan proponents could effectively *disenfranchise* the holders of such claims by placing them in a separate class and confirming the plan over their objections by cramdown. With its unsecured voting rights effectively eliminated, the electing creditor's ability to negotiate a satisfactory settlement of either its secured or unsecured claims would be seriously undercut. It seems likely that the creditor would often have to "elect" to take an allowed secured claim under § 1111(b)(2) in the hopes that the value of the collateral would increase after the case is closed. Thus, the election under § 1111(b) would be essentially meaningless. We believe Congress did not intend this result.[113]

This view expressed by Judge Jones may be criticized from several perspectives. First, if separate classification is allowed, the dominant

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In re 500 Fifth Ave. Assocs., 148 B.R. 1010, 1015-16 (Bankr. S.D.N.Y. 1993) (Brozman, J.).

111. 995 F.2d 1274 (5th Cir. 1991), *cert. denied*, 113 S. Ct. 72 (1992).

112. *See* 11 U.S.C. § 1111(b)(1)(A) (changing non-electing undersecured nonrecourse creditors into recourse creditors).

113. *Greystone*, 995 F.2d at 1279-80 (emphasis added); *accord* 680 Fifth Ave. Assoc. v. Mutual Life Ins. Co. (*In re* 680 Fifth Ave. Assocs.), 156 B.R. 726, 731 (Bankr. S.D.N.Y. 1993) (Conrad, J.); *In re* 500 Fifth Ave. Assocs., 148 B.R. 1010, 1021 (Bankr. S.D.N.Y. 1993) (Brozman, J.); *In re* Meadow Glen, Ltd., 87 B.R. 421, 427 (Bankr. W.D. Tex. 1988) (Ayers, C.J.).

undersecured creditor is not *disenfranchised*.[114] The secured party still *votes*. The issue is whether a dominant creditor should be able to "veto" a chapter 11 by outvoting the other general creditors.[115] If the unsecured deficit claim of the dominant secured creditor is placed in a separate class, the creditor still may vote the deficit claim and therefore is not disenfranchised. By voting no, the creditor obtains cram-down rights, which is the true significance of voting.

Second, Judge Jones assumes that separate classification must be illegal because it cuts down the power of the dominant creditor in any settlement negotiation. But this presupposes the very conclusion for which this remark is supposed to serve as an argument. Whether an undersecured creditor *deserves* so much power is precisely the question.[116]

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114. One recent commentator goes so far to use the very title of his article to assert this criticism. *See* Peter E. Meltzer, *Disenfranchising the Dissenting Creditor Through Artificial Classification or Artificial Impairment*, 66 AM. BANKR. L.J. 281 (1992). Meltzer writes:

> [I]t is impossible to permit separate classification of these claims without acknowledging that the sole purpose for doing so is to circumvent § 1129(a)(10) of the Code and to disenfranchise the dissenting lender in the process. Interpreting one Code provision (§ 1122) in such a manner so as to eradicate completely the effects of another (§ 1129(a)(10)) can hardly be considered sound reasoning.

Id. at 303. It is inaccurate to say that flexible classification "disenfranchises" the dominant secured creditor. Such a creditor still gets to vote. In fact, it gets to vote twice—once as a secured creditor and once as an unsecured creditor. True, this creditor is effectively deprived of a veto, but this same creditor is still entitled to vote. Any voter who feels disenfranchised because she is not given a complete blackball right is taking a rather egotistical attitude toward her own importance.

Also, if one accepts, as Meltzer does not, that creditors with different economic interests are entitled to be in different classes for the purposes of § 1129(a)(10), then it is wrong to say that § 1129(a)(10) is being illegitimately circumvented. Rather, the plan will have legitimately met the demand that § 1129(a)(10) imposes.

115. Thus, in *In re* 500 Fifth Ave. Assocs., 148 B.R. 1010 (Bankr. S.D.N.Y. 1993), Judge Tina Brozman defends the veto because it "comports with the democratic voting power that the Code gives the majority of any class claims." *Id.* at 1021. In fact, there is nothing democratic at all about this veto; rather, it is dictatorial, allowing one creditor to make decisions at the expense of other creditors.

116. According to Peter Meltzer, the purpose of § 1129(a)(10) is to encourage the debtor to negotiate; but if gerrymandering is allowed, then negotiation is unnecessary. Meltzer, *supra* note 114, at 319-20. In fact, it is not that negotiation is unnecessary, but admittedly negotiation becomes a lot easier *for the debtor* if other creditors are less angry and more cooperative than the dominant secured creditor. Who has power in a negotiation will turn on whether separate classifications are allowed. That a dominant secured creditor is weakened by separate classification is no argument against it, but rather simply restates the legal result that is being challenged.

Meltzer quotes another commentator as saying: "Classification schemes should

And third, if Judge Queenan is correct, and Judge Jones is wrong, the section 1111(b)(2) election—or more precisely, the recourse afforded in case the election is *not* made—is far from meaningless. Rather, the non-election guarantees a nonrecourse lender a general dividend on the recourse deficit claim that is thereby awarded. It always guarantees the dominant creditor the power of the absolute priority rule. Thus, Judge Clark, in his opinion in *Greystone*, specifically denied that section 1111(b)(1)(A) was passed with an eye toward making section 1129(a)(10) difficult to achieve. Rather, he thought that section 1111(b)(1)(A) existed only to ensure that the undersecured creditor would have the cram-down rights of an unsecured creditor as well as those of a secured creditor.[117]

C. The Right to Accruing Cash Collateral

Other differences of rank may be located, separate from what section 1111(b)(2) implies. Under the Supreme Court's much criticized opinion in *Dewsnup v. Timm*,[118] a subdivision of the total claim of an undersecured creditor cannot be final until a chapter 11 plan is confirmed (and even then the section 1111(b)(2) election, if made, repeals the bifurcation in a plan). Therefore, it follows that any unsecured claim might enjoy a change in rank if appreciation value accrues. Such a claim always enjoys the potential of being secured—an improvement in rank denied to other secured creditors.

This is especially poignant whenever the undersecured party claims a security interest in cash income from collateral (as in a real estate case where the mortgage encumbers the rents). In such a case, the unsecured deficit is in a constant state of shrinking, as collateral continues to accrue. This shrinkage can easily be characterized as a matter of rank, justifying separate classification.[119] Indeed, it may as well be pointed out that, given

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generally seek to foster reorganization efforts within the structures of the absolute priority doctrine and the unfair discrimination doctrine." Anderson, *supra* note 21, at 127. Meltzer responds:

> The problem with this statement is that, since the author had already concluded that deficiency claims may be separately classified from the general unsecured trade claims . . . [o]ne may infer that, in his opinion, such separate classification *is* within the strictures of the absolute priority and unfair discrimination doctrines. Unfortunately, this puts the rabbit in the hat.

Meltzer, *supra* note 114, at 306. Yet, Mr. Meltzer is just as guilty of presupposition. Having concluded that dominant secured creditors utterly deserve their veto, he too has put his own rabbit into the hat.

117. *Greystone*, 102 B.R. at 569 n.11.

118. 112 S. Ct. 773 (1992) (Blackmun, J.). For criticism, see Margaret Howard, Dewsnup*ping the Bankruptcy Code*, 1 J. BANKR. L. & PRAC. 513 (1992).

119. Peter Meltzer, who favors the "priority" view of classification that Judge

enough time, the undersecured creditor's vaunted classification veto will disappear because the undersecured creditor is destined eventually to become an oversecured creditor, as cash accrues.[120] The *Greystone* veto is purely a temporary phenomenon.[121]

To be sure, the confirmation of a chapter 11 plan bifurcates undersecured claims (unless the undersecured creditor makes the section 1111(b)(2) election). Bifurcation effectively disencumbers the income stream, so long as the plan does not go into default. That is to say, so long as the plan is in effect, the debtor probably can use the cash proceeds as if they were unencumbered. But, in any case where the undersecured creditor receives payment over time, the undersecured creditor must also "retain the liens securing such claims."[122] This analysis implies that, after confirmation, the rents are still encumbered even while the plan itself prevents foreclosures or collections on the collateral. And, in any case, postconfirmation rights should never be considered as a justification for separate classification; rather, only preconfirmation rights should be considered.[123] Thanks to *Dewsnup v. Timm*, the unsecured deficit claim of a dominant creditor will usually enjoy the potential of accruing cash collateral, which

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Queenan propounds, nevertheless thinks that only two kinds of priorities exist: secured priorities and unsecured priorities. According to Meltzer, "it makes no sense to presume that a dollar owed to a trade creditor is somehow different from a dollar owed to an undersecured lender or any other unsecured creditor." Meltzer, *supra* note 114, at 301. Furthermore, he points out that § 506(a) "does not make any distinction between this kind of unsecured claim and any other kind of unsecured claim." *Id.* Obviously, Queenan takes the position that secured versus unsecured does not exhaust the universe of priorities in the world.

Meltzer's view is also disproved by subordinated unsecured debt. Under Meltzer's argument, subordinated debentures cannot be separately classified because this priority is not recognized in § 506(a). Yet, clearly subordination agreements profoundly affect classification. *See generally* Daniel C. Cohn, *Subordinated Claims: Their Classification and Voting Under Chapter 11 of the Bankruptcy Code*, 56 AM. BANKR. L.J. 293 (1982).

120. As happened, for example, in *In re* Landing Associates, 157 B.R. 791, 798 n.1 (Bankr. W.D. Tex. 1993) (Clark, J.).

121. *In re* Bloomingdale Partners, 155 B.R. 961, 976 n.11 (Bankr. N.D. Ill. 1993) (Barliant, J.). For cases where the erosion of the classification veto actually occurred, see *In re* Oaks Partners, Ltd., 141 B.R. 453 (Bankr. N.D. Ga. 1992); *In re* Club Assocs., 107 B.R. 385 (Bankr. N.D. Ga. 1989) (Murphy, J.). It *should* have occurred as well in *In re* Birdneck Apt. Assocs., II L.P., 156 B.R. 499, 506 (Bankr. E.D. Va. 1993), but Judge Douglas Tice ruled that the surrender of cash collateral did not reduce the unsecured deficit claim, but rather had to be characterized as postpetition interest—even though undersecured creditors are not supposed to receive postpetition interest under the holding of United Savs. Ass'n v. Timbers of Inwood Forrest Assocs., 484 U.S. 365 (1988) (Scalia, J.).

