

The Pervasive Problem Of Numerosity

Law360, New York (June 02, 2010) -- In the highly strategic world of distressed debt investing, the ability to control a class of debt or hold a blocking position in such class is often critical to the successful implementation of an investment strategy.

Outside of bankruptcy, the ability to control or block a class of debt from supporting a transaction will depend solely on the amount of debt acquired by the distressed investor. Generally, if the investor is able to obtain a majority in amount of the debt, no decision may be made by the class of debt holders without such investor's consent and the investor may make certain decisions and amendments to the documents unilaterally.

At first blush, the standard for obtaining a block or control in a Chapter 11 reorganization proceeding also seems straightforward — a class of creditors is deemed to have voted in favor of a plan of reorganization if two-thirds in amount and more than one-half in number of such creditors votes in favor of the plan. Given the conjunctive, the path to obtaining a blocking position is clear — purchase more than one-third in amount of the claims in such class.

The ability to control the class, however, is less certain because of the “numerosity” requirement. Does the purchaser of multiple claims have one vote for each claim purchased or one vote altogether? Do affiliated purchasers of fungible bank or bond debt (i.e. affiliated funds within a financial institution) each have a vote, or should they be limited collectively to one vote?

The limited published decisions on these issues provide some guidance, but there remain potential pitfalls and ambiguity of which the distressed investor should be aware.

Voting Rights Generally

Pursuant to Section 1129(a) of the Bankruptcy Code, a plan of reorganization cannot be confirmed unless, inter alia, each class of impaired claims has voted to accept the plan. While this seemingly strict rule can be mitigated through implementation of the “cramdown” mechanics of Section 1129(b), it cannot be entirely avoided.

Despite the fact that dissenting creditor classes may be generally silenced if the plan is fair and equitable to their claims, Section 1129(a)(10) of the Bankruptcy Code requires that at least one impaired class affirmatively accept the plan in order for it to be confirmed. This requirement is a critical gating item for proponents of a plan of reorganization. Unless such proponents can rely on at least one impaired class supporting the plan, the proponents cannot be assured that the plan will be approved once the solicited votes are counted.

Section 1126(c) of the Bankruptcy Code provides the relevant standard for achieving acceptance by a creditor class. Section 1126(c) provides that “[a] class of claims has accepted a plan if such plan has been accepted by creditors, other than any entity designated under subsection (e) of this section, that hold at least two-thirds in

amount and more than one-half in number of the allowed claims of such class held by creditors, other than any entity designated under subsection (e) of this section, that have accepted or rejected such plan.” 11 U.S.C. § 1126(c).

For distressed investors, questions regarding whether one creditor may hold multiple claims for voting purposes is a gating inquiry. The limited case law that is available on this topic is clear that, under appropriate circumstances, a single creditor may exercise more than one vote. The key to the analysis lies in the fact that the plain language of 1126(c) states that holders of “more than one-half of allowed claims” must vote to accept a plan. As such, the number of claims, not creditors, is the touchstone.

Thus, for example, in *Figter Ltd. v. Teachers Ins. and Annuity Ass'n of America*, (In re Figter Ltd.), 118 F.3d 635 (9th Cir. 1997), the Ninth Circuit held that a secured creditor who purchased 21 of the 34 unsecured claims that comprised the only impaired class was entitled to vote each of those claims against confirmation of the debtor’s plan. *Id.* at 640.

Similarly, in *In re Gilbert*, 104 B.R. 206 (Bankr. W.D. Mo. 1989), the bankruptcy court held that an unsecured creditor who originally held only one of five unsecured claims was permitted to vote a second claim that he had purchased solely for the purpose of satisfying the numerosity requirement of plan confirmation. *Id.* at 211. Establishing the broad rule that a single creditor has the right, in certain circumstances, to vote multiple claims is only the first step in the analysis, however. Defining the parameters of this right is a task of significantly greater difficulty.

