

## Separate Classification Gone Too Far

*Law360, New York (July 21, 2014, 10:20 AM ET) --*

In a ruling that should be well received in the secured lending community, the U.S. District Court for the Eastern District of North Carolina in *CWCapital Asset Management LLC v. Burcam Capital II LLC*, (June 24, 2014), reversed a bankruptcy court's order confirming a Chapter 11 plan on the basis that the debtor engaged in "blatant gerrymandering" in order to obtain an impaired accepting class required for confirmation.

### Background

Burcam Capital II LLC owned a large commercial real estate development in Raleigh, North Carolina. After a series of assignments, CWCapital Asset Management, as trustee (CWC), became the holder of two promissory notes secured by deeds of trust on Burcam's property. As of the petition date, Burcam owed CWC between \$12.12 million and \$15.13 million<sup>[1]</sup> and owed approximately 30 unsecured trade creditors a total of less than \$46,000. The property securing CWC's claim was valued at approximately \$18 million.

Burcam filed a plan of reorganization in which it proposed to pay its creditors in full. The plan provided for treatment of the debtor's unsecured creditors in two classes: (1) class 5 consisted of allowed general unsecured claims to be paid in quarterly installments of \$5,000.00, commencing three months after the effective date, with interest at the federal judgment rate on confirmation, and (2) class 6 was a convenience class consisting of allowed small unsecured claims to be paid in full in 120 days after the effective date. Both unsecured classes were "impaired."

In an effort to block confirmation, CWC purchased a majority of the unsecured claims in classes 5 and 6 and voted all of them to reject the plan. After the votes had been tallied — and recognizing that it would not be able to confirm the plan with no impaired accepting class — Burcam modified the plan to create a new separate class of allowed unsecured claims that consisted of solely the CWC-purchased claims, which claims would be paid out over a longer period of time than the other two unsecured classes.

CWC objected to confirmation asserting, among other arguments, that Burcam's separate classification of the claims that CWC purchased was done for the sole purpose of manipulating the vote to confirm



Scott M. Grossman

the plan and, thus, constituted “gerrymandering” in violation of 11 U.S.C. § 1122. Burcam, on the other hand, claimed that the separate classification was proper under Fourth Circuit precedent because it was done for a “legitimate business purpose” — in order to maintain its ongoing business relationships with trade creditors in classes 5 and 6.

### **The Bankruptcy Court’s Decision**

In a published decision, the bankruptcy court held that Burcam could separately classify the claims purchased by CWC because Burcam had articulated a legitimate business reason for doing so<sup>[2]</sup> — Burcam’s desire to maintain strong professional relationships and foster future business with those creditors. Burcam argued, and the bankruptcy court accepted, that the same rationale did not apply to the claims acquired by CWC and that, in any event, the treatment afforded to the purchased claims is typical of treatment given to a secured creditor.

The bankruptcy court noted that “the impetus to pay an off-duty police officer’s claim quickly is no longer a driving force once an institutional creditor such as [CWC] purchases the claim. Therefore, the desire to pay the unsecured claims not purchased by [CWC] more quickly is a legitimate business purpose.” The bankruptcy court confirmed Burcam’s plan and CWC appealed.

### **The District Court’s Decision on Appeal**

The question presented on appeal was whether Burcam’s separate classification of CWC’s purchased claims was permissible under applicable Fourth Circuit law. The district court acknowledged that in certain circumstances, paying trade claims on terms different from otherwise-similar unsecured claims may be a legitimate business justification for separate classification of those claims and is not proscribed by Section 1122(a) or the relevant case law, but that this case was not one of those circumstances.

The district court began its analysis by determining that a finding of legitimate business justification is a factual finding that is subject to review for “clear error.” That standard is highly deferential to the bankruptcy court’s findings of fact, such that a finding can only be “clearly erroneous” when the reviewing court is near certain that a mistake has been made.

With that backdrop, the district court shifted its focus to the facts supporting the bankruptcy court’s determination — facts that the district court determined simply could not support the bankruptcy court’s findings and conclusions. Chief among those facts was that Burcam initially placed the unsecured claims into two classes (a convenience class and a class for all other unsecured creditors). It was only after CWC purchased a majority of the unsecured claims and voted them to reject the plan that it became evident that Burcam would not be able to confirm its plan. Thus, Burcam modified the plan to place all of the CWC-purchased claims into a new separate class.

The district court found Burcam’s segregation of the “no-votes” shortly after tabulating the plan ballots to be substantial evidence of voting manipulation that the bankruptcy court failed to take into account.

The district court also determined that the bankruptcy court’s legitimate business justification finding was not supported by the record. Specifically, the district court noted that the only evidence supporting Burcam’s purported justification for separate classification was the self-serving testimony of its counsel (by proffer) that the debtor desired to pay trade creditors first, and similar testimony from Burcam’s principal, who admitted to having almost no firsthand involvement with the trade creditors.

Further, Burcam offered no testimony from any of its trade creditors. The bankruptcy court also failed to consider that only two of the non-CWC-purchased claims (both of which were held by insiders) voted on the plan and that the remaining claimants — all trade creditors — failed even to submit ballots.