122. 11 U.S.C. § 1129(b)(2)(A)(i)(I) (1988).

123. *See infra* notes 166-173 and accompanying text.

should justify separate classification.

D. Subordination Agreements

Another possible justification, based on rank, for separate classification might come from some explicit or implicit subordination agreement. Although few dominant undersecured creditors, after taking a mortgage, will have subordinated themselves outright to general creditors,[124] many mortgage agreements permit the payment of some trade creditors before payment of the mortgage. Could this agreement to forego payment in favor those who improve or maintain the collateral count as a matter of "rank," as a subordination agreement clearly would?

In an early anti-gerrymandering case, *In re Pine Lake Village Apartment Co.*,[125] Judge Howard Schwartzberg thought not. The secured creditor in *Pine Lake* had agreed to the following:

> Interest shall be payable monthly out of Net Cash Flow . . . . If, however . . . rental and other income . . . after payment of the operating expenses (the Net Cash Flow) is insufficient to pay interest . . . the amount by which said interest exceeds Net Cash Flow shall accrue. . . . The accrued interest, mentioned above, shall not be grounds for foreclosure . . . . At the Maturity Date, the entire unpaid balance of principal and interest accrued and unpaid hereunder shall become due and payable.[126]

In other words, if rental income fell, the debtor was authorized to defer interest payments and let them accrue. Judge Schwartzberg thought that this right did not constitute subordination:

> The so-called subordination language . . . clearly expresses an understanding that if the Net Cash Flow (including payments to trade creditors) exceeds the monthly interest obligation due the mortgagee, the excess interest amount shall accrue, but such unpaid interest shall be due and payable at maturity. This language merely postpones unavailable monthly interest in favor of operating expenses. There is no hint of any intention to subordinate the mortgagee's principal indebtedness to the claims of trade creditors. Indeed, the interest is not forgiven, it is merely postponed to maturity when "the entire unpaid balance of

124. Even this is not unknown. Allegaert v. Chemical Bank, 657 F.2d 495, 502 (2d Cir. 1980) (Moore, J.) (subordinated creditor had valid security interest, so that only the unsecured deficit was subordinated).

125. 19 B.R. 819, 830 (Bankr. S.D.N.Y. 1982).

126. *Id.* at 830.

> principal and interest accrued and unpaid . . . shall become due and payable." Accordingly, the debtor's contention that the mortgagee contractually subordinated his claim for principal and interest under the matured and defaulted mortgage to the claims of trade creditors is without merit.[127]

According to Judge Schwartzberg, then, the quoted clause simply changes the maturity date for interest payments; this does not constitute subordination.

What then is subordination? According to one study, subordination of one debt to another is an assignment of a bankruptcy dividend by the junior creditor as security for the senior debt. Under this view, the junior creditor is surety for the senior debt.[128] These assignments are usually contingent, such that prior to the stated contingency the junior creditor is free to receive payment.[129] After the contingency, the junior creditor must return all payments received to the senior creditor to whom they belong.[130] Finally, another key idea of debt subordination is that the senior creditors have privity of contract with the junior creditors—either directly or through a third-party beneficiary theory.[131]

Changing the maturity date for interest due is not subordination under this definition. The clause in question merely changed the maturity date that bankruptcy automatically accelerates.[132] Once accelerated, this claim then stands as equal vis-à-vis other unsecured claims.

One factor overlooked in *Pine Lake* was that the mortgagee's claim might be considered unimpaired, because no interest was due and owing so long as trade creditors were not paid. According to section 1124(2), a claim is not impaired if the debtor

> (A) cures any such default that occurred before or after the commencement of the case under this title, other than a default of the a kind specified in section 365(b)(2) of this title [*i.e.*, an *ipso facto* clause];

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127. *Id.* at 831.

128. David Gray Carlson, *A Theory of Contractual Debt Subordination and Lien Priority*, 38 VAND. L. REV. 975, 978 (1985) ("[S]ubordination of the junior claim is an assignment by a nonrecourse guarantor in order to secure a senior claim.").

129. *Id.* at 983-86.

130. *Id.* 993-96.

131. *See* Jessica A. Hauser, Note, *Nonconsensual Repeal of Third-Party Beneficiary Contract Rights: Senior Creditors Under Subordination Agreements*, 8 CARDOZO L. REV. 1227 (1987).

132. This is accomplished in 11 U.S.C. § 502(b) ("[T]he court . . . shall determine the amount of such claim . . . as of the date of the filing of the petition . . . .").

(B) reinstates the maturity of such claim or interest as such maturity existed before such default;

(C) compensates the holder of such claim for any damages incurred as a result of any reasonable reliance by such holder on such contractual provision or such applicable law; and

(D) does not otherwise alter the legal, equitable or contractual rights to which such claim or interest entitles the holder of such claim or interest.[133]

If interest was not due because rental income had fallen below the sum of trade claims plus debt service, then the debtor possibly could have reinstated the maturity of such interest rates through negative amortization.[134] Under this view, the mortgagee, so treated, would not even have an impaired claim and hence no right even to vote on the plan, much less to be classified with trade creditors for the purpose of voting.[135]

IV. RATIONAL DISCRIMINATION ON PRACTICAL GROUNDS

A. Greystone

Some courts insist that only matters of priority or rank justify separate classification.[136] But surprisingly, *Greystone*, which is cited as if it

133. 11 U.S.C. § 1124(2).

134. *See In re* Club Assocs., 107 B.R. 385 (Bankr. N.D. Ga. 1989) (imposing negative amortization in chapter 11 plan where prepetition contract called for it), *appeal dismissed*, 956 F.2d 1065 (11th Cir. 1992).

135. *See* Anderson, *supra* note 21, at 125:

> Since a reorganization envisions ongoing operations, and since the [*Pine Lake*] mortgagee was postponed in satisfaction to claims of trade creditors, this would appear to be a reasonable case where the trade creditors were entitled to full payment before the mortgagee and that this would further appear to justify both separate classification and separate treatment under a reorganization plan.

136. *In re* Bjolmes Realty Trust, 134 B.R. 1000, 1003 (Bankr. D. Mass. 1991). In *Bjolmes* Judge Queenan felt bound by Granada Wines, Inc. v. New England Teamsters & Trucking Indus. Pension Fund, 748 F.2d 42 (1st Cir. 1984), where Judge Coffin ruled that "all creditors of equal rank with claims against the same property shall be placed in the same class." *Id.* at 46. But Queenan also criticized the *Granada Wines* dictum for relying on old chapter X cases, when chapter XI had a more flexible rule. Whether § 1122 was intended to follow the chapter X or the chapter XI rule is unclear. *See supra* text accompanying notes 38-45.

Judge Queenan also ruled that the artificial recourse claim is inherently one of different priority, because of the § 1111(b)(2) election. Not only was this distinction one of rank, by the election created practical advantages as well—even though practical differences could not be considered. According to Judge Queenan:

> This distinction is not a technicality without significant practical aspects.

represented a per se rule against separate classification of trade creditors and the artificial recourse claim,[137] takes a more liberal position. According to the judges at all levels of the case, mere practical differences that do not rise to the level of difference in priority will suffice to justify separate classification. What the judges did not agree on was whether, in the case, practical differences had been successfully located.

In the *Greystone* plan, the debtor proposed to pay the trade claims and the mortgagee, as holder of an unsecured deficit claim, slightly over three cents on the dollar.[138] For our purposes, the crucial part of the plan was that the trade creditors and the unsecured claim of the mortgagee were placed in different voting classes. As a result, the trade creditors voted yes on the plan, but the mortgagee voted no.[139] Hence, the requirements of section 1129(a)(10) were ostensibly met—at least one impaired class of creditors had voted in favor of the plan.

Although Judge Leif Clark satisfied himself that the beer of creative classification cohered with the sausage of legislative history,[140] he also

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> The FDIC's mortgage interest greatly influences the manner in which it will vote its unsecured claim. This became obvious at the hearing when the FDIC indicated that it would vote its claim against the plan in order to strengthen its case for terminating the automatic stay now preventing it from foreclosing on the building. Holders of trade claims would receive nothing from the foreclosure and little if anything from liquidation of the Debtor's other assets, consisting primarily of equipment. Thus, they would likely vote in favor of the plan. The potential held by the FDIC's unsecured claim for a difference in legal rank with the trade debt is therefore an indication of very real differences in these debts.
>
> This is no bad faith gerrymandering of the votes of the unsecured. In light of the heavy linkage in law and fact between the FDIC's secured and unsecured claims, its unsecured claim is that in name only. No policy concerns require that it dilute, here dominate, the vote of those truly acting in their interests as unsecured creditors.

Bjolmes, 134 B.R. at 1003-04.

137. *See supra* text accompanying notes 12-16.

138. *Greystone*, 102 B.R. at 561.

139. Taking no chances, the debtor actually put the trade creditors into *two* different classes, lest one class vote no. Judge Clark did not allow this distinction and ordered all trade creditors to be considered in a single class. *See Greystone*, 127 B.R. at 139-40. The debtor-in-possession also set up separate classes for tenants who had supplied rent deposits. Later, on appeal, Judge Edith Jones would rule that the tenants could not be considered creditors at all because the debtor had assumed all the leases under § 365 of the Bankruptcy Code. *Greystone*, 955 F.2d at 1281. Another class contained a claim for *ad valorem* taxes. Apparently, the tax creditor was not impaired and hence could not vote (or at least the debtor did not claim so when badly in need of an impaired yes-voting class.) Therefore, if § 1129(a)(10) was met, it was by virtue of the yes vote by the trade creditors.

140. For a discussion of Judge Clark's historical analysis, see *supra* text accompanying

denounced classification solely for the purpose of generating a yes-voting class to satisfy section 1129(a) (10).[141] Clark stated: "If we take as a given that some independent reasonable grounds for separate classification must be found in order to authorize the classification scheme, then one recognized rationale is a demonstrated economic need to treat certain otherwise similar claims differently."[142] The key, then, was to find *practical reasons* why the trade claims should be classified differently from the unsecured deficit claim of the dominant undersecured creditor.

Before we examine the reasons that Judge Clark actually located, remember that separate classification was not only permissible in *Greystone*, but mandatory. This conclusion is compelled by the observation made earlier: that the trade claims have a high priority, and the artificial recourse claim a low priority, in a chapter 11 proceeding.[143]

This fundamental point was overlooked by Judge Clark. Yet he still managed to find other reasons to support separate classification. He emphasized that the trade creditors had claims with different legal characteristics; they collect from the general partners of the debtor, but the dominant secured party—whose recourse came solely from section 1111(b)(1)(A)—could not.[144] This was not quite the same as saying that in chapter 11 the nonrecourse claim and the trade claims have different priorities. Indeed, the *Greystone* plan itself treated these claims identically, paying each type of creditor only three cents on the dollar.[145]

The "practical" difference that Judge Clark relied on, then, was the fact that, outside the plan, the general partners would pay off the trade creditors in full.[146] Whether rights against an insider surety—without the aid of the priority difference developed above—justifies separate classification is a

notes 49-73.

141. Clark did not exactly embrace this proposition warmly. He criticized the original anti-gerrymandering case, *In re* Pine Lake Village Apartment Co., 19 B.R. 819, 829-30 (Bankr. S.D.N.Y.) (Schwartzberg, J.), calling its underpinnings "shaky." He also cited *In re* Sun Country Development, Inc., 764 F.2d 406, 408 (5th Cir. 1985) (Reavley, J.), for the proposition that a plan is in good faith so long as it is proposed with the legitimate and honest purpose to reorganize and is not otherwise prohibited by law.

142. *Greystone*, 102 B.R. at 569.

143. This idea was developed *supra* notes 74-92 and accompanying text.

144. *Greystone*, 102 B.R. at 570.

145. It is possible to characterize the plan differently. If, as some courts believe, the bankrupt estate inherently owns the right to pursue the general partners on behalf of the trade creditors, and if the plan permits the trade creditors to fend for themselves outside the plan, then the estate had essentially abandoned property rights to the trade creditors. *In re* Heron, Burchette, Ruckert & Rothwell, 148 B.R. 660, 682 (Bankr. D.D.C. 1992((Teel, J.). Accordingly, the trade creditors in fact received *more* than the artificial recourse claimant—and under the plan!

146. *Greystone*, 102 B.R. at 570.

difficult question in general. In *Greystone* the general partners were, of course, insiders. Insider votes must by ignored for purposes of section 1129(a)(10), by the express terms of that provision. If insiders are subrogated to the rights of outside creditors, arguably, the votes of those creditors should be entirely ignored for section 1129(a)(10) purposes. That is, far from not justifying separate classification, suretyship from an insider might disqualify the assured creditors from voting at all—at least insofar as section 1129(a)(10) is concerned.[147]

However, this thought should ultimately be rejected. At least in *Greystone*, the dominant secured creditor was junior to the trade claims under section 1129(a)(7), which incorporates by reference the priorities of chapter 7, where the dominant nonrecourse secured creditor would have no claim at all.

The second practical reason developed by Judge Clark is that trade creditors supposedly get ornery when not paid. Judge Clark thought different classification for trade creditors would therefore improve the business climate for the reorganized debtor.[148]

On appeal District Court Judge Walter Smith found that these business reasons for separate classification were findings of fact within the discretion of the lower court[149]—a position that other courts have taken.[150]

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147. This idea is, however, further exacerbated by the thought that general partners, subrogated to the rights of the trade creditors, would be subrogated to all other partnership creditors in the partnership bankruptcy. This is so as a matter of state partnership law. UNIF. PARTNERSHIP ACT § 40(b), 6 U.L.A. 469 (1969). Accordingly, the general partners have special private motivation to ensure that the recourse creditors are well treated, further making suspect the votes of the recourse creditors in chapter 11.

148. *Greystone*, 102 B.R. at 570; *accord* AMFAC Dist. Corp. v. Wolff (*In re* Wolff), 22 B.R. 510, 512 (Bankr. 9th Cir. 1982) (per curiam) (but ruling that the debtor failed to prove that happy trade creditors made a difference in that case). Discriminations in favor of trade creditors were approved early in the history of the Chandler Act. *See In re* Realty Assocs. Sec. Corp., 53 F. Supp. 1010 (E.D.N.Y. 1943).

149. *Greystone*, 127 B.R. at 141. In addition, the undersecured creditor pointed out that at the confirmation hearing the debtor had orally modified the plan to delete reference to payment of the trade creditors by the partners. This, according to the appellant, repealed the trade creditor vote in favor of the plan, so that § 1129(a)(10) was not met after all. Judge Smith avoided this embarrassment by ruling that the tenants, an impaired class, also voted in favor of the plan. *Id.* at 143. But, as mentioned earlier, Judge Edith Jones would rule that these tenants were not creditors at all because their leases had been assumed by the debtor. *See supra* note 139. In any case, because the deleted portion of the plan simply repeated the state-law rights of the trade creditors to pursue the general partners of the debtor, the deletion should not have been considered important enough to mandate a new vote by the trade creditors.

150. *E.g.*, Bustop Shelters of Louisville, Inc. v. Classic Homes, Inc., 914 F.2d 810, 813 (6th Cir. 1990) (Kennedy, J.) (upholding judge's rejection of debtor's classification); Hanson v. First Bank, 828 F.2d 1310, 1313 (8th Cir. 1987) (Wollman, J.); Teamsters

The court of appeals reversed, however, because it felt the classification was motivated solely by the illegitimate desire to manipulate the voting results. "[T]hou shalt not classify similar claims differently in order to gerrymander," declaimed Judge Edith Jones.[151] But, notwithstanding this memorable sound bite, Judge Jones indicated that, if the debtor could offer genuine reasons for the classification (other than pure gerrymandering), the classification might be upheld.[152] In this sense, as Judge Jones acknowledged, her position was not different from that of the overruled Judge Clark.[153]

The real meaning of the reversal is that Judge Jones found wanting the reasons proffered by Judge Clark to justify separate classification. But her understanding of those reasons was not always lucid. She understood Clark to be presenting three reasons. First, she wrote that "[t]he alleged distinction between the legal attributes of the unsecured claims is that under state law [the mortgagee] has no recourse against the debtor personally. However, state law is irrelevant where, as here, the Code has eliminated the legal distinction between non-recourse deficiency claims and other unsecured claims."[154] This, of course, mischaracterizes Clark's opinion.

Clark obviously saw that both classes had recourse *against the debtor.*

Nat'l Freight Indus. Negotiating Comm. v. U.S. Truck Co. (*In re* U.S. Truck Co.), 800 F.2d 581, 586 (6th Cir. 1986) (Kennedy, J.). After Judge Jones's reversal in *Greystone*, one case nevertheless still emphasized that classification was an issue consigned to the discretion of the bankruptcy court. Travelers Ins. Co. v. Bryson Props., XVIII (*In re* Bryson Props., XVIII), 961 F.2d 496, 502 (4th Cir.) (Restani, J.), *cert. denied*, 113 S. Ct. 191 (1992).

151. *Greystone*, 995 F.2d at 1279.

152. *Id.* ("[C]lassification may only be undertaken for reasons independent of the debtor's motivation to secure the vote of an impaired, assenting class of claims."); *see In re* Kliegl Bros. Univ. Elec. Stage Lighting Co., 149 B.R. 306, 309 (Bankr. E.D.N.Y. 1992) (Holland, J.) (reading Judge Jones's opinion in this way). For example, in Heartland Federal Savings & Loan Ass'n v. Briscoe Enterprises, Ltd., II (*In re* Briscoe Enterprises, Ltd., II), 994 F.2d 1160 (5th Cir. 1993), the city of Forth Worth invested in a real estate project as a junior creditor. When the debtor classified the senior unsecured deficit differently from the unsecured claim of the city, the dominant creditor protested that its veto had been gerrymandered away. Judge John Minor Wisdom upheld the plan, however, because the city had public motives different from the purely private motives of the dominant secured creditor. "We emphasize the narrowness of this holding," he cautioned. "In many bankruptcies, the proffered reasons as in *Greystone* will be insufficient to warrant separate classification. Here it seems justified." *Id.* at 1167; *see also* T-H New Orleans Ltd. Partnership v. Financial Sec. Assurance, Inc. (*In re* T-H New Orleans Ltd. Partnership), 5 F.3d 86 (5th Cir. 1993) (DeMoss, J.) (reversing bankruptcy court because it did not give debtor opportunity to add reasons for separate classifications after confirmation was initially refused).

153. *Greystone*, 995 F.2d at 1279.

154. *Id.*

Clark's point was that the trade creditors had recourse against the *general partners* of the debtor, whereas the mortgagee did not. Hence, Jones's reversal may have been based on a misunderstanding.[155]

Judge Jones also read Clark as holding that gerrymandering was always justified if absolutely necessary to achieve cram down:

> As the bankruptcy court viewed this issue, the debtor's ability to

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155. For the identical misunderstanding, see Lumber Exch. Bldg. Ltd. Partnership v. Mutual Life Ins. Co. (*In re* Lumber Exch. Bldg. Ltd. Partnership), 968 F.2d 647 (8th Cir. 1992) (Wollman, J.); Travelers Ins. Co. v. Bryson Props., XVIII (*In re* Bryson Props., XVIII), 961 F.2d 496, 502 (4th Cir.) (Restani, J.), *cert. denied*, 113 S. Ct. 191 (1992); Boston Post Rd. Ltd. Partnership v. FDIC (*In re* Boston Post Rd. Ltd. Partnership), 154 B.R. 617, 622 n.3 (D. Conn. 1993) (Nevas, J.); *In re* 499 W. Warren St. Assocs., 151 B.R. 307, 312 (Bankr. N.D.N.Y. 1992) (Gerling, J.); *In re* Main Rd. Props., Inc., 144 B.R. 217, 220 (Bankr. D.R.I. 1992) (Votolato, J.); *In re* 266 Washington Assocs., 141 B.R. 275, 284 (Bankr. E.D.N.Y. 1992) (Feller, J.), *aff'd sub nom.* 266 Washington Assocs. v. Citibank, N.A. (*In re* Washington Assocs.), 147 B.R. 827 (E.D.N.Y. 1992); Meltzer, *supra* note 114, at 299. In John Hancock Mutual Life Ins. Co. v. Roswell-Hannover Joint Venture (*In re* Roswell-Hannover Joint Venture), 149 B.R. 1014 (Bankr. N.D. Ga. 1992), Judge Joyce Bihary seems to have comprehended Judge Clark's point, but rejected the distinction as insufficient to justify separate classification. *See id.* at 1020.

A different kind of case is *In re* 500 Fifth Ave. Assocs., 148 B.R. 1010 (Bankr. S.D.N.Y. 1993) (Brozman, J.), in which both the dominant undersecured creditor and an even more junior would-be secured creditor were nonrecourse. Neither creditor had recourse against the general partner of the debtor; thus, the court properly found no distinction between the two unsecured claims to justify separate classification.

A particularly mystifying dismissal of Judge Clark's point occurs in John Hancock Mut. Life Ins. Co. v. Route 37 Bus. Park Assocs., 987 F.2d 154 (3d Cir. 1993):

> The reliance on state law is curious since [the secured party] moved for relief from the automatic stay in order to pursue its state-law rights and the debtor opposed the motion in order to prevent [the secured party] from doing so. In any event, we cannot accept this justification because it begs the relevant question: why is this a reasonable scheme for measuring creditors' votes? The debtor's explanation, based on the rights that [the secured party] would have under state law if freed from the strictures of the Bankruptcy Code, is entirely beside the point.

Id. at 161. It is difficult to explain in just a few words why a view as foolish and confused as this one is defective. Suffice it to say that Judge Clark does *not* beg the question of whether classification is reasonable. He *answers* it by showing that the state-law rights of the creditors are substantially different, and these changes would affect the way these creditors would vote their claims.

All of the above cases involved unsecured deficit claims created artificially by § 1111(b)(1)(A). Because such claims have a lower priority than do recourse claims (by virtue of § 1129(a)(7)), all of the above cases were wrongly decided. In each case, separate classification was not only permissible, but compelled.

> achieve a cramdown plan should be preferred over the creditor's § 1111(b) election rights because of the Code's policy of facilitating reorganization. The bankruptcy court resorted to policy considerations because it believed Congress did not foresee the potential impact of an electing creditor's deficiency claim on the debtor's aspiration to cramdown a plan.[156]

Jones viewed the desire for cram down insufficient to justify separate classification of the trade creditors,[157] but this too shows a misunderstanding of Clark's opinion. By his historical argument, Judge Clark had tried to establish that section 1129(a)(10) did not block flexible classifications under section 1122.

In the end, Clark reached the same conclusion that Jones did—there must be a reason, other than pure gerrymandering, for a classification that nullifies the undersecured party's veto of a single-asset cram down. Judge Clark's preference for cram down over the "hyper-technical (and largely

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156. *Greystone*, 995 F.2d at 1280.

157. According to Judge Jones:

> We disagree with this approach for three reasons. First, it results here in violating § 1122, by gerrymandering the plan vote, for the sake of allegedly effectuating a § 1129(b) cramdown . . . . Second, as shown, it virtually eliminates the § 1111(b) election for secured creditors in this type of case. Third, the bankruptcy court's concern for the viability of cramdown plans is overstated. If [the undersecured party's] unsecured claim were lower and the trade debt were higher, or if there were other impaired cases that favored the plan, a cramdown plan would be more realistic. That Greystone's cramdown plan may not succeed on the facts before us does not disprove the utility of the cramdown provision. The state law distinction between Code-created unsecured deficiency claims and other unsecured claims does not alone warrant separate classification.

Id.

There is much wrong with this passage. First, the § 1111(b) election is precisely what the undersecured party did *not* make, hence entitling it to an award of recourse against the debtor. Second, Judge Clark's opinion did not eliminate the purpose of recourse under § 1111(b)(1)(A). In fact, Clark painstakingly defined the purpose of § 1111(b)(1)(A) as giving the undersecured creditor an advantage in cram down, not an advantage under § 1129(a)(10). From that perspective, Clark's opinion does not eliminate the utility of § 1111(b)(1)(A) for undersecured parties, though, admittedly, one might think that § 1111(b)(1)(A) also has the purpose of giving undersecured creditors a veto over plan confirmation via § 1129(a)(10). In any case, all of Clark's comments on the purpose of § 1111(b)(1)(A) related to the jurisprudential exercise undertaken before he decided that some reason other than gerrymandering had to be found to justify the separate classification of trade creditors. This latter view was precisely the view that Judge Jones adopted in her own opinion. Hence, the entire passage quoted above does not address the actual reasons Clark presented for upholding the separate classification of trade debt.

impractical) requirements of Section 1129(a)(10)"[158] was not a reason for approving the separate classification of trade debt. Rather, it was part of Clark's jurisprudential frolic-and-detour that preceded the presentment of the reasons.

The third reason that Judge Jones discussed finally had some bite. Judge Clark found that the need to keep the trade creditors happy justified their separate classification, but Judge Jones spotted a *non sequitur* in these reasons. The plan itself had no relation to the happiness of the trade creditors. In fact, the plan treated the trade claims and the deficit claim of the undersecured creditors precisely alike; each class received 3.42 cents on the dollar.[159] If trade creditors received better treatment, it was by virtue of the liabilities the general partners had to the trade creditors outside the plan.[160] Furthermore, no evidence existed on the record to support the view that trade creditors would punish the debtor unless they were separately classified under the plan so that the plan could be confirmed.[161]

Perhaps Judge Clark was guilty of confounding two different issues. One issue is whether different classes of the same rank may be accorded different treatment in spite of section 1129(b)(1)'s equal protection rule. Preferential treatment may be justified by the need to keep certain key trade creditors happy. This issue is different from whether creditor democracy is served, or disserved, by different voting classifications. Keeping the trade creditors happy might justify a better dividend, but it is hard to see how the *same* dividend would make the trade creditors happier.

But even if this conflation of two different issues is conceded, still Judge Jones ignored other compelling reasons for separate classifications of trade debt. First and foremost, trade claims have a different priority than an artificial recourse claim stemming from section 1111(b)(1)(A).[162]

Second, aside from this priority consideration, the trade creditors still faced a different economic situation. They could collect from the general partners, while the mortgagee could not.[163] If the trade creditors had been

158. *Greystone*, 102 B.R. at 566.

159. *Greystone*, 995 F.2d at 1280-81.

160. *Cf. In re* Kliegl Bros. Univ. Elec. Stage Lighting Co., 149 B.R. 306 (Bankr. E.D.N.Y. 1992) (Holland, J.) (plan preferred and separately classified union in order to keep them cooperative).

161. *Greystone*, 995 F.2d at 1281. For a case following Judge Jones in all respects, see *In re* Cantonwood Assocs., 138 B.R. 648, 655 (Bankr. D. Mass. 1992) (Goodman, J.).

162. *See supra* notes 74-92 and accompanying text.

163. Recourse against sureties was found capable of justifying separate classification in *In re* Creekside Landing Ltd., 140 B.R. 713, 715 (Bankr. M.D. Tenn. 1992) (Lundin, J.); *In re* Aztec Co., 107 B.R. 585, 587 (Bankr. M.D. Tenn. 1989) (Lundin, J.) (disapproving plan on other grounds). It was found incapable of justifying separate

placed in the same class as the unsecured deficit claim of the mortgagee, their interests would have been swamped by the inconsistent interests of the mortgagee.[164] Surely the trade creditors' opinion is worth something, even though their claims are modest compared to that of the dominant secured creditor. Indeed, under the view that minor creditors don't count but dominant secured creditors do, one should remember that a secured creditor whose deficit claim is only thirty-four percent of the total secured claims can still veto a chapter 11 plan. Therefore, by asserting that the unsecured deficit must be classified with all other general creditor claims, Judge Jones is not simply ignoring a few minor trade creditors, but is potentially ignoring a large majority of unsecured creditors.[165]

B. Other Practical Differences

One aspect of the *Greystone* opinion that has already seriously undermined Judge Jones's *jihad* against gerrymandering is her remark that, in *Greystone*, the separate classification was a gerrymander "[b]ecause there is no separate treatment of the trade creditors in this case."[166] If Judge Jones meant that separate classification of the unsecured deficit is permissible because the plan itself creates a discrimination, then *Greystone* is useless in preventing gerrymandering. This point was driven home by Judge Frank Monroe in *In re Schoeneberg*.[167] Emphasizing that the plan in *Greystone* treated the unsecured deficit claim and the trade claims identically,[168] Judge Monroe concluded that "the Fifth Circuit left open the door for separate classification of unsecured debt so long as it is treated separately and there exists good business reasons for the separate classification and treatment."[169]

The reason offered by the debtor in *Schoeneberg* for separate classifica-

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classes in Piedmont Assocs. v. Cigna Property & Casualty Insurance Co., 132 B.R. 75, 78 (N.D. Ga. 1991) (Forrester, J.).

164. *In re* Bjolmes Realty Trust, 134 B.R. 1000, 1004 (Bankr. D. Mass. 1991) (Queenan, J.).

165. For example, in *In re* 500 Fifth Ave. Assocs., 148 B.R. 1010 (Bankr. S.D.N.Y. 1993) (Brozman, J.), the dominant undersecured creditor exercising the veto had an unsecured deficit claim of $103 million, while an even more junior secured party (whose claim was completely under water) had a $61 million claim. Judge Tina Brozman ruled against separate classification in order to uphold the veto of the dominant creditor. However, here one can see that the "minor" creditor who was denied a voice was no minor creditor at all.

166. *Greystone*, 995 F.2d at 1281.

167. 156 B.R. 963 (Bankr. W.D. Tex. 1993).

168. *Id.* at 967-68.

169. *Id.* at 968.

tion was that the secured party, who claimed cattle as collateral, had been harmed by a recent precipitous fall in market prices. It was therefore "important to give [the secured party] replacement collateral and not the other unsecured creditors."[170] That is, the plan treated the unsecured deficit claim better than the other creditors, which seemed to be enough to justify separate classification. Indeed, given the better treatment, Judge Monroe went so far as to question the honesty of the secured creditor's motives for seeking a classification veto.[171]

Can different treatment in the plan justify separate classification?[172] If

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170. *Id.*

171. According to Judge Monroe:

> So, the crux of the different classification and better treatment is that the [unsecured deficit] is being treated *better* than the other unsecured creditors; and it is complaining. Not only does a question of standing to complain arise, but a question with regard to the motivation to the objecting party arises. Clearly [the secured party] has told its lawyers to do whatever is necessary to make sure that the Debtor's plan is not confirmed regardless of what it provides and to push its own liquidation plan instead. The purpose is to try to force full payment of all its claims in cash as soon as possible regardless of the effect on the Debtor's business and the Debtor's ability to earn a living for himself as a rancher in the future.

Id. at 968-69.

172. For a case answering no, see John Hancock Mut. Life Ins. Co. v. Roswell-Hannover Joint Venture (*In re* Roswell-Hannover Joint Venture), 149 B.R. 1014 (Bankr. N.D. Ga. 1992). In *Roswell-Hannover*, the debtor had proposed to discriminate between the trade creditors and the unsecured deficit. The trade creditors were to get only 25%, while unsecured deficit was to be allocated 40 cents on the dollar. The debtor then went on to argue that, given the different treatment in the plan, separate classification for voting purposes was mandated.

Judge Bihary rejected the classification for voting purposes on the ground that the "better" treatment of the unsecured deficit (40%) was not really better than the treatment of the trade claims (25%) because the trade claims would be paid in cash and the unsecured deficit would be paid over time. However, because the valuation of the deficit claim is supposed to be based on genuine present value, Judge Bihary was in the position of implying that the valuation of the 40% was defective—that the 40% was really only 25%.

Nevertheless, *Roswell-Hannover* was wrongly decided for precisely the same reason that *Greystone* was wrongly decided. The lender in *Roswell-Hannover* was a nonrecourse secured creditor. The unsecured deficit claim in chapter 11 was artificial recourse. Therefore, the claim was junior to any claim that had recourse in a hypothetical chapter 7 proceeding. Because of this priority difference, artificial recourse was not only permissible, but was compulsory.

Judge Bihary's opinion in *Roswell-Hannover* may be compared to its mirror opposite in *In re* Pattne Holdings, 151 B.R. 628 (Bankr. N.D. Ga. 1992). In *Pattne* Judge Homer Drake thought that the mere origin of the claim justifies separate classification. He concluded that an unsecured franchisor was simply inherently different from

so, *Greystone* is a paper tiger, and the classification veto is dead. Of course, in *Greystone*, everyone overlooked the fact that trade claims have a higher priority than does the unsecured deficit claim of the dominant secured creditor. Therefore, the classification veto *ought* to be dead. But in a case where the unsecured deficit is *not* an artificial recourse claim, different treatment in the plan should not justify separate classification.[173] The plan itself is capable of treating very similar creditors differently, thereby allowing absolutely free gerrymandering. Rather, voting should be conducted on the basis of preconfirmation factors. If voting is designed to provide for creditor expression of just treatment, only preconfirmation differences can make manifest these expressions of creditor opinion.

Other practical differences have been considered as well. A point that has often been overlooked in this controversy is that the unsecured deficit claim is being used strategically to bolster the position of the separate secured claim. In *Norwest Bank Worthington v. Ahlers*,[174] the Supreme Court approved the mortgagee's voting its unsecured deficit in aid of the secured claim. According to Justice Byron White:

> Respondents contend that the nature of bankruptcy proceedings—namely, their status as proceedings in "equity"—prevents petitioners from inequitably voting in the class of unsecured creditors, and requires that a "fair and equitable" reorganization plan in the best interests of all creditors and debtors be confirmed. Similarly, the Court of Appeals found it significant that—in its view—respondents' wholly unsecured creditors (as opposed to petitioners, who have partially secured claims) would fare better under the proposed reorganization plan than if the farm was liquidated.
>
> The short answer to these arguments is that whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code. The Code provides that undersecured creditors can vote in the class of unsecured creditors, the Code provides that a "fair and equitable" reorganization plan is one

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trade creditors and, thus, could be classified separately. Furthermore, he determined that a 33% dividend to the large franchise creditor (due over time with no interim interest payments) was not discriminatory compared to the 25% cash payment the creditors would receive. Rarely have judges from the same judicial district reached such disparate results!

173. According to § 1123(a)(4), creditors treated differently under the plan *cannot* be put in the same class, "unless the holder of a particular claim or interest agrees to a less favorable treatment of such particular claim or interest." 11 U.S.C. § 1123(a)(4) (1988). Because the trade creditors in *Schoeneberg* had voted yes on the plan, they arguably had agreed to a lesser treatment within the meaning of § 1123(a)(4). Therefore, they *could* be put in the same class as the better treated deficit claim, which gave the dominant undersecured creditor an effective veto over the plan.

174. 485 U.S. 197 (1988) (White, J.).

> which complies with the absolute priority rule, and the Code provides that it is up to the creditors—and not the courts—to accept or reject a reorganization plan which fails to provide them adequate protection or fails to honor the absolute priority rule.[175]

Does not this right to vote the unsecured deficit claim in aid of the separate secured claim give the mortgagee economic interests that are different from those of the trade creditors?[176]

This argument received a mystifying dismissal from Judge Samuel Alito in *John Hancock Mutual Life Insurance Co. v. Route 37 Business Park Associates*.[177] As Judge Alito noted, "The distinction between those who do and do not 'truly act[] in their interests as unsecured creditors' finds no support in the Code."[178] He further stated:

> Absent bad faith or illegality, the Code is not concerned with a claim holder's reason for voting one way or the other, and undoubtedly most claim holders vote in accordance with their overall economic interests as they see them. Moreover, even if the concept of an unsecured creditor that truly acts in its interest as an unsecured creditor were meaningful, it is not apparent that trade creditors . . . would fall within this concept any more than holders of unsecured deficiency claims. Trade creditors are often thought to vote their unsecured claims in order to further their interests as potential future suppliers of goods and services to the debtor. Thus, they could be said to be voting to further their interests as future contractors with the debtor rather than their interests as unsecured creditors.[179]

In other words, Judge Alito seems to have interpreted the debtor's argument in a curious way: those who vote according to the abstract concerns of a

175. *Id.* at 206-07 (citations omitted).

176. *See In re* SM 104 Ltd., No. 92-22698-BKC-AJC, 1993 WL 366619, at *13-17 (Bankr. S.D. Fla. Sept. 15, 1993) (Ginsburg, J.) ("quite persuasive"); *In re* Marin Town Ctr., 142 B.R. 374, 379 (N.D. Cal. 1992) (Patel, J.); *In re* Bjolmes Realty Trust, 134 B.R. 1000, 1004 (Bankr. D. Mass. 1991) (Queenan, J.) ("In light of the heavy linkage in law and fact between the FDIC's secured and unsecured claims, its unsecured claim is that in name only."); *In re* Aztec Co., 107 B.R. 585, 587 (Bankr. M.D. Tenn. 1989) (Lundin, J.) ("every incentive to vote its large deficiency claim to affect the treatment of its secured claim"). *But cf. In re* 500 Fifth Ave. Assocs., 148 B.R. 1010, 1019-20 (Bankr. S.D.N.Y. 1993) (Brozman, J.) (acknowledging the bias of the undersecured creditor in voting the unsecured claim but nevertheless refusing to justify a separate classification on this ground).

177. 987 F.2d 154 (3d Cir. 1993).

178. *Id.* at 161.

179. *Id.* at 161-62

general creditor ought to vote separately from those who vote in a self-interested manner. As all creditors vote according to self-interest, Judge Alito thought the classification to be based on phony distinctions.

This interpretation badly misunderstands the claim the debtor was, or should have been, making. The claim is that practical differences in the self-interest of creditors justify separate classification. The claim that trade creditors vote according to some Kantian noumenal essence of general credit, while the unsecured deficit creditor does not, is a foolish claim, but presumably not the one debtor's counsel was making.

As to the point that the Bankruptcy Code does not concern itself with why creditors vote the way they do, nothing could be further from the truth. Quite the opposite is true. *Greystone*[180] itself holds that classification rests on *practical* differences between creditors. According to this view, classification should be molded to give every group a voice depending on their particular circumstances, and the Bankruptcy Code is *vitally* concerned with the reasons creditors have for voting.[181]

V. UNNECESSARY IMPAIRMENT

As an adjunct to anti-gerrymandering agitation, some dominant creditors have started to argue that impairment of minor trade creditors and the like is unnecessary and in bad faith.[182] If this argument prevails, a court might nullify the vote of an artificially impaired class of creditors,[183] thereby assuring that the debtor-in-possession will run aground upon the shoals of section 1129(a)(10).

Of course, impairment can mean just about anything that changes the state-law rights of creditors. According to section 1124, "[A] class of claims or interests is impaired under a plan unless, with respect to each claim or interest of such class, the plan— (1) leaves unaltered the legal, equitable,

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180. An opinion cited by Judge Alito with admiration, by the way. *Route 37*, 987 F.2d at 159.

181. For another exercise in pragmatic differentiation, see FHG Realty Credit Corp. v. Newark Airport/Hotel Ltd. Partnership, 155 B.R. 93, 98-99 (D.N.J. 1993) (Bassler, J.) (holding that union claims from rejected executory contract could be separately classified because the union cared about future jobs).

182. *See* 11 U.S.C. § 1129(a)(3) (plan can be confirmed only if the plan "has been proposed in good faith").

183. According to Bankruptcy Code § 1126(e): "On request of a party in interest, and after notice and a hearing, the court may designate any entity whose acceptance or rejection of such plan was not in good faith, or was not solicited or procured in good faith or in accordance with the provisions of this title." 11 U.S.C. § 1126(e). One might argue that unnecessary impairment constitutes the bad-faith "procuring" of the class's acceptance.

and contractual rights to which such claim or interest entitles the holder of such claim."[184] Thus, one commentator remarks: "Impairment is an easily met standard. Virtually any alteration of a creditor's rights—no matter how minor—will suffice. Even enhancement of a claim constitutes impairment."[185]

At least one court has rejected the idea that impairment can be a sham. In *In re Sun Country Development, Inc.*,[186] a secured creditor argued that impairment was unnecessary and therefore the entire plan was in bad faith. Judge Thomas Reavley disagreed: "Congress made the cram down available to debtors; use of it to carry out a reorganization cannot be bad faith."[187]

Judge Glen Ayers has managed to disable *Sun Country* by pointing to a phrase in Judge Reavley's opinion indicating that impairment was necessary after all.[188] Since the *Sun Country* court did not need to rule on

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184. 11 U.S.C. § 1124.

185. Meltzer, *supra* note 114, at 310-11 (footnotes omitted). For cases holding that enhancement of creditor rights is impairment, see L & J Anaheim Assocs. v. Kawasaki Leasing Int'l, Inc., 995 F.2d 940 (9th Cir. 1993) (O'Scannlain, J.) (debtor-in-possession argues enhanced creditor was unimpaired, so that creditor's plan could not be confirmed because no *impaired* class of creditors voted yes on the plan); *In re* Temple Zion, 125 B.R. 910, 919 (Bankr. E.D. Pa. 1991) (Scholl, J.); *cf. In re* Barrington Oaks Gen. Partnership, 15 B.R. 952, 962 (Bankr. D. Utah 1981) (Mabey, J.) (emphasizing that valuation should not play a role in determining whether impairment exists).

One court has held that increasing the rights of a creditor is not impairment:

> In a flawed syllogistic attempt, the Debtor argues that because a class may be impaired even where the value of a claim is enhanced, the class is impaired. Yet this conclusion is neither supported by law nor logic . . . . "[I]f the [D]ebtor were correct, . . . any time a plan proponent needed an impaired class for a favorable vote, the debtor would simply add $1.00 to such class members' claims—a transparent and unacceptable stratagem."

Boston Post Rd. Ltd. Partnership v. FDIC (*In re* Boston Post Rd. Ltd. Partnership), 154 B.R. 617, 623 (D. Conn. 1993) (Nevas, J.) (alterations in original). Actually, the broad definition of impairment is supported by *both* law and logic. If *any* change is impairment, then a change for the better is no different. Judge Alan Nevas goes on to note that the debtor argued only that the creditors' rights were *enhanced*, not *altered*. For this unhappy choice of words, the debtor lost a chance to cram down its plan. *Id.*

186. 764 F.2d 406 (5th Cir. 1985).

187. *Id.* at 408; *see also In re* Landing Assocs., 157 B.R. 791, 812-15 (Bankr. W.D. Tex. 1993) (Clark, J.) (rejecting claim of unnecessary impairment); Greystone III Joint Venture, 102 B.R. 560, 570-71 (Bankr. W.D. Tex. 1989) (Clark, J.) (same), *aff'd*, 127 B.R. 138 (W.D. Tex. 1990), *rev'd* 995 F.2d 1274 (5th Cir. 1991), *cert. denied*, 113 S. Ct. 72 (1992).

188. *In re* Meadow Glen, Ltd., 87 B.R. 421, 425 (Bankr. W.D. Tex. 1988) (Ayers, C.J.) (citing *Sun Country*, 764 F.2d at 408 ("[E]ven if [the creditor's] argument went to the issue of good faith, the district court, after a hearing, found that the status of the unsecured creditors was changed because Sun Country's cash flow was insufficient to pay

the permissibility of sham impairment, Judge Ayers felt free to knock out a chapter 11 on this ground. In contrast, Judge Leif Clark insisted that the meaning of *Sun Country* was that the debtor was completely free to impair a class as it saw fit, without a showing that impairment was "necessary."[189] But just in case Ayers was right, Clark also located a slight convenience for the debtor in impairing the trade creditors, thereby proving impairment was "necessary" after all.[190]

In contrast, other courts have struck down plans on grounds of bad-faith artificial impairment.[191] This may have occurred in *In re 266 Washington Associates*.[192] In this case, Judge Jerome Feller would not permit separate classification of trade debt. One of his many reasons was that the debtor had not paid interest to the undersecured party since the beginning of the bankruptcy proceeding.[193] Feller therefore deduced that the debtor was awash in unencumbered cash that could have been used to pay the trade creditors. Accordingly, if the trade creditors were impaired, it was an illegitimate tactical impairment that could not be condoned.[194]

It is not clear how this suspicion of artificial impairment squared with the assignment of rents the undersecured creditor claimed in the *Washington Associates* case. Unless this lien on rents was somehow void in bankruptcy, all the rents belonged to the secured party. These rents were cash collateral, which could not be used without adequately protecting the undersecured party in some way.[195] As the debtor had no other income except rent, the

off the debts [to the unsecured creditors] at the initiation of the plan.")).

189. *In re* Landing Assocs., 157 B.R. 791, 813-14 (Bankr. W.D. Tex. 1993).

190. *Id.* at 814-15.

191. *E.g.*, Windsor on the River Assocs. v. Balcor Real Estate Fin., Inc. (*In re* Windsor on the River Assocs.), No. 92-3712, 1993 WL 394319 (8th Cir. Oct. 8, 1993) (Arnold, J.); Sandy Ridge Dev. Co. v. Louisiana Nat'l Bank (*In re* Sandy Ridge Dev. Corp.), 881 F.2d 1346, 1353 (5th Cir. 1989) (Garwood, J.); Willows Convalescent Ctrs. Ltd. Partnership v. UNUM Life Ins. Co. (*In re* Willows Convalescent Ctrs. Ltd. Partnership), 151 B.R. 220, 223 (D. Minn. 1991) (Alsop, J.); *In re* Lettick Typographic, Inc., 103 B.R. 32, 38-39 (Bankr. D. Conn. 1989) (Shiff, J.) ("In a transparent attempt to stage compliance with (a)(10), the debtor created an artificially impaired class by amending its Second Plan so that [an otherwise unimpaired creditor] is to be paid two weeks after the effective date of the Plan."); *In re* Meadow Glen, Ltd., 87 B.R. 421, 427 (Bankr. W.D. Tex. 1988) (Ayers, C.J.); Meltzer, *supra* note 114, at 319-29 (artificial impairment should not be allowed because otherwise the veto of 1129(a)(10) is trivial).

192. 141 B.R. 275 (Bankr. E.D.N.Y.), *aff'd sub nom.* 266 Washington Assocs. v. Citibank, N.A. (In re Washington Assocs.), 147 B.R. 827 (E.D.N.Y. 1992).

193. Undersecured creditors are not entitled to postpetition interest under the holding of United Savings Ass'n v. Timbers of Inwood Forest Assocs., 484 U.S. 365 (1988) (Scalia, J.).

194. *Washington Assocs.*, 141 B.R. at 287.

195. *See* 11 U.S.C. § 363(e) (1988).

debtor may have had no unencumbered dollars with which to pay the trade creditors. If so, then Judge Feller's claim of sham impairment does not hold up.

When a debtor-in-possession is solvent, it is possible to write a plan in which no class of general creditors is impaired.[196] But when the debtor-in-possession is insolvent, impairment of some creditor class is inevitable.[197]

Now a dominant undersecured creditor claiming that the yes vote of trade creditors ought not to be honored is in the delicate position of demanding that discrimination occur, so that extra resources are used to pay off the trade creditors. Furthermore, as Judge Leif Clark has emphasized,[198] the dominant undersecured creditor is complaining of the impairment of creditors who actually saw fit to vote "yes" on the plan. If the *impaired* creditor is happy, why should some other creditor be allowed to complain of impairment?

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196. Thus, in Windsor on the River Assocs. v. Balcor Real Estate Finance, Inc. (*In re* Windsor on the River Assocs.), No. 92-3712, 1993 WL 394319 (8th Cir. Oct. 8, 1993), Judge Morris Sheppard Arnold ruled that an apparently solvent debtor could not impair the small trade creditors to win a yes vote from their class.

197. One dominant secured creditor recently claimed that, because the chapter 11 plan contemplated a new value contribution by the old equity holders, the postconfirmation estate would have the wherewithal to pay the trade creditors. Accordingly, impairment was unnecessary and a sham, on this argument. Judge Gregory Kishel rejected this argument, but only because the debtor did not have the opportunity to develop the record on whether impairment was necessary. *In re* Kellogg Square Partnership, No. 3-92-5211, 1993 WL 434051 (Bankr. D. Minn. Oct. 22, 1993). This argument is quite ominous, in that all single-asset cases entail new value as a subterfuge of the absolute priority rule. *See supra* text accompanying notes 17-21.

The argument, however, should be rejected on the following grounds: a new value contribution can occur only after the bankrupt estate has been valued for purposes of cram down. Through this valuation, the entitlements of the trade creditors are set. Only after the entitlements are calculated does the new value flow in. Accordingly, the trade creditors have no right to receive the new value; their right is only to the preconfirmation value of the firm. Therefore, the availability of new value should never constitute grounds to find that impairment is unnecessary.

If the rule were otherwise, and assuming that a bankruptcy court's valuation of the firm is correct, then no investor would ever buy newly issued equity shares in a chapter 11 firm, for the same reason that investors would never buy shares in an insolvent company. Such investments assign all or part of the investment to the creditors—a sort of gift from equity to debt. Only if equity believes the valuations are wrong would such an investment make sense. *See* John D. Ayer, *Rethinking Absolute Priority After* Ahlers, 87 MICH. L. REV. 963, 1011-91 (1989) (criticizing the new value exception on the assumption that creditors are entitled to all new value contributed).

For this reason, the possibility of a new value exception should not be used to prove that impairment is a sham and that § 1129(a)(10) cannot be met.

198. *In re* Landing Assocs., 157 B.R. 791, 814 (Bankr. W.D. Tex. 1993).

Yet a point made earlier has some force in favor of sham impairment, at least in some cases. As was stated earlier, trade claims have a higher priority in chapter 11 than do artificial recourse claims—by virtue of Bankruptcy Code section 1129(a)(7), which ties chapter 11 entitlements to chapter 7 entitlements.[199] Therefore, at least in a case where the general partner is solvent, the trade creditors should always get 100 cents on the dollar in chapter 11. Accordingly, impairment is always less than necessary in such cases.

But this does not prove that a debtor-in-possession has a duty to render a creditor unimpaired. No such duty is set forth in the Bankruptcy Code. The rules pertaining to impairment do establish certain consequences pertaining to voting; but nowhere is it written that a debtor-in-possession has a duty to maximize the opportunity for one single creditor to veto the proceedings. If debtors have a duty to minimize the chances of confirming a chapter 11 plan by strategically disimpairing all creditors in favor of the plan, chapter 11 jurisprudence would be substantially different from what it is.

VI. BUYOUTS OF THE TRADE CREDITORS

The *Washington Associates* court ruled that the impairment of the trade creditors was unnecessary and that these trade creditors should therefore be treated as an unimpaired class, with no standing to propel the debtor past the stumbling block of section 1129(a)(10). In addition to the above accusation of sham impairment, the undersecured party in *Washington Associates* apparently stood ready to pay the trade creditors itself just to get rid of them.[200] Judge Feller appeared impressed with this offer in the course of proclaiming the impairment to be a sham.[201] Therefore, it is possible that the mere offer of the dominant secured party to buy out the trade creditors will prevent their impairment (though, it is hoped, the undersecured party should, in fairness, be forced to go through with its offer once the automatic stay has been lifted because no reorganization plan can be confirmed).

Assuming the trade claims are actually purchased, the dominant secured creditor is in a position to deny the debtor a yes-voting class. Should this defensive use of trading claims in bankruptcy be permitted?

There is substantial authority for the proposition that claims bought for the purpose of blocking confirmation of a plan should not be allowed to vote.[202] According to section 1126(e), "On request of a party in interest,

199. *See supra* text accompanying notes 74-92.

200. *Washington Assocs.*, 141 B.R. at 287.

201. *Id.* at 287 n.20.

202. For a recent case, see Wiston XXIV Ltd. Partnership, 153 B.R. 322 (Bankr. D.

and after notice and a hearing, the court may designate any entity whose acceptance or rejection of such plan was not in good faith, or was not solicited or procured in good faith or in accordance with the provisions of this title."[203] The legislative history also hints that a purchase of unsecured claims by a secured creditor might be in bad faith:

> Subsection (e) permits the court to designate for any class of claims or interests any person that has, with respect to that class, a conflict of interest that is of such nature as would justify exclusion of that person's claim or interest from the amounts and number specified in subsection (c) or (d). A person might have such a conflict, for example, where he held a claim or interest in more than one class. Exclusion from one class for voting purposes would not require his exclusion from the other class as well.[204]

One case the legislative history specifically condemns[205] is *Aladdin Hotel Co. v. Bloom*,[206] a case where shareholders who bought debentures used their blocking position to enhance the plan's treatment of the equity shareholders. Similarly, the votes of trade claims purchased by the dominant secured creditor in order to achieve a veto of the plan might be struck down as votes cast in bad faith in violation of section 1126(e).

This leaves the difficult question of what a court might do when the dominant creditor has purchased *all* the trade claims. If all these votes are disqualified, it is still true that no class of creditors will have voted in favor of the plan, as section 1129(a)(10) requires. In such a situation, a court may have to rule, after taking evidence, that the trade claims *would* have voted for the plan. This hypothetical vote would then have to suffice to meet the requirements of section 1129(a)(10). Otherwise, bad faith will be seen to prevail so long as it is thoroughgoing.

Kan. 1993) (Puasteri, J.).

203. 11 U.S.C. § 1126(e) (1988).

204. H.R. REP. NO. 595, *supra* note 41, at 411, *reprinted in* 1978 U.S.C.C.A.N. at 6367. Section 1126(e) has its origin in the case of Texas Hotel Securities Corp. v. Waco Development Co., 87 F.2d 395 (5th Cir. 1936), *cert. denied*, 300 U.S. 679 (1937). In this case, a disgruntled lessee, who was made to forfeit hotel improvements under the lease, bought enough unsecured claims to block the plan. The Fifth Circuit saw nothing wrong with this maneuver. To reverse this case, Congress enacted § 203 of the Bankruptcy Act, requiring that votes be cast in good faith. *See* Young v. Higbee Co., 324 U.S. 204, 211 n.10 (1945). Therefore, § 1126(c) stems from a distaste for the practice of buying up claims just to interfere with confirmation of the plan. *See* Fortgang & Mayer, *supra* note 25, at 91-99.

205. H.R. REP. NO. 595, *supra* note 41, at 411, *reprinted in* 1978 U.S.C.C.A.N. at 6367.

206. 200 F.2d 627 (8th Cir. 1953).

One should also remember that, even if a dominant creditor has bought all or substantially all of the impaired claims, a blocking strategy *could* have been accomplished by merely purchasing thirty-four percent of the impaired claims.[207] In other words, a secured party could discriminate among general creditors, paying a premium only to the point necessary to establish its veto; the rest of the general creditors could be ignored. Any court approving the purchase of claims to block confirmation should be aware that a broad holding to this effect is potentially anti-majoritarian, discriminatory, and undemocratic.[208]

VII. CONCLUSION: SHOULD SEPARATE CLASSIFICATION BE ALLOWED?

In this Article, I have taken the position that, in cases involving a dominant secured creditor, separate classification should be allowed. The dominant secured creditor should not have an absolute veto over the plan when differently situated creditors are in favor of it. The following reasons can be asserted in favor of liberal classification and against the veto.

To start with, the two prevailing interpretations of section 1122 both sustain separate classification. According to one of these interpretations, any practical difference between unsecured creditors can justify separate classification. On this view, it must be said that the practical concerns of the dominant secured creditor and the trade creditors (or other comparatively minor unsecured creditors) diverge radically. This is especially so because the Supreme Court in *Norwest Bank Worthington v. Ahlers*[209] hinted that the dominant secured creditor can vote the unsecured claim in aid of the secured claim. If this conflict of interest is allowed, it must be conceded that the interests of the dominant creditor in its unsecured phase and the other general creditors can be highly diverse.

Under the competing interpretation of section 1122, separate classifications can be justified only if an unsecured creditor has a different legal priority than the other general creditors. Even under this more rigorous rule, separate classification can be justified because the dominant secured creditor's unsecured claim is subject to unique rights. First, when the undersecured creditor relies on artificial recourse under section 1111(b)(1)(A), the trade creditors have a higher priority by virtue of section

207. *See supra* note 165 and accompanying text.

208. One further limitation recently imposed is that any buyout of happy trade creditors must occur before the trade creditors have actually voted. In *In re* Kellogg Square Partnership, No. 3-92-5211, 1993 WL 434051 (Bankr. D. Minn. Oct. 22, 1993), Judge Gregory Kishel ruled that a dominant undersecured creditors buying trade claims could not change the vote from yes to no once the vote had been cast.

209. 485 U.S. 197 (1988) (White, J.).

1129(a)(7). Second, as Judge Queenan emphasized in *In re Bjolmes Realty Trust*,[210] the unsecured claim can make the section 1111(b)(2) election. Third, the unsecured claim is entitled to (and routinely gets) postpetition proceeds as collateral and any other appreciation value that might accrue. In other words, especially in a real estate case, the unsecured deficit claim is always potentially a secured claim, whenever appreciation value is conceivable.

Therefore, under either interpretation of section 1122, separate classification can be strongly justified.[211]

Meanwhile, the case against separate classification, asserted by Judge Jones and quite dutifully repeated by a legion of courts since then, is that separate classification of the unsecured deficit claim is "gerrymandering." But this is mere name calling. Gerrymandering is simply a classification where no significant difference exists between the classes—where the debtor-in-possession wants only to subvert the harsh rule of section 1129(a)(10). Yet, as has just been argued, practical and legal differences usually exist between the unsecured deficit claim of the dominant creditor and the unsecured claims of ordinary creditors. When these differences exist—and when one class of impaired creditors votes yes on the plan—then it is fair to say that the requirements of section 1129(a)(10) have been met.[212]

The assertion that the dominant secured creditor deserves a veto appears to be unpersuasive, as a policy matter. The dominant creditor would like to use a veto through its unsecured deficit claim, thereby overriding the will of lesser creditors, but unsecured creditors are supposed to be equal in bankruptcy. Granting a veto to the unsecured creditor makes the dominant creditor better than equal, contrary to the *esprit* of the Bankruptcy Code.

The issue of the veto raises, of course, the purpose of bankruptcy. There is substantial opinion that the bankruptcy courts should not traffic in single-asset cases. But the following point can be made about these single-

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210. 134 B.R. 1000, 1004 (Bankr. D. Mass. 1991) (Queenan, J.).

211. Peter Meltzer, who prefers a dominant creditor veto, disfavors the "flexible" view and favors the view that only difference in legal priority justifies separate classification: "There are simply too many instances where a creditor's vote on a given plan may be affected by a whole range of considerations which are completely unrelated to that creditor's proposed treatment as the member of a given class." Meltzer, *supra* note 114, at 300. This view overlooks the point that, even under a more stringent "priority" view, the unsecured claim is inherently different from other unsecured claims, because of the higher priority for trade creditors implied by § 723, the § 1111(b)(2) election, and the prospect of accumulating cash collateral as time passes.

212. Linda J. Rusch, *Gerrymandering the Classification Issue in Chapter 11 Reorganizations*, 63 U. COLO. L. REV. 163, 200-01 ("In fact, giving the dissident creditor the classification club would work against two primary Code purposes—debtor relief and a preference for feasible reorganizations . . . .").

asset cases featuring one dominant creditor: dominant isn't the same as unitary. Other creditors do exist, even if their claims are minor compared to that of the dominant creditor. Furthermore, even if these claims do not exist, they could easily exist if an insolvent debtor treated all creditor claims as equal. In such a case, creditor equality will mean that every creditor suffers a shortfall. If only the dominant secured creditor remains unpaid, it is because the debtor has preferentially diverted assets to pay the minor creditors.[213] In other words, every "single-creditor" case is implicitly a multiple-creditor case. The idea of single-creditor cases is therefore misleading.

Even if courts strike down separate classification of trade creditors, a debtor willing to engage in advanced bankruptcy planning can easily evade the rule of section 1129(a)(10). For example, if the debtor buys some equipment on a purchase-money security interest, the newly created secured party is clearly entitled to separate classification. If such a creditor is cooperative, the debtor will have produced a yes-voting one-member class.[214] The same might be true of some local taxing authority with a property tax lien, where the local authority is anxious to keep the firm going. There are literally infinite possibilities for evading section 1129(a)(10), if a debtor can plan for chapter 11 in advance.[215]

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213. *See* Robert K. Lifton, *Real Estate in Trouble: Lenders' Remedies Need an Overhaul*, 31 BUS. LAW. 1927, 1988 (1976).

214. Rusch, *supra* note 212, at 203. Of course, a judge may strike down such a set-up as an abuse of process. *See* Willows Convalescent Ctrs. Ltd. Partnership v. UNUM Life Ins. Co. (*In re* Willows Convalescent Ctrs. Ltd. Partnership), 151 B.R. 220, 223 (D. Minn. 1991) (Alsop, J.) (yes vote of small secured creditor class struck down as sham impairment). But this possibility should not render the Bankruptcy Code immune from criticism. Indeed, if we can always rely on the intuition of judges to correct all faults, there would be no need for the Bankruptcy Code in the first place.

215. One idea that will not work is to impair an administrative creditor or postpetition lender. According to § 1126(a), only creditors with claims under § 502 can vote. Since administrative creditors and postpetition lenders do not have claims under § 502—their claims are allowed under § 503(b) or § 364—they are disenfranchised. *In re* Kliegl Bros. Univ. Elec. Stage Lighting Co., 149 B.R. 306 (Bankr. E.D.N.Y. 1992). *But see In re* Century Inv. Fund VIII Ltd. Partnership, 114 B.R. 1003 (Bankr. E.D. Wis. 1990) (McGarrity, J.). In *Century Investment*, the debtor presented a plan in which one of the classes consisted of postpetition lenders who proposed to advance funds if the plan were confirmed. The court hinted that such a classification was legitimate and that, if the class voted yes, § 1129(a)(10) would be met. Yet, § 1129(a)(10) requires that an *impaired* class of creditors vote yes on the plan. How could an entity that had not yet even advanced funds be viewed as "impaired" by the plan? Impairment presupposes some preexisting loan agreement, and the plan cuts back on these contractual rights. In addition, § 1126(a) implies that only claims allowed under § 502 can vote; yet postpetition lending claims are allowed under § 503. *Cf. In re* Atlanta W. VI, 91 B.R. 620 (Bankr. N.D. Ga. 1988) (Cotton, J.) (postpetition lender already had a prepetition unsecured impaired

Yet it must be admitted that the argument to the contrary is not without force. Traditionally, the purposes of bankruptcy are (1) to give debtors a fresh start, and (2) to maximize collections from the debtor's estate. In single-asset real estate cases, the argument for the fresh start of the debtor is somewhat weakened. If bankruptcy refuses to intervene in these cases, state-law foreclosure is readily capable of at least saving the jobs of the custodian and the rental agent. Any buyer of the property is likely to retain the old personnel if they have been doing a good job. The general partners are usually cold-hearted, sophisticated investors who knowingly took risks they are well able to bear. The limited partners are usually dentists on the lookout for tax shelters. These dubious characters are not compelling candidates for bankruptcy's fresh start.

Nevertheless, the premise of chapter 11 is that all creditors are at least as well off in chapter 11 as in chapter 7. If one has confidence in the ability of a court to do valuations, then this "best interest of the creditors" test is always capable of papering over objections to the use of chapter 11 in lieu of some other mode of liquidation.[216] Thus, in *Toibb v. Radloff*,[217] the Supreme Court held that, under the literal language of the Bankruptcy Code, a consumer could file a chapter 11 plan.[218] When the objection was raised that consumers under chapter 11 could keep their postpetition wages when chapter 13 debtors could not, Justice Blackmun dismissed the objection by reminding us that creditors are at least as well off in chapter 11 as in liquidation.[219]

Similarly, we need not worry too much about using chapter 11 in single-asset cases because the premise of chapter 11 is that the creditors must be at least as well off there as in liquidation. For example, precisely this observation was used to excuse the classification peculiarities in *Seidel v. Palisades-on-the-Desplaines (In re Palisades-on-the-Desplaines)*,[220] a leading pre-Code case. Furthermore, single-asset cases are singularly hard to cram down over the opposition of the dominant secured creditor when the security interest encumbers the income stream of the debtor.

In valuing the asset of the debtor, the net cash flow of the asset should just precisely equal the cram-down interest rate necessary to render any

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claim).

216. *In re* ZRM-Okla. Partnership, 156 B.R. 67, 71 (Bankr. W.D. Okla. 1993) (Bohanon, J.).

217. 111 S. Ct. 2197 (1991) (Blackmun, J.).

218. *Id.* at 2199.

219. *Id.* at 2201. Furthermore, if liquidation sales preserve going concern value, then § 1129(a)(7) is hard to meet, and the chapter 11 proceeding therefore must collapse. Salvatore G. Gangemi & Stephen Bordanaro, *The New Value Exception: Square Peg in a Round Hole*, 1 AM. BANKR. INST. L. REV. 173, 192-93 (1993).

220. 89 F.2d 214, 218 (7th Cir. 1937) (Sparks, J.).

cram-down debt instruments equal to the present value of the collateral. In such a case, the confirmability of the chapter 11 plan must depend on substantial new value contributions of the old equity participants, or on irrational expectations that the real estate market will turn around in the future.[221] If a bankruptcy judge values the asset correctly, cram down will be rare and entirely beneficial to all concerned. According to Professor Linda Rusch, liberal classification "allows a dispassionate third party, the bankruptcy judge, to decide whether the reorganization fulfills the Code's requirements and purposes."[222] Meanwhile, "[t]he undersecured creditor . . . does not need the additional protection of the classification club to protect its legitimate interests unless one is willing to state that bankruptcy judges are not performing their statutory duty to make the judgments required under section 1129."[223]

On the other hand, this must be said against cram downs of single-asset real estate cases: Often, a liquidation means that the partners of the debtor must realize income on their personal taxes, whereas, if a cram down can be achieved, this income can be deferred;[224] therefore, it appears that John Q. Public is footing the bill through what amounts to a tax subsidy. This seems particularly unfair, especially in light of the subsidy already paid to savings-and-loans in the 1980s through government insurance. Thanks to relaxed regulation coupled with deposit insurance, the taxpayers provided cheap loans for ill-considered real estate deals. Should they pay again by subsidizing the new value contributions of the old equity participants in a cram down of a single-asset case?

This tax angle is a serious concern, but it must be pointed out that tax breaks routinely fuel chapter 11 proceedings. Often loss carry forwards are the only asset a firm has; if a merger can be arranged, the new entity can use the loss carry forwards as deductions against income. This and many other tax practices are apparently condoned by the Bankruptcy Code. Therefore, it is hard to argue that a tax subsidy should uniquely influence bankruptcy policy in single-asset cases.

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221. These expectations are irrational because a good valuation of the asset should already include all expectations of future upside potential. If a court confirms a plan on the theory that the real estate market may some day turn around, the court is basically admitting that its valuation of the asset is no good.

222. Rusch, *supra* note 212, at 165.

223. *Id.* at 199.

224. *See generally* Albert J. Cardinali & David C. Miller, *Tax Aspects of Non-Corporate Single Asset Bankruptcies and Workouts*, 1 AM. BANKR. INST. L. REV. 87 (1993). I would like to thank Professor Jack Williams of the Georgia State University School of Law for emphasizing the tax angle in single-asset cases.