The “Separateness” Test

Whether a single creditor may vote more than one claim will depend on whether the claims held by such creditor are sufficiently “separate” to warrant more than one vote. While the separate nature of claims is a factual inquiry, courts often consider two key indicators: (1) whether the claims in question derive from independent underlying transactions with the debtor, and (2) whether separate proofs of claim were (or will be) filed for the claims. In *re Gilbert*, 104 B.R. at 211.

Satisfying the first indicator is relatively simple when the claims being compared are trade claims or lease/contract rejection claims. These categories of claims are often highly distinguishable, as one can generally point to an independent contract or other governing document giving rise to each of the claims.

However, with respect to banks debt and/or bond claims, there is typically no ability to differentiate among the numerous claims held by such class. Unless there is some unique characteristic that separates these claims on their face (e.g., a claim arising from initial draw vs. an incremental draw to a bank loan; a swap/hedge transaction vs. a term loan claim governed by the same bank facility), any assertion that the claims arise from independent underlying transactions may be untenable.

By contrast, the second indicator referenced above in *Gilbert* should typically be able to be satisfied with respect to bank and bond debt. Pursuant to Section 501 of the Bankruptcy Code, “a creditor or indenture trustee may file a proof of claim.” The Bankruptcy Code defines a “creditor” to mean an “entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor,” and further defines a claim as “a right to payment.”

Thus, each creditor of the debtor is entitled to file a proof of claim, even if the result is that multiple claims will be filed which all relate to the same underlying transaction (e.g., a bank loan). Accordingly, it is the norm for each lender and each bondholder to vote for or against the plan of reorganization, even if for administrative convenience a master ballot[1] structure is used in the solicitation process.[2]

With these general standards in mind, we turn next to the application to some more complicated fact patterns.

Practical Applications

Case law analyzing the voting of multiple claims by single creditors is sparse — as such, it is difficult to eliminate all risk in connection with an investment strategy aimed at obtaining control for bankruptcy purposes of a certain class of creditors. However, there are certain actions that can be taken by creditors, particularly in the prepetition period, to increase the likelihood that a court will view its bond or bank debt claims as separate:

Plan Ahead

While tax issues often govern how investors hold bank and bond debt, consideration should be given to structuring debt portfolios in a manner that maximizes voting power in the event that the borrower ultimately files for bankruptcy. As discussed above, the touchstone is the claim itself, and not who holds it. However, separation of the identity of the holders can be a useful fact in attempting to prove that the claims are separate, particularly when the debt was purchased in the primary market.

For example, in *In re Kreider*, 2006 Bankr. LEXIS 2948 at *8 (Bankr. E.D. Pa., Sept. 27, 2006), a particular creditor class consisted of four seemingly related American Express funds, as well as five completely unrelated entities. The five unrelated entities voted in favor of the plan, while the four American Express funds voted to reject. The debtors filed a voting report which grouped the American Express entities as having one aggregate vote to reject. The Judge attacked the debtors' voting report as "inaccurate," stating that the votes of the four American Express entities should be counted separately:

"[I]t is hardly clear that the four votes against the plan emanated from one creditor. The creditors were American Express Travel Related Services Company, American Express Bank, FSB and American Express Centurion Bank (voting two claims). While the identities of the creditors suggest that they are related entities, I have no basis in the record to conclude that they are 'the same party.' In fact, on their face, the ballots suggest the contrary." *Id.*

While not dispositive, the ruling in *Kreider* appears to indicate that providing loans to a debtor through multiple affiliated entities enhances the likelihood that such group will be entitled to vote multiple claims in a bankruptcy of the debtor.

See also Kenneth N. Klee and Matthew C. Heyn, *Disclosure Statements, Solicitation and Lock-Up Agreements: The Shifting Dynamics of Plan Voting*, ALI-ABA Course Study Materials, March 2007 ("[W]here affiliated entities loaned money to or make investments in a debtor prepetition, there would appear to be no reason to collapse their claims into a single claim.").