The district court found the trade creditors' silence deafening, which strongly suggested that different treatment of their claims was not necessary to maintain strong business relationships. Burcam's contention that the different treatment was critical to foster future business relationships was also undercut by the facts that the trade creditor claims were dwarfed by the value of the estate and represented less than \$15,000 in total, and that Burcam had close to \$650,000 in cash on hand, more than a sufficient sum to pay its unsecured creditors in full.[3] For all these reasons, the district court found that the bankruptcy court committed clear error in finding that there was a legitimate business justification for the separate classification of otherwise similar claims.

The district court further noted that not only did the bankruptcy court commit clear error in its factual findings, but that its failure to consider evidence of gerrymandering also constituted legal error. The bankruptcy court incorrectly suggested that paying trade creditors more quickly is a per se permissible business justification for separate classification of otherwise similar claims, contrary to Fourth Circuit law. While a plan proponent has considerable discretion to classify claims, it does not have the type of unlimited discretion that the debtor exercised — and that the bankruptcy court permitted — here. As a matter of law, the district court concluded, Burcam's blatant gerrymandering of classes was unlawful.

Finally, the district court also rejected Burcam's argument that separate classification of the trade claims was appropriate based on the identities of the holders of the claims — namely, CWC versus the trade creditors. The court explained that in determining whether claims are "substantially similar," the court is confined to viewing the "legal attributes of the claim, not who holds them." Looking at the claims, and not who holds them, the district court concluded that the CWC-purchased claims and the trade creditor claims were substantially similar under the Bankruptcy Code. On these bases, the district court reversed the order confirming the plan and remanded the matter back to the bankruptcy court for further proceedings.

## **Analysis**

The district court's decision in *Burcam Capital* reinforces bankruptcy law's prohibition on separate classification of otherwise similar claims for the sole purpose of manipulating voting on a plan, and is a sharp rebuke of the bankruptcy court's endorsement of impermissible gerrymandering.

Taken to its extreme, if the separate classification condoned by the bankruptcy court in *Burcam Capital* were permissible, a plan proponent in a single-asset real estate case (and possibly other cases) could simply wait for the votes to be tallied and then, if the plan is not confirmable, amend the plan to reclassify the "no-votes" into a separate class and confirm the plan over objections of the other creditor(s).

Permitting such blatant gerrymandering by plan proponents would threaten the balance of rights given to debtors and creditors under the Bankruptcy Code that are integral to the bankruptcy process, and could result in disenfranchising the largest creditors in bankruptcy cases, contrary to the applicable provisions of the Bankruptcy Code.

While only a district court-level decision, *Burcam Capital* may bolster the arguments of secured creditors in opposing cramdown efforts by debtors who may have been emboldened by other recent decisions

supporting certain creative classification schemes, such as *Western Real Estate Equities LLC v. Village at Camp Bowie I LP* (In re *Village at Camp Bowie I LP*), 710 F.3d 239 (5th Cir. Feb. 26, 2013). In that case, the Fifth Circuit rejected the concept of artificial impairment of classes as a limitation on a class' ability to vote, but held that gerrymandering remained as a defense against voting abuse.

Although the *Burcam Capital* decision is generally favorable for secured lenders, the district court did suggest that on remand, *Burcam* may wish to pursue an argument that CWC's votes rejecting the plan were submitted in bad faith and therefore should be designated under Section 1126 of the Bankruptcy Code.

At bottom, though, *Burcam Capital* reinforces the notion that while the Bankruptcy Code provides debtors with substantial leverage in seeking to restructure its secured debt, that leverage is not unfettered. Where there are legitimate business reasons for separate classification of unsecured claims, separate classification may be permissible. But where the facts of a case clearly demonstrate that the purported business reasons for separate classification are not legitimate — such as post-vote tabulation reclassification of claims — separate classification should not be permitted.

Secured lenders should continue to monitor further legal developments on classification of claims and artificial impairment, and factor in those developments in considering whether and on what terms to extend credit to borrowers or acquire debt positions.

—By Scott M. Grossman and Ari Newman, Greenberg Traurig LLP

*Scott Grossman is a shareholder in Greenberg Traurig's Miami and Fort Lauderdale offices, and Ari Newman is an associate in the firm's Miami office. Both are members of the firm's business reorganization and financial restructuring practice.*

*The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.*

[1] The parties disputed the amount of CWC's claim.

[2] In re *Burcam Capital II*, 2013 WL 593709 (Bankr. E.D.N.C. Feb. 15, 2013).

[3] While the district court did not directly address *Burcam's* apparent artificial impairment of classes 5 and 6, the court's comment that the debtor had sufficient cash on hand to pay the unsecured creditors in full at confirmation and yet elected to impair those creditors instead suggests that it may have denied confirmation on that basis as well. See In re *Swartville LLC*, 2012 WL 3564171 \*5-6 (Bankr. E.D.N.C. 2012) (denying confirmation because only impaired accepting class had been artificially impaired).

[4] See In re *Bryson Properties XVIII*, 961 F.2d 496, 502 (4th Cir. 1992).