Purchase Claims where a Proof of Claim has Already Been Filed

If purchasing claims in the post-petition period to increase voting power, it is helpful, if possible, to purchase such claims after your seller has filed a proof of claim. As discussed above, courts place weight on whether a separate proof of claim was filed in evaluating the separateness of claims.

While it is theoretically possible for a single creditor to acquire two claims related to the same issuance of bonds or bank debt prior to the bar date and argue that the claims are still separate (i.e. had it not purchased the second piece of debt, each creditor would have filed a separate proof of claim), this argument will be an uphill battle.

By contrast, it is much more persuasive, from an evidentiary perspective, to be able to present two proofs of claim to the court as support for an argument that the claims should be separated.

Post-Purchase Gerrymandering is Not Permissible

Dividing what would otherwise be one claim into multiple claims solely for voting purposes will likely face challenge and be rejected. While no court has expressly ruled that such actions are impermissible, the Ninth Circuit stated in dicta in *Figter* that “of course, that is not to say that a creditor can get away with splitting one claim into many, but that is not what happened here.”

In re *Figter*, 118 F.3d at 641; see also Kenneth N. Klee and Matthew C. Heyn, *Disclosure Statements, Solicitation and Lock-Up Agreements: The Shifting Dynamics of Plan Voting*, ALI-ABA Course Study Materials, March 2007 (stating that “it is clear that a holder of a claim must be prohibited from selling parts of its claim to multiple entities with which it is affiliated for the sole purpose of enhancing its voting rights”).

Thus, while it may be tempting to consider splitting a large piece of debt into multiple pieces and distributing such pieces to affiliates or subsidiaries, such actions will not likely result in the intended outcome.

Secondary Market Affiliated Purchasers^[3]

Perhaps the most often raised and difficult question for a secondary market purchaser of distressed debt is whether the purchase by multiple affiliated funds of bank or bond debt in one transaction should allow such affiliates to each cast a vote or whether the affiliates will be consolidated into one vote. To answer this question, one must analyze whether the facts and circumstances are closer to those of *Kreider* or the dicta referenced in *Figter*.

While there appears to be no reported decision on this precise question, we would recommend the following factors be considered in assessing the issue. First, is the purchase an arms-length transaction? A “sale” by one affiliate to several others would likely implicate the *Figter* decision.

Second, when was the purchase implemented? The earlier in the restructuring process that the purchase was implemented, the less likely it will be that a claim for gerrymandering will be successful. In contrast, the purchase through multiple affiliated funds of bonds by an existing bondholder on the eve of the voting deadline would certainly raise a red flag.

Finally, is the coordinated purchase by affiliated funds a typical investing structure for the purchaser? If the purchaser typically allocates similar investments among its affiliates, that will be a helpful fact in avoiding claims of gerrymandering.

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[1] A master ballot is often used in connection with classes of bond debt. The indenture trustee collects the votes of the bondholders and then reflects such votes in a master ballot to be submitted by the indenture trustee which provides the total votes by amount and claim holder.

[2] The recent wave of real estate related bankruptcies provide additional factual complexities, however, which are not addressed by this article. In recent cases involving large multitiered CMBS loans, e.g. General Growth Properties, debtors have taken the position that only the special servicer has the authority to vote on the plan of reorganization, and individual beneficial holders of mortgage certificates are not entitled to vote.

[3] When purchasing claims in the secondary market, distressed investors should additionally be wary of Section 1126(e) of the Bankruptcy Code, which provides that a court may designate (disqualify) the vote of an entity whose acceptance or rejection of a plan was not made in "good faith." 11 U.S.C. § 1126(e). Courts have generally found that purchasing claims with the purpose of blocking confirmation does not, by itself, constitute bad faith. See *In re Marin Town Center*, 142 B.R. 374, 379 (N.D. Cal. 1992). However, purchasing claims for purposes other than maximizing one's distribution as a creditor, including, for example, assuming control of a strategic competitor or putting a debtor out of business for strategic or malicious purposes will generally be found to lack "good faith" under 1126(e). See *In re DBSD North America Inc.*, 421 B.R. 133, 139 (Bankr. SDNY 2